The European Rescue of the European Union?

The existential crisis of the European political project

Edoardo Chiti, Agustín José Menéndez and Pedro Gustavo Teixeira (eds)

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Cover picture: ‘The Uprising’, Honoré Daumier, 1848 or later. The Phillips Collection, Washington D.C.

Preface

Reconstituting Democracy in Europe (RECON) is an Integrated Project supported by the European Commission's Sixth Framework Programme for Research, Priority 7 'Citizens and Governance in a Knowledge-based Society'. The five-year project has 21 partners in 13 European countries and New Zealand, and is coordinated by ARENA – Centre for European Studies at the University of Oslo.

RECON takes heed of the challenges to democracy in Europe. It seeks to clarify whether democracy is possible under conditions of pluralism, diversity and complex multilevel governance. See more on the project at www.reconproject.eu.

The present report is part of RECON's work package 7 'The Political Economy of the European Union', which analyses the relationship between public finance and democracy in the EU's multilevel political system. The report contains the proceedings of the RECON workshop 'The European Rescue of the European Union: The Socio-Economic Malaise of Integration', which was held in León on 9-10 September 2011.

Erik Oddvar Eriksen
RECON Scientific Coordinator

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Edoardo Chiti
Agustín José Menéndez
Pedro Gustavo Teixeira

León, December 2011

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Chapter 1

A European Union *allo sbando*?

Agustín José Menéndez
University of Léon

The RECON project (Reconstituting Democracy in Europe) has articulated three different conceptions of the purpose and point of European integration in *polity* terms. At the same time, RECON's work package 7 on 'The political economy of the European Union' (WP 7) has added a second dimension by means of analysing the conceptions of distributive justice that different visions of European integration gravitate towards.

A previous report emanating from this project (Letelier and Menéndez 2009) explored the analytical, axiological and policy implications of this bi-dimensional understanding of the socio-economic constitution of the European Union (EU) by means of contrasting two of the main pillars of the European socio-economic constitution: the four economic freedoms that constitute the *common market*, on the one hand, and the *fiscal and monetary* constitutional principles on which the asymmetric European Monetary Union has been built since 1999 on the other. This arrangement is asymmetric in the sense that it combines *federal and technocratic* monetary policy with formally *national and political* fiscal and wage policy. This unprecedented coupling has been matched by a series of governance arrangements, which were supposed to ensure the coherence of monetary and fiscal policy.

While the key elements of the previous as well as the present report were decided six years ago, when the application for the RECON project was written, the issues could not have been more topical at the time of holding the two workshops leading up to these reports,[1] and in particular at the time of publication of the present report. While the 2008 workshop was held only days after the fall of the Lehman Brothers, the 2011 workshop may well have been held only weeks before a dramatic transformation of the European Union, whether in a disintegrative sense (if the monetary union were to collapse, or if its rescue were to result in a mutation of the Union) or in an integrative sense (if responding to the crisis of the monetary union were to result in a democratising impulse). The jury is still out at the time of writing this introduction.

The socio-economic malaise of European integration

The present report contains the contributions to the second WP 7 RECON workshop 'The European rescue of the European Union: The socio-economic malaise of integration', which was held in September 2011. The first panel questioned the shape and place of the *internal market* within the EU's socio-economic constitution. Instead of taking the conception as granted and necessarily requiring the kind of socio-economic arrangements underpinning the present understanding of the four economic freedoms as part of the creation of a stateless market, WP 7 has shown that not only is there a plurality of understandings of what the internal market means (a common market, a single market, a transnational market), but Union law has also reflected different understandings over time (Letelier and Menéndez 2009). Indeed, the specific characterization of the internal market depends on the specific understanding and shape of the key principles on which the market is grounded, namely the four economic freedoms (plus the principle of undistorted competition). In particular, there is a sea of difference between the common-market approach (followed from the beginnings to the late 1970s) and the single-market approach (followed from the early 1980s). There is thus

[1] RECON workshop 'The sinews of peace: Democratising the political economy of the European Union', 19-20 September 2008 and RECON workshop 'The European rescue of the European Union: The socio-economic malaise of integration', 9-10 September 2011, both organised at the University of León.

no *one single* right conception of what the single market is or what the four economic freedoms entail, but many. The *internal market* project constitutes an essentially contested terrain, which is open to be shaped and defined by different conceptions of European integration, and may thus be duly influenced not only by different polity views, but also by different conceptions of distributive justice.

A key problem which has been identified within WP 7 is the lack of *historical depth* in analysis, assessments and policy proposals on the socio-economic constitution of the European Union. Regardless of the underlying position taken by lawyers and political scientists, the tendency is to see integration unfolding in a given and pre-established direction. As a result, the socio-economic context in which the key principles of the European economic constitution have evolved, as have the key decisions and non-decisions shaping the current institutional structures and decision-making processes, is lost. In this context, the contribution by Hagen Schulz-Forberg is particularly valuable and was selected to open the workshop. In Chapter 2, he expands on his recently published and co-authored history of European integration with Bo Stråth, which combines a plea for a non-Whig historiography of the Union, capable of detaching itself from the teleological reading of a 'happy' European constitution, and an actual alternative history of European integration (Schulz-Forberg and Stråth 2010). According to the latter, a fundamental paradigmatic shift took place in the early 1970s. The drive towards a political union articulated through the means of a Keynesian fiscal and monetary union was disrupted by the economic turbulence resulting from the fall of Bretton Woods and the two oil crises and mutated into the neo-liberal project of an asymmetric monetary Union. The ensuing workshop debate revealed that *getting the history wrong* or sometimes *simply ignoring history* might in fact be one of the reasons why the EU finds itself in its present troubles. Such claims have also been advanced by other historians closely interested in European integration, such as Mark Gilbert (2012).

Outline of the report

Christian Joerges in Chapter 3 offers a renovated defence of the relevance of the third RECON model of post-national democracy by means of providing a critical reconstruction of the case law of the European Court of Justice (ECJ) on economic freedoms from the perspective of conflicts of law as the constitutional theory of

Community law (Joerges 2011; Joerges and Ralli 2011). Joerges tests the main premises of the constitutional theory of conflicts with reference to the insights of Karl Polanyi's anthropological analysis of the key tenets of the socio-economic constitution of capitalist societies. In particular, he applies Polanyi's theory about the three false commodities (labour, land and money) to selected cases of the ECJ, which leads him to make another plea for constitutional modesty and the recalibration of the jurisprudence of the ECJ.

Agustín José Menéndez in Chapter 4 states that the case law of the ECJ on the four economic freedoms constitutes the yardstick of European constitutionality. Having said that, Menendez claims that while the ECJ should play a central role in the guardianship of European constitutionality, it should do that in a way compatible with the fact that the legitimacy credentials of the Luxembourg judges are defined by the peculiar *synthetic* nature of European constitutional law. Consequently, European judges should take the *pluralistic* character of Community law seriously. They should also pay attention to the fact that their guardianship of European constitutionality is shared with national courts. The structural case for the ECJ acting as a European constitutional court does not, however, tell us much about how the ECJ discharges its task. Menéndez claims that the widely held assumption that the principle of proportionality has a legitimising effect should be abandoned. Based on a proper legal-theoretical reconstruction of the ECJ's case law, he argues that proportionality could rather be used as a device to render explicit the *substantive choices* made by the ECJ when confronted with constitutional conflicts between economic freedoms and fundamental rights, and thus open such choices to criticism and contestation; critically, to *political* criticism and contestation. This leads Menéndez to a plea for constitutional modesty by the Luxembourg judges, and a recalibration of their case law on economic freedoms, abandoning the maximalistic understanding of 'obstacles' to the four economic freedoms.

In Chapter 5, Jeremy Leaman deals with the economic and political consequences of understanding the single market as resulting from the *obstacles* turn in the thinking of the European Commission and the ECJ in the late 1970s, and partially consecrated in the Single European Act of 1986. Leaman documents the dramatic economic transformation of the taxing systems of the European Union, which to a large extent proceeded in the absence of concomitant explicit decisions. Such shifts are not only of relevance in understanding the socio-economic malaise of the Union, but essential to explore the causes of the present EU crisis. As Leaman states, not only "the distributional shifts represented […] are unprecedented in modern times; they help to illustrate the extent of the neo-liberal calamity that has befallen the global economy, notably the relative reduction in disposable household income which could 'at best' be compensated by the encouragement of private borrowing". The elephantiasis of the financial sector, one of the core roots of the present structural crisis, was fed by tax policy in two simultaneous ways: By means of increasing the share of capital income, and thus fuelling the demand of financial products in a context of declining profits of the non-financial sector; and by means of pushing dependent workers into debt to compensate for diminishing income. The tax debacle was further compounded by the specific way in which the integration of Eastern economies into the European economy was governed, both before and after formal enlargement. The "demonisation of the state in neo-liberal thinking" which gained ground in the old EU was peddled in full strength to Eastern Europe. Structurally similar to the dynamics within the asymmetric monetary Union, clear structural pressures combined to push Eastern European countries into a strategy of radically lowering taxes in the hope of eliciting capital investment which could compensate for their inferior position vis-à-vis the old EU-15. But instead of a catching-up outcome, the actual result was a chronic dependence on capital imports, which were determinant of the extreme structural weakness of many of the new states when the financial crisis hit the European shores in 2007 (and severely since 2008). Leaman rightly reminds us that the Union has, despite its present policy, the size and resources needed to decisively influence the structural conditions underlying the member states' tax systems. The pledge of the Union and the G20 to tackle tax evasion at its roots (tax havens) may have been intended more as window-dressing than as a serious policy pledge (as the UK-Switzerland bilateral agreement proves), but the fact that the issue has been put on the agenda is in itself interesting. While no positive signs are coming from the national political processes, the Union *could* still make a serious difference here. The Commission's proposal to extend the automatic exchange of tax data among member states and the review of the European constitutionality of the UK-Switzerland agreement indicate that the fiscal crisis of the member states has created the conditions where they are more likely to take serious action to rescue the tax base of the European social and democratic *Rechtsstaat*.

Michelle Everson and Frank Rodrigues in Chapter 6 deal with the *medium of social integration* through which monetary policy is conducted in Europe, and in particular with the emergence of comitology arrangements in the System of European Central Banks. Combining a reflection of the empirical evolution of these institutional arrangements with the constitutional reflection on what kind of coupling of efficiency and democratic legitimacy they stand for, they offer a plausible yet disturbing key to understanding the constitutional self-understanding of the ECB, pointing to the limits of the governance paradigm itself.

In his second chapter in the report, Jeremy Leaman offers a cogent challenge to the authority of the European Central Bank, to what could perhaps be labelled as the emerging 'myth' of the 'masterful' way in which Frankfurt has come to discharge its tasks – a myth which has become an article of faith for the political elites, and which is but the successor of the previous Bundesbank, forged in the 1970s, the origins of which were elucidated by Leaman in his previous work. Leaman claims that not only the characterisation of 'price stability' as two per cent inflation is open to contestation, but also that this has distracted us from a key destabilising development, the growth of money through private credit creation, a core cause of the pledge in which Europe finds itself at the moment. The 'privatisation' of the creation of money through the money market and the shadow banks was not a core concern of the ECB for years, indeed, the ECB renounced, as Leaman documents, to keep growth in track, and thus abandoned any hope of keeping the growth of fictitious capital in check.[2] The ECB's decisions since August 2007, reaffirming public power and substituting itself for the interbank market, reveal the contradiction between a socio-economic settlement which transfers fundamental powers to private actors, which undermine the revenue basis of the state (essentially its taxing capacities), but keeps the role of the state as a lender and insurer of last resort. According to

[2] It was only in late 2005 and 2006 that the ECB started to be concerned with what it labelled inadequate risk pricing.

Leaman, any reform of the model of European fiscal constitution would need to take this contradiction into account.

David G. Mayes in Chapter 8 offers a reconstruction and assessment of the present financial crisis very much inspired by the first RECON model of an audit democracy. Contrary to other contributions in this report, Mayes claims that the crisis has not revealed any major structural deficiency of an asymmetric monetary Union, but rather that the conduct of fiscal policy has in some instances been inadequate. Provided a good enough solution is found providing an exit strategy (of the fiscal and economic crisis or of the monetary Union) of Greece and probably also of Ireland and Portugal, it should be possible to restabilise the fiscal constitution of the Union with rather marginal tinkering with its institutional structure and substantive normative discipline.

In Chapter 9, Stefan Collignon, Piero Esposito and Hanna Lierse express a rather different view. On the basis of a republican conception of democratic legitimacy, which fits somehow with the third RECON model, they reiterate Collignon's view that the asymmetric monetary Union was intended as a transitional arrangement, allowing the Union to overcome the 'turbulence' associated with the famous Padoa-Schioppa's inconsistent quartet. The authors argue that the establishment of a European government is required in the long run in order for the monetary union to be legitimate and efficient. In the short run, this could be ensured through issuing Eurobonds and substituting the Growth and Stability Pact by a collective system of debt issuance permits. This does not coincide with the political preferences of the present German government headed by Chancellor Angela Merkel, however, which in the authors' view could have dramatic economic consequences for the Union.

Michel Husson in Chapter 10 analyses the causes of the crisis, which he traces back both to the structural contradictions of 'pure capitalism', the form that capitalism has taken in the last 40 years, and to the design of the asymmetric monetary union, which was consciously and unconsciously inspired by a neoliberal understanding of the socio-economic structure of society. Husson takes issue with the policies implemented since 2007, which have only exacerbated the contradictions of the present European project. Austerity is a short name for the further twisting of the socio-economic order in favour of capital holders. That is, however, not a sufficient reason to call it quits. Leaving the euro zone is far from being a miraculous solution to the *malaise* of peripheral countries. The real radical alternative is a reconstitution of the European Union, one inspired by a strategically sophisticated view of causes and consequences of policy choices. The extent to which public debt represents the direct or indirect shifting of the 'fictitious capital' which has fed the various speculative bubbles justifies a drastic writing off of such debt. The monetary power should be mobilised in favour of the common, not the financial good, while a radical redesign of the tax system should be instrumental in the redefinition of the European socio-economic constitution.

In Chapter 11, Nicola Scotto reconsiders the independence of the ECB. After decades in which independent, if not autistic, central banks were regarded as essential in the proper conduct of policy in modern states, thus leading to the insulation of monetary from fiscal policy, the 2007 crisis has forced central banks to take decisions which seriously challenge both the extent to which fiscal and monetary policy are really separated,[3] and consequently, what remains of the independence of the ECB (and also of the independence of political authorities). Scotto claims that insufficient attention has been paid both to the degree of transparency of ECB decision-making, and to the structures through which the ECB is held accountable. He thus claims that instead of denying facts, it would be far more adequate to focus on the necessary constitutional reforms needed to ensure the proper functioning of the new and different ECB, which is bound to emerge from the crisis.

In the final Chapter 12, Edoardo Chiti, Agustín J. Menéndez and Pedro G. Teixeira offer both an analytical framework to understand the European crisis and a reconstruction of the key constitutional decisions taken by the European Union since August 2007. They claim that the apparent intractable character of the present crisis is

[3] The standard example of the first being the unconventional measures adopted by the ECB in the name of ensuring the proper transmission of monetary policy, but which are in many cases a perfect equivalent of fiscal decisions, as the recent Long-Term Refinancing Operation (LTRO) with three years maturity has abundantly proven.

closely related to its insufficiently acknowledged manifold character. There is not one European crisis, they argue, but five crises. Whereas the financial origins of the crisis are well known, with the credit crunch starting in August 2007 and the collapse of the Lehman Brothers in 2008 commonly perceived to be the triggers, other factors have received insufficient attention. The growth of fictitious capital was closely related to the long-term economic crisis of Western societies, to the falling rate of profits accelerated by the economics of turbulence unleashed by the fall of Bretton Woods and the reaching of the limits of the post-war model of economic growth. Similarly, insufficient attention is paid to the causal role played by both the economic and the financial crisis on the sovereign debt crisis. The resilience of the fiscal state of the four European PIGS[4] was severely undermined by their radical embracement of a form of "private Keynesianism" (Crouch 2009; 2011), that is, growth through debt. The attempts to sort out these three crises have tested the constitutional law both of the Union and of its member states, and have resulted in serious breaches to the *rule of law* as well as to the commitments of the welfare state. As a consequence, the European Union has entered a serious crisis. Different measures have pushed the Union into conflicting directions, causing further stress in the EU's institutional and decision-making capacities. The European response to the crisis reflects the complex character of the European socio-economic constitution. However, through a proper reconstruction Chiti, Menéndez and Teixeira are able to discern four key developmental paths: (1) The European response drifted into a path of constitutional mutation challenging the fundamental principles of the EU's legal and political order. It has implied a breach of constitutional standards and may open the way to executive emergency-constitutionalism. While the authors think that it will not necessarily lead to the collapse or abolishment of the EU, it will likely lead to a progressive mutation of the underlying political and economic project of European integration; (2) National decisions on the extension of guarantees, acquisition of assets and recapitalisation of banks, point to a *renationalisation* of competences (critically corroborated by state aid conditions by the European Commission), which have been clothed in European garments; (3) The constitutional transformation regarding the institutionalisation of a European Monetary Fund and

[4] Portugal, Italy, Greece and Spain.

the creeping role of the ECB as an indirect lender of last resort point in a federal direction, but has highly problematic democratic implications; (4) The governance arrangements coupling fiscal and monetary policy, as well as those coupling the various national fiscal policies, are undergoing transformation. This process is underpinned by a contradictory aim of reinforcing the use of both hard law and governance mechanisms, as well as by the contradictory stance of consolidating the European Monetary Fund and increasing the sanctioning of non-compliant member states. They conclude that fiscal policy cannot remain aloof of neither *efficiency* constrains, as this would require not following rules, nor *legitimacy* constrains, as fiscal decisions have fundamental political consequences.

Two appendixes round off the report. One is a clarion call from the past, the other a very contemporary and decisive ruling.

The intellectual biography of Lionel Robbins is far from simple. A man of deep federal convictions, he mounted a fierceful resistance against 'Cambridge' Keynesianism from the London School of Economics in the 1930s, and gave a decisive helping hand in the painful labours of birth of the neoliberal movement in the late 1940s and early 1950s. But as the essay in Appendix I proves, Robbins cut a figure larger than that. He was more of a traditional liberal than a neo-liberal, and indeed he came to recant his opposition to Keynes and Keynesianism in the last years of his life (which was indeed a long one, so long that he had the chance of experiencing the Thatcher revolution first hand). His essay 'The Economic Basis of Federalism', which was written in the terrible days of the fragile peace of 1939, is both of enduring value and topical. Robbins offers a normative and economic foundation of a federal socio-economic constitution, a constitution which resembles more the original project of the Rome Treaties than the asymmetric socio-economic constitution decided in Maastricht and Amsterdam. While all economic freedoms, and in particular the free movement of labour, are regarded as firm building blocks of a lasting peace, Robbins is no *doctrinaire*, and is thus interested not in the *deregulation* of the movement of people, but in assigning the competence to do that to the federal level of government. Similarly, it is stimulating to be reminded that what a federation requires is not so much a single currency as the avoidance of monetary anarchy, which accrues when monetary policy is conducted in a fully uncoordinated manner. The editors are very grateful to the Federal Union for the kind permission to reprint Robbins' text, which was originally published as Federal Tract number 2 in 1940.

The contemporary ruling is the judgment of the German Constitutional Court on the financial assistance provided by member states of the euro zone to Greece. The tension between the institutional mandate of the German Constitutional Court as the guardian of the supremacy of the German Constitution and its derived role as the guardian of the collective constitutional law of the Union underlies the complex decision of the Court. While many commentators have rightly stressed the constitutional constrains that seem to follow from the ruling to the issue of common European public debt, insufficient attention has been paid to the fact that such limits were fostered by the way in which the German government argued the case (which was a consequence of the constitutional fetishism to which the present teutonic government has been prey) and even less to the fact that the German Constitutional Court has been forced to reconcile the defence of the ideal of integration through democratic constitutional law with the changing socio-economic realities of the European economy. If the German Court deserves criticism, it seems to me that such criticism should focus more on the 'old' paradigm through which it understood Community law from *Solange I* to Maastricht (with the exception of its ruling on the European Elections in 1979) than on its rulings in Lisbon, *Mangold* and the present Greek aid case.

Looking forward: The European rescue of the European Union

In the epilogue to the report, Alexander Somek invites to leave aside the urgent daily questions and reflect on what is fundamentally at stake, what it is that Europeans are really taking a decision about when dealing with the manifold European crises. In his view, the way in which the Union has been conceived and shaped in the last thirty years and the way in which the crisis has been governed are leading us to the erasing of politics as such from the European continent. The pretentious dream of governance without government, of politics without the state, has poisoned not only our political practice, but also our capacity to imagine the political community, to engage into *political action*. Europe is in many senses the last chance not only for democratic politics, but for politics as such. The chapter is thus a plea for political engagement, and at the same time, a bold and salutary criticism on the vain character of a good deal of the literature of the last three decades on European studies.

Duly challenged by Somek, the workshop that this report is based on resulted more in the posing of questions than in answering them. Although the following chapters deal in depth with these issues, five questions that are especially pertinent beyond the research undertaken within RECON's WP 7 remain: (1) What is, and what should be, the relationship between the fundamental principles of European constitutional law framing the internal market and the European fiscal and monetary policy? (2) To what extent have policy proposals and reforms been based on a proper understanding of the manifold character of the European crisis? (3) How is equality before the law of member states and of individual Europeans faring during the crisis? What is left of equality beyond it being a purely formal principle? (4) Can the European Union shape its socio-economic environment or is condemned to drift? (5) What kind of European Union is likely to emerge from the crisis?

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Chapter 2

On the historical origins of the EU's current crisis, or the hypocritical turn of European integration

Hagen Schulz-Forberg
Aarhus University

Ignoring Kairos

Kairos (*Καιρός*) is a young and fast little god, the latest-born of Zeus, with an interesting haircut. He only has one curl on an otherwise bald head. And he dodges all those who try to clasp his hair and to hold him tight. To miss his ponytail is unfortunate, however, because he is the God of the opportune moment. To catch him means to achieve something of unique quality in history. While he usually plays hard to get, Kairos seemed to have had a weak spot for European integration and willingly offered his hair to European political actors from the 1950s until today. But they did not seize the opportunity in their hands. This is not to say that European integration has not been successful; indeed it has been very successful, and yet it could have been more than it became at many occasions in history. Certainly, such is the nature of politics, always aiming high, proposing to take five steps together and then take only one, but at least this step has been taken. It so appears that the history of European integration may be read in a clearer way through the metaphor of meandering rather than that of a straight flow forward. In fact, the story of European integration can also be turned around from one of ever-tighter integration to a story of ever-tighter entanglements that lack political integration and may become entrapments.

Indeed, the integration process of Europe has throughout been a history of leftovers, a story of missed opportunities, of the lowest common denominator, of much less than originally proclaimed as the political goal. Ever since the 1950s, plans for European integration have been by far more comprehensive and ambitious than the finally implemented results. Indeed, if the Council of Europe is included as the first effort at building a European political institution, this story begins in the mid-1940s. A random sample of the history of institutional and contractual steps illustrates this historical uniqueness of European integration. When the constitution failed in the French and Dutch referendums in 2005, the Reform Treaty (later called Lisbon Treaty) was what remained. When the French government launched an ambitious project for a political union in the shape of a European confederation in 1961, the other Member States did not want a Europe under French domination with its main institutions located in Paris. Only Adenauer complied to de Gaulle's initiative and the Franco-German Friendship from January 1963 became the leftover of an ambitious French plan for European confederation. Hopes were high in the early 1950s that a political institution-building would follow the European Coal and Steel Community (ECSC) in the shape of the European Defence Community (EDC) and the European Political Community (EPC). The plans failed, Jean Monnet went underground with his Action Committee for the United States of Europe, which was open for all but radical socialists and Gaullists, and what was left over were the Treaties of Rome, a shadow of what the EDC and EPC had aimed at.

One of these historical moments of ignoring Kairos can also be located in the 1970s when the Werner and Davignon Plans from the early 1970s sketched out an ambitious road to financial, economic and political union that ended with the Copenhagen declaration of European identity in 1973. But more importantly, the 1970s represent not only another example of failed political ambitions, but are marked by a semantic turning point as well. The logics of integration turned from one of political management and political economy to a new conviction that may be summarized as 'democracy-through-market'. Since the late 1970s, and more prominently since the 1980s, the belief that market integration would bring political, cultural and social integration in its wake in the form of a more democratic European society, dominated models of European integration. In what was imagined as a machine that runs itself, a *perpetuum mobile*, further integration was simply expected to happen, for example through the continuous Europeanization of national societies. The opportune historical moment would arrive in the near to mid-term future.

The roots of what I want to call the hypocritical turn of European integration can be found in this change of paradigm as well. Hypocrisy is not a lie. It is self-deception. In situations in which continuous self-reflection and self-critique would be necessary to solve a problem of which all actors are somehow aware are shunned and instead self-righteousness and a glossing over of problems occurs, hypocrisy has taken over. It is a rhetorical flight forward. By couching the analysis of problems in hegemonic discourse, in meanings that are shared by the majority and well-known, and by avoiding a critical reflection of these hegemonic meanings, hypocrisy becomes a political performance to buy time and to push the contestation of a problematic situation into the future – in the hope that this problem may have solved itself.

With a daily routine, today's crisis illustrates the institutional entrapments of the European Union and the tensions between a transnational, deregulated market and the national organization and negotiation of social issues. The market is European, the social is national. This tension is at the heart of Europe's current crisis.

When the belief in the self-regulating or constantly integrating market was firmly established in the 1980s, most visibly through the Single European Act, another shift occurred. The concept of European identity changed from a still rather clear-headed and political understanding of the term to one of European culture. Today, the economic integration machine sputters. Alan Milward's classic phrase of the European rescue of the nation-state (Milward 1992) does not apply to European integration anymore. Rather, national economic slumps and crises occur increasingly, something unimaginable before, when European integration was synonymous with constant economic growth of its Member States. And European identity today is about national stereotypes of laziness and thrift rather than common denominators. The fragile nature of the European institutional landscape and of European integration as a whole has come to the light. The crisis of the Euro is a crisis of European integration that has its origins in the hypocritical turn of the 1970s and early 1980s.

From political economy to democracy-through-market

The 1970s and the failed Werner and Davignon Plan emerge as the key decade in which an ambitious plan to create a political Europe that connects the economic and the social failed and a paradigm shift from Keynesian economic logics, broadly understood, towards a neo-liberal one, in its monetarist and supply-based gown, can be detected. I would like to illustrate today's socio-economic malaise of Europe with the help of the conceptual nexus of crisis-critique-hypocrisy developed by the German conceptual historian, Reinhart Koselleck in his major book *Critique and Crisis* (Koselleck 1988) and by relying on ideas developed in the book The Political History of European Integration written by Bo Stråth and myself (Schulz-Forberg and Stråth 2010). After elaborating on the role of hypocrisy and the modern condition of constant critique and crisis in an open-ended historical process – that is without any inbuilt *telos* towards which history moves – I will address the question of a European democracy and the role of democracy in Europe through historicizing its development and through dwelling on the role of identity that is connected to recent ideas of European democracy. Finally, I will conclude that a European rescue of the European Union is unlikely and that only a National and Global Rescue of the European Union appears as the theoretical and practical alternative, albeit as of today without much underpinning in reality because of the lack of a clear European agenda.

The inbuilt tensions of European integration

In the recent history of European integration, three interconnected fields of contradiction and particular tension can be discerned: tensions between official rhetoric and institutional capacity to follow up the rhetoric, between enlargement and deepening of the integration and between market integration and social disintegration. Taken together these three fields of tension highlight the question of EU and democracy and one may ask on the background on these tensions: What does EU as a democracy really mean and when did this language of Europe-as-a-democracy emerge? What have been the implications of the EU-as-a-democracy language?

In particular two sets of tensions seem to be relevant: between enlargement and deepening, and between market integration and social cohesion (and thus democracy). These two sets of relationships have in the debate hardly been seen as the tense, contentious and contradictory connections they represent. Little attention has been paid to the problems involved in the attempts to connect enlargement with deepening and market with democracy.

Following from this basic set of tensions European integration history re-emerges from the perspective hinted at above. A perspective in which the early 1970s represent the point of culmination of the European integration project with the plan for an economic and monetary union, the Werner Plan, and the *Report by the Foreign Ministers of the Member States on the Problems of Political Unification* (called the Davignon Report or Plan), both adopted in October 1970. The Werner and Davignon Plans were much more ambitious than their Maastricht imitators. They came to nothing in the face of the global economic crisis of the 1970s and the subsequent semantic shift from a Keynesian to a neo-liberal conceptualization of economy and society as disembedded. The Werner Plan was based on Keynesian ideas of political management of the economy at the European level. The European Monetary Union that were decided upon in Maastricht as well as the EU enlargement of 2004 were both based on neo-liberal ideas of a market-driven European economy and democracy. Instead of democracy-through-market, however, there are increasing signs of experiences of national bargaining on the European level, social disintegration, political extremism and populism in the wake of economic integration.

Interestingly, European democracy was conceptualized in connection with market integration where democracy was linked to markets as a causally logical result leading to the assumption that free markets make free and democratic societies. The tensions which erupted in the ensuing European crisis since 2005, and which built up over a long period since the late 1970s, culminated in a very condensed short period between the enlargement from EU 15 to EU 25 in May 2004 and the French and Dutch abrogation of the constitution one year later, when the constitutional vision evaporated within just three days on 29 May (France) and 1 June 2005 (Netherlands).

During the historical build-up of the tensions, hypocrisy was the tool to conceal rather than to cope with a situation challenging the EU"s legitimacy. Experiences of crisis were glossed over with hypocritical language. This was the case when the idea of a European constitution emerged in response to the problems of the enlargement, when the idea of a European public sphere emerged in the absence of a European demos, and this had been the case when a European identity was declared in 1973 after the political will behind the Werner and Davignon Plan rapidly lost momentum against the backdrop of the breakdown of the Bretton Woods order and the world economic crisis.

The European hypocrisy

The term hypocrisy is not meant to describe the actors of European integration as hypocrites, far from it. Rather, it here used as a technical term based on the historical analysis of European modernity provided by Koselleck. I understand hypocritical language and hypocrisy thus as a more general category. The dynamics generated by his inter-related concepts of critique and crisis is well known but less so the fact that in his model he also operated with the arrogance of the victors. The dynamics between critique and crisis triggered the French revolution and became a crucial dimension of modernity. After the revolutionaries' victory, dislike of continued critique emerged. In the perspective of Koselleck smugness and hypocrisy followed the revolution instead of continuous self-critique and conscious political involvement. After the revolution, self-critique became self-illusion and the victors got trapped in their own language. The revolutionary rhetoric hardened into institutional self-righteousness, and a hypocritical tension between language and institutional capacity to respond to the rhetoric emerged.

Crisis derives from the Greek word κρινειν, *krinein*, to separate, to distinguish, to decide, to determine, to judge. It was in this sense that the Greek historian Thucydides used the term in his accounts of the Peloponnesian War and the battles at land and sea which led to the crisis in the great conflict between the Greeks and the Persians. In the same way, the Greek physician Hippokrates referred to the crises, which occur in diseases in exactly the moment when the disease either increases in intensity or begins to abate. In Thucydides' depiction of the plague in Athens, he relates how the crisis came after seven to nine days. More than a thousand years later, the philosophers Rousseau and Paine took over the concept of crisis in exactly this vital and existential meaning – and transfigured its meaning in the process. Crisis became, in their eyes, an emancipating dissolver of the old order. The outcome of a crisis was no longer open but got a direction towards a better future. The solution of a crisis was temporalised through the depiction of a good future. It thus began to connote progress. Karl Marx' crisis theory developed a notion of progress towards socialism, for example. He understood the economic depressions which had occurred since 1825 as crises, which were an unavoidable and at the end mortal mechanism built into the capitalist system. From Marx, the concept of crisis spilt over into neoclassical economic theory, which regarded crisis as a temporary disequilibrium in a natural state of equilibrium within a free market, where the end of each crisis was principally given. Crises became conceptualized as temporary periods of market imperfections. With the use of the crisis concept by the neoclassical economists, the term resolutely lost its original meaning of openness towards the future and connotes not only a market imperfection, but connected to the market also a temporary malfunction of an otherwise perfectly well-balanced economic, social and political order.

Koselleck saw the close etymological and semantic connection between crisis and hypocrisy. Hypocrisy comes from the Greek ὑπόκρισις, *hypokrisis*, which means play-acting, acting out, feigning or dissembling. The word is an amalgam of the Greek prefix hypo-, meaning 'under', and the verb *krinein*, just referred to, meaning to sift or decide. Thus the original meaning closely connected to the crisis concept implied a deficiency in the ability to sift or decide. *Hypokrisis* as 'play-acting', the assumption of a counterfeiter, gives the modern word hypocrisy its negative connotation. The orator Demosthenes ridiculed his rival Aeschines, who had been a successful actor before taking up politics, as a *hypokrites* whose skill at impersonating characters on stage made him an untrustworthy politician. Hypocrisy is the act of pretending to have beliefs, opinions and qualities that one does not actually have. Hypocrisy is not simply an inconsistency between speech and act. Failure or lack of courage or capacity to undertake what one wants to oneself or recommends to others is not hypocrisy. There is a connotation to self-care but also to self-deception and self-doubt, to glossing over. Without these connotations hypocrisy would simply be cynicism or, alternatively, escapism from reality. Rather than that, hypocrisy is a method to try to cope with lost control and as such an alternative to escapism. In some cases, hypocrisy may even occur because of a simple lack of a different argumentative logic, because of a lack of a new language. After the crisis of the French and Dutch 'No' to the proposed European constitution in 2005, EU representative and heads of state designed themselves as a self-confident, self-reflexive and united community, in which strong and determined politicians rule. This was the hypocritical response to crisis in the sense in which both these terms have been discussed here. Hypocrisy thus depicts a situation in which a semantic hegemony of certain concepts, such as the notion that market integration may somehow lead to democratic integration, remains in a position of authority. Jean-Claude Junker's expression from June 2005 that there is no Plan B to the European constitution reflects the power of semantic hegemony that simply does not open up even a minimal opportunity for critical self-reflection. This in itself is the result of a process of self-deception.

For Koselleck, hypocrisy is a typical feature of European modernity. Further features are the continuous struggle over the meaning of key concepts and a constant birth of new futures; some utopian, some dystopian. The depiction of the future gives credence to political change in the present.

The road towards the future was, in Koselleck's scenario, not a smooth and easily foreseeable evolution but it was always paved with debates and conflicts, critique, crisis and hypocritical language. Dialectics of crisis, critique and hypocritical conflict-solution have marked European history since the eighteenth century and continue as a trademark of the public sphere to this day. Obviously, hypocrisy is here understood not in the sense of Jon Elster as base human motives or pure self-interest that is tamed by publicity, which has the power to turn a vice into a virtue (Elster 1998). Rather, hypocrisy, as I read Koselleck, reflects unwillingness or sometimes incapacity to self-critique and self-scrutiny. In such situations, publicity does not turn hypocrisy into a civilizing force in the sense of Elster. Rather, hypocrisy depicts horizons of expectations that are out of sync with reality. The difference between the historical and semantic approach to hypocrisy proposed by Koselleck and the one proposed by Elster, which is based on an understanding of hypocrisy as a form self-interest that is turned into a wider public good through deliberation, is the definition of the very term hypocrisy, however. Koselleck's hypocrisy is not part of a normative theory as in the case of Elster – whose conceptualization of hypocrisy has been criticized as "shallow and normatively suspect" (Johnson 1998) and who has been reminded recently that in public discourse and under pressure to conform there may simply be hypocrisy in the absence of any civilizing effect (Knight and Johnson 2011) – but part of a historical theory based on an analysis of political discourse over a considerable stretch of time.

Historically, social critique emerged from translations of experiences into new horizons of expectations. The contentious public discourse on the translation of experiences into expectations was the breeding ground of modernity, the place where future was shaped. Experiences of crisis through critique triggered political attempts to respond to and integrate the critique through outlines of new horizons of expectation. The expectations were the mobilizing instruments that provoked action to change human conditions. The language of expectation manifests itself in an array of utopias, while the actual experience never even comes close to the expectations raised by the visions of the future.

According to Koselleck, both worlds, the space of experience and the horizon of expectations, are drifting further and further apart. Eventually leading to an intensification and generally higher frequency of crises in shorter amounts of time. This is the pathology (or, pathogenesis, as Koselleck called it) of bourgeois society. The intellectual tool to cope with this situation of continuous loss of control is hypocrisy. Instead of permanent critique as the motor of society hypercritical reassurances that everything is fine lulled societies into feelings of security. Hypocrisy integrates critique and provides a temporary solution, but the credibility of the hypocritical language is undermined by accelerating crises. Koselleck wrote this in a Cold-War situation where many felt the threat of nuclear extinction and how the threat was glossed over by two hypocritical languages about freedom and equality; one in the West, one in the East. Writing in 2011 and not in the 1950s, it can be concluded that this pessimistic interpretation of modernity as an era that was born to destroy itself is wrong. The observation of the role of hypocrisy, understood as buying time through false promises in moments of crisis and in the absence of critical and constructive reflection, remains a historical observation that is valuable to take into account as a key feature of modernity. The current crisis of the Euro illustrates this point poignantly. Interestingly, the hypocrisy – and thus the helplessness – of the political actors in this crisis is obvious that the glossing over lasts merely for days.

A constant self-reflection in the face of crises such as the War on Terror and the financial and economic collapse in 2008 that hit the core of Western self-understanding is a much needed exercise, however. One of the most important undertakings in the name of self-reflection is thereby the destabilization of hypocritical language.

The historical origins of today's crisis

In 1970, with the experience of the previous European deadlock in the 1960s through de Gaulle's obstruction politics and veto against British membership to the EEC, and against the backdrop of growing tensions to the USA after 1965 in financial and security political terms, the second generation of European leaders rose to the occasion when de Gaulle stepped down in 1969. They saw the possibility to once more raise the horizon of expectations through decisive institutional steps towards a federal Europe. The federalist language became more concrete with a clear institutional design. The decision was taken at the summit in the Hague in December 1969 to intensify the co-operation in the fields of security politics and economic and monetary politics, and to enlarge the membership from six to nine. This deepening implied the drawing of outlines of an economic and monetary union, based on both economic and monetary politics as the basis of a shared currency, and a security political union: the Werner and Davignon Plans.

The Werner Plan was brave in its architecture since it attempted to merge the economic and the social. It was a clear step in a federal direction. The gap between rhetoric and institutional setting decreased. It should be noted that the plan and its security political counterpart, the Davignon Plan, were designed before the international economic order broke down in the early 1970s with the Dollar collapse in 1971 and the oil price shock in 1973. The tension-ridden relationship with the USA since around 1965 belongs to the framework of the design as much as the stalled process of European integration provoked by the French President, who was just as crucial in the build-up of the transatlantic tension through his repeated threat to change the French Dollar reserves for gold. Another factor was the rapidly growing social protest in the Western world at the end of the 1960s ('1968'), which pushed political leaders towards the wall and promoted their search for political initiatives.

The Werner and Davignon Plans meant a clear step in a federal direction, although they did not mean the transformation into a federation. Cohesion and co-ordination of economic and monetary policy were to be transferred "from the national to the Community" level, but only "within the limits necessary". The Community would have at its disposal "a complete range of necessary instruments, the utilisation of which, however, may be different from country to country within certain limits" (Werner Plan 1970: 10). Transfer of powers from the local and national levels to the Community level should take place to the extent necessary, but "allow for a differentiated budgetary structure operating at several levels, Community, national, etc.". The need for a continuity of European values as they were formulated in the national welfare communities was also expressed in Werner's emphasis on the collaboration of 'social partners'. Market Europe was envisaged as a social Europe.

This European attempt to create a distance to the experiences of de Gaulle as well as to the USA soon faced heavier winds and rougher waters, however. The whole international order established in Bretton Woods in 1944 was about to break down. When the Six met in Paris in October 1972 the Dollar collapse of 1971 was already a framework factor, which, given the tensions built up between the EC and the USA in the 1960s, rather served to promote European unification, however.

Yet the oil price shock eroded the commitment of the Six. European self-confidence evaporated ever more as reminiscences of the collapses of the 1930s – which according to hegemonic theories in economics and social sciences never would recur – returned under the subsequent conditions of the collapse of key industries and the emergence of mass unemployment.

Furthermore, the collapse of the Dollar in 1971 provoked memories of the gold standard's second breakdown in 1931. The international shock wave after the dramatic rise of oil prices and subsequent high inflation more generally, made the implementation of the Werner and Davignon Plans much more difficult. The next wave, the return of mass unemployment, more than anything else reanimated the memories of the 1930s. Under these conditions of mass unemployment and the additional collapse of key industries like steel, shipbuilding and coal that followed *en suite* after the oil price rise, both plans were put on hold. The attempt to unify the economic and the social at the European level was under these conditions exposed to severe strain.

After a long period of preparation, Pompidou invited the prime ministers, the foreign ministers, and the ministers of finance from the Six plus the three candidate countries to a conference in Paris. After some hesitation the president of the Commission, Mansholt, was invited as well, although he had to sit at a separate table (Knipping 2004: 202–203). The Paris summit in October 1972 developed a programme for a political Europe. In the final declaration, the Six confirmed their democratic self-understanding of the Community and emphasized their will to establish an economic and monetary union, guarantee economic expansion, to increase the living standard and the development aid, to promote world trade, to contribute to a politics of détente and peace, and to take its place in world politics as one entity.

The Paris summit also led to some clear commitments. The economic and monetary union was to be established by the end of 1980 and a fund for regional development in operation already at the end of 1973. Until early 1973, a plan should be elaborated about how to get more dynamic development aid and until mid-1973, a plan for negotiations about multilateral trade relationships. The institutional relationships within the Community should be improved, in particular the relationships between the Council, the Commission and the Parliament. At the end the Six declared that their most urgent goal was to transform the commitments already agreed upon in the treaties of the EC into a European Union.

Identity instead of institutions: The European bypassing of the social issue

In the context of these developments, the idea of a European identity was introduced as an instrument to stabilize the situation and to support the Werner and Davignon Plans. It was more precisely designed at the Copenhagen Summit in December 1973. The idea of identity was not based on ideas of culture and commonalities, but it was based on the principle of the unity of the Nine – this was just after the first enlargement – and their responsibility towards the rest of the World. The meaning of "responsibility towards the rest of the World" was expressed in a hierarchical way. First, it meant responsibility towards the other nations of Europe with whom friendly relations and co-operation already existed. Secondly, it meant responsibility towards the countries of the Mediterranean, Africa and the Middle East. Thirdly, it referred to relations with the USA, based on the restricted foundations of equality and the spirit of friendship. Next in the hierarchy was the narrow co-operation and constructive dialogue with Japan and Canada. Then came *détente* towards the Soviet Union and the countries of Eastern Europe. At the bottom of the list came China, Latin America, and, finally, a reference was made to the importance of the struggle against underdevelopment in general.

The fact that the USA was mentioned after the Middle East must be understood in the framework of the prevailing oil price shock and the fact that President Nixon since 1971 refused to let the dollar guarantee the Bretton Woods order. Refused is perhaps not the right word. He could not. The Vietnam War had overstretched the dollar to the edge of collapse, but already de Gaulle, heavily influenced by his economic advisor, Jacques Rueff, had begun to undermine the confidence in the American substitute for the gold standard by his repeated threats to change his Dollar reserves for gold.

The declaration on European identity looks at first glance like a brave new step in a federal direction after the Werner and Davignon Plans had lost their dynamics, but the framework of the statement hinted rather on the limits of the federal step. Caught between the Yom Kippur War and the oil price shock, the post-de Gaulle initiatives from December 1969 began to lose momentum. Already in April 1973, the Commission warned that the dynamics were evaporating from the two plans. This was even before the oil price shock. The determined commitment to establish a European alternative to the US American global hegemony in financial and military political terms was easier in argument than in action.

In the summer of 1973, Jean Monnet proposed to Edward Heath and Willy Brandt and to Georges Pompidou that the chiefs of government and state of the Nine should form a provisional European government committed to implement the Paris declaration from 1972 with the aim to establish a European Union with a European government and a directly elected Parliament. Heath and Brandt supported Monnet's idea, but Pompidou only partly. In particular, the French President was against a European government. Under the impression of the oil price shock, Monnet increased his pressure on the three leaders on 31 October and proposed a small meeting between them and their six colleagues of the EC 9 before the end of the year. Monnet thought of an informal meeting without a formal agenda at which all questions could be brainstormed without protocol, prestige and final communiqué. The Commission and the prime ministers of the smaller member states as well as the foreign ministers feared to be sidestepped and Monnet's idea was transformed into a big formal summit meeting (Knipping 2004).

As an instrument for European integration, the identity politics for the definition of Europe through identification of its others failed. Without institutional cover the concept, in its political gown, soon evaporated and was diluted in the 1980s when it was channelled in new, cultural and democracy-through-market directions.

The market and the social — identity and democracy

In the 1980s, identity was linked to the market language as it emerged in Delors' plan for an internal European market. The introduction of the new concept of a European citizen provided a link between market and identity. In the 1980s the identity concept also began to connote a European cultural value basis. The concept lost its connection to an imagined European political economy and reconnected to cultural imaginations. On a strictly economic level, even pragmatic Keynesians such as those in charge of the OECD's so-called McCracken Report from 1977, called for a movement from the welfare state to the 'disciplinary' state, that is a state that spends wisely and is fiscally strict. Ironically, this report had some influence on the neo-liberal governments of Thatcher and Reagan (Gilpin and Gilpin 2001), even though they were much more inspired by their parties' think tanks (Jackson 2012, forthcoming).

A report by the Belgian Prime Minister Leo Tindemans in 1975 tried to keep the Werner and the Davignon Plans alive, and argued for a social Europe, but his proposal for institutional development was without success. In 1977, the MacDougall Report to the European Commission suggested a European Keynesian strategy to bridge the economic crisis and the collapse of key industries. A serious attempt was made in 1977/78 to translate national tripartite bargaining structures, which had functioned so well during the era of economic growth in the 1950s and 1960s, to a European level alongside a politics of de-industrialisation in industries like shipbuilding and steel. However, in the bargaining about capacity reduction and layoffs, ties of solidarity between employers, trade unions and governments followed national lines rather than those of transnational sectorial interests. The bargaining partners that the trade unions needed were missing. Business regarded its producers' interests well represented in national lobbying processes and did not see much sense in having to deal at the European level. The European project fell dormant for a while. The proposals in the MacDougall Report were never realized and a European pattern of interest and solidarity ties never emerged.

In 1977, the OECD published the above-mentioned report (the McCracken Report) recommending action to tackle the crisis. These recommendations proposed a quite different approach, offering solutions and hopes in the market by moving towards the disciplined state. The OECD's suggestion won the support of the governments, and meant one of the first general breakthroughs for more market-liberal government approaches implying a 'less-is-more' logic, and the MacDougall Report was forgotten. The road was open for neo-liberal policies. The entrance of Margret Thatcher on the scene in 1979 reinforced these developments.

The Werner Plan was stone dead even before all its stages were due for fulfilment. The 'Snake', the exchange rate mechanism and other responses to the dollar's collapse absorbed the political energy. During a brief period of some twenty-five to thirty years after the

Second World War economic theory legitimized the belief that economies could be politically governed. Key objectives of this governance were the political assurance of welfare, with the guarantee of full employment as perhaps the most important instrument. This belief in political economic management experienced severe hardships in the 1970s. The international economic order (Bretton Woods), on which the belief was based, broke down.

The failure of the institutional design around 1970 cannot conceal the fact, however, that the 1970s, often seen as the crisis decade of European integration, contained the most ambitious attempts ever to transform the EC into a federal direction with a European demos. Compared to the Werner and the Davignon Plans, the Tindemans and the MacDougall Reports, and the declaration on a European identity and the decision on direct elections to the Parliament, Maastricht 1992 was a retreat to more timid aims. Maastricht was seen as a break-through for a federal Europe because of the name shift from Community to Union. In retrospect, the culmination of the European federal effort came quite clearly in the early 1970s.

The ambition in the early 1970s dealt with a political connection of the economic and the social at the European level, in a situation where the European rescue of the nation-states, i.e. a European market and national guarantee of social solidarity, experienced severe tensions. The unification of the economic and social at the national level in the 1930s, after more than half a century of political contention and, often, violent conflict, was, as we know, an explosive mix (Polanyi 2001). The original idea in the 1950s was the European separation of the two dimensions, the European rescue of the nation-state through a European economy and national welfare provision. This solution lasted until the early 1970s. The social question moved to the European agenda with the plan for financial and monetary integration. However, it moved there under political contention, which after a while pushed it back to the national level through the separation between European economic integration and national social responsibility. With the enlargement in 2004 the social question overwhelmed the European institutions. The idea of a separation of the economy and the social between EU and the member states did no longer work under the conditions of growing social differences on the European labour markets.

From identity to democracy?

What happened to the idea of a European connection of the social and the economic between the Werner Plan and the Maastricht Treaty, where the union was seen much more in strictly monetary terms than in the Werner Plan? The Werner Plan which built on the goal of some kind of European solidarity and welfare responsibility was, as demonstrated, dead before its planned inauguration in 1980. Despite the fact that the initiative by Monnet and Brandt gradually won general support by five member states they could not break the French resistance.

After 1980, identity was all that was left, but was then linked to new connections in the framework of the new culturalist language as well as neo-liberal globalization rhetoric since the 1990s. The European variation of this culturalist trend emerged as a response to the perceived so-called *eurosclerosis* when the ideas of a Central Europe began to frame an understanding of Europe as a cultural, tolerant, diverse, multi-cultural, multi-religious, open-minded and deeply intellectual area. Milan Kundera's famous essay from 1984: 'A Kidnapped West or Culture Bows Out', depicted a bureaucratic, faceless, power-minded and cold Western Europe without any of its historical features left; culture had bowed out. The place where Europe as it should be was located was Central Europe. It was kidnapped because it had been conquered by the Soviet Union as a sphere of influence.

It was the Central Europe discourse, which continued as a heated debate until the early 1990s when it was additionally fuelled by the fall of the Berlin Wall and the end of the Cold War, that clearly connected the top-down engineering of a European identity with a broader historical tradition and an imagined Europe populated with tolerant individuals in a civil society of cosmopolitan qualities.

The European Parliament, popularly elected for the first time in 1979, under the chaperoning of Altiero Spinelli's *Crocodile Club*, infused new life into the identity concept by canalising it in new directions. Spinelli's draft treaty for a European Union from February 1984 asserted that the citizens of the member states should *ipso facto* be citizens of the Union. Citizenship of the Union would be dependent on citizenship of a member state. National law was to be co-ordinated with a view to constituting a homogeneous judicial area. To achieve this objective measures were to be taken to reinforce the feeling of individual citizens that they were citizens of the Union.

With the introduction of the European citizenship, European identity was back on the table again, but detached from defining the identity of the European institutions and their geopolitical setting. Gaston Thorn, President of the Commission up until the end of 1984, emphasised the need to equate the European integration with ordinary Europeans: "We have put in place measures which will make the citizens, and particularly the young, understand Europe, identify themselves with it and support it… Some simple measures, with a strong symbolic content, must be quickly taken." François Mitterand welcomed enthusiastically Spinelli's and the Parliament's draft treaty. At the conclusion of the European Council meeting in Fontainbleau in June 1984 he stated that it was "essential that the Community responds to the expectations of the people of Europe by adopting measures to strengthen and promote its identity." An ad hoc committee, chaired by Pietro Adonnino, fittingly named the *People's Europe*, was set up to look into ways of engaging the public symbolically with Europe and delivered its report in June 1985. The report dealt with "important aspects of special rights of citizens, of education, culture and communication, exchanges, and the image and identity of the Community", which would make "a substantial contribution to the realisation of an ever closer union among the peoples of Europe." The suggestions included a model driver's licence valid in the whole Community, a Euro lottery, 9 May as Europe Day, a Community joint study exchange programme, European sports teams, a European flag, anthem and emblem in order to give "the individual citizen a clearer perception of the dimension and existence of the Community".

The aims of the committee on the People's Europe fitted in very well with the internal market agenda of the new President, Jacques Delors. With the rekindling of the identity discourse in 1984-85 the connotation to a social Europe was cut, however. The new association was with the citizen concept which somehow without closer analysis was linked to ideas of a European democracy and a European internal market. The importance of the symbol production for the establishment of a European identity was emphasized. Imaginations of a European democracy were connected with branding and symbol production and the democratic people(s) were envisaged in terms of free individuals acting in a common market rather than tied to each other through social bonds still mainly organized on national levels.

In the new argumentative chain the market-based civil society promoted citizens, which became the imagined constituents of an emerging European democracy and identity transcending the nation through transnational attachment to Europe. The connection between the social and democracy and identity was no longer given. The emerging democracy-and-identity-through-the-market language began to widen the gap between rhetoric and institutional capacity to follow up the language. The mid-1980s were crucial for the shift of perspective from the Werner Plan idea of EMU to the one realised with the Maastricht Treaty in the early 1990s, less because of Delors' internal market design as such than because of Spinelli's outline of democracy and identity through market and branding.

The tensions between the social and the economic

The now very tangible tension between the social and the economic in European unification can be epitomized in a historical perspective as a tension between Europe and the nations. The problem of the social disintegration in connection with economic integration emerged on the political agenda across Europe as the social issue from the 1830s onwards. The social disintegration was for a long time emphasized by the concept of class. Nationalism reintegrated the social protest, but, as the developments in the 1930s demonstrated, under a deep and violent division of Europe. From the early 1950s under the conditions of the Cold War, the response to this division was (Western) European market co-ordination in order to guarantee social welfare in the nation-states. The European rescue of the nation-states meant a historical separation of the economic and the social, which had become unified categories in the long and violent process of nation building since the 1870s. The separation of the economic and the social and the distribution of labour between the (West) European Economic Community and the Member States was an invention opposed to the situation before 1945 when the economic and the social had been unified at the level of the nation-states under European division. This invention worked well under the conditions of economic growth in the 1950s and 1960s and against the background of the legitimizing role of the Cold War. The model continued to work, although under growing problems in the stagnating economies of the 1970s. The SEA and the Maastricht

Treaty confirmed it. The enlargement in 2004 overstretched it and the current financial and economic crisis in Europe again highlights the tensions of a Europe à la Hayek (Anderson 2010) that leaves the social question to the nations. The social protest imposed the social question on the European agenda, but the capacity to handle it at the European level is limited and this remains a problem for Europe today. Democracy is all about the continuous absorption of social tension through deliberation and consensus-building. Under conditions of a separation of the social and the economic such continuous absorption becomes problematic when the nation is incapable of solving social problems and the institutionalized European political deliberation that would be necessary in order to tackle them simply does not exist.

The developments since 2008 have produced wide-spread fear, fury or resignation in various combinations, which provides an explosive mix attractive to political exploitation. Are there alternatives to reintegration of the social protest at the national level with the risk of nationalism, populism and European division to which historical experiences alert us? What prospects are there of a European regulation and control of the piracy on financial markets beyond hypocritical language? It seems to be the case that the rescue of the European Union today cannot be successfully undertaken by European institutions. The impetus for saving the EU must come from the national governments and from global institutions such as the International Monetary Fund and the national central banks. In a situation of national bargaining one can only hope that the existing institutional structures are able to put enough pressure on the national governments to change the European institutional setup and that Europe reappears on the national agendas as a *conditio sine qua non*. Europe's historical success lies in the safeguarding of democracies within its member states. Does the EU need to be a democracy too to continue this historical role? If the answer to this question is yes, very clear follow-up questions regarding federation or confederation need to be asked rather than trying to make the existing European institutions look like a new form of democracy when the crucial capacity of the nation-state – the harmonization of the social and the economic through democratic deliberation – cannot be fulfilled on the European level as of now. To reach a situation in which Europe is politically able to do so should be the guiding star for new political initiatives which can only emerge from national governments. The current crisis illustrates the differences of the European member states and the political fragility of the European institutional setup. The national rescue of the European Union thus needs to result in a condition of European self-sustainability. The end of European hypocrisy is the first and foremost demand to reach such a sustainable solution. Europe does not need a new narrative; it needs political will and a clear institutionalization of political deliberations. Maybe Kairos reappears again in the near future. Europe, then, should finally fall for him and hold his curl very tightly.

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Chapter 3

What is left of the integration through law project? A reconstruction in conflicts-law perspectives

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Introductory remark

This chapter will defend the 'conflicts-law approach' and develop further its presentation at the workshop on 'The changing role of law in the age of supra- and transnational governance' in November 2009 at the university Carlos III in Madrid (Joerges, 2011a). The argument will proceed in three distinct steps. I will first recall very briefly the legacy of the 'integration through law' project and submit that the conflicts-law approach can be understood as an effort to rewrite and to re-conceptualise the project of Europe's 'integration trough law'. The main section of the chapter will confront the legacy of 'integration through law' with Karl Polanyi's economic sociology and its warnings against the commodification of land, labour and money. On that basis the potential of the conflicts-law approach will be explored in three scenarios which the commodification of these goods have provoked. The concluding part will contrast the approach with Jürgen Habermas' renewed plea for a democratisation of the European project on the one hand and the *Großraum* theory of Habermas' favourite enemy on the other.

The legacy of the 'Integration-through-Law' project

'Integration through Law' has been the trademark of the European project since the early 80s. It designates one of Europe's great accomplishments, namely the taming of the Weberian *Nationalstaat* and its commitment to national economic and political power by a supranational legal order und the transformation of state of nature among the Member States of the Union into a Kantian *Rechtszustand* with legally binding commitments (Joerges 2012). The role of law as it was envisaged in the formative period of the EU was not meant to des-empower politics, however. In Joseph H. H. Weiler's famous conceptualisation of the European constellation, legal supranationalism was complemented and accompanied by political bargaining processes (Weiler 1981). As I read his argument, the relation between law and politics is not written some constitution stone but can be more adequately characterised as a precarious equilibrium with no built-in stabilising mechanism.

During the dynamic development of the integration project since the mid-80s the relation between Law and 'the Political' was continuously re-defined and re-institutionalised. The tragic of this process and the present state of the Union is the weakness of Politics in the Union which so many protagonist of the European project seek to compensate by juridical techniques which tend to overburden the law and its legitimating potential. This misconceived reliance on law can be observed in the legalisation of monetary policy, in the European responses to the quest for social justice and a 'European social model' and, most recently, in the new debates on nuclear energy in which the European treaties are being invoked as barriers against new energy politics. This threefold *problématique* will be discussed in the following section.

Europe's 'socio-economic malaise' and Karl Polanyi's economic sociology

Karl Polanyi's reconstruction of the core instability of industrial capitalism lays heavy emphasis on the role played within capitalist society by three 'fictitious commodities': money, labour and land. These three fictitious commodities denote 'goods' which nonetheless predate and transcend 'the market', and whose subsequent 'commodification' not only provokes crises within and around capitalism, but also proves to be an impetus for counter-movements to the market (Polanyi [1944] 2001: 69ff). In view of the by now chronic instability within European monetary and economic union, the steady erosion of national labour and/or social constitutions, as well as continuing conflicts in the area of energy policy, Polanyi's theses and conclusions appear to have gained a depressing degree of general topicality. The following analysis, however, limits itself within this paradigm to the European 'integration through law project', and to the question of what European law has and is experiencing, and what it, itself, has precipitated.

De-legalisation

The contours of economic and monetary union were laid down in the 1992 Maastricht Treaty. This was without doubt a political project; albeit one that was to be shielded strictly from the influence of daily politics and entrusted to the medium of law instead. From the early 1970s onwards and following its own post-ordoliberal 'Keynesian moment' – which was legally anchored within its 1967 stability law (*Stabilitätsgesetz*) (Joerges 2011a) – Germany had pursued a monetarist programme encompassing an institutional constellation that was readily reproduced at European level: the primacy of fiscal policy and establishment of an economic policy dedicated to realisation of the 'magical quadrant' – price stability, high employment, balance of payments and appropriate economic growth – were to be secured by virtue of the guaranteed status of monetary policy and its anti-inflationary dedication to price stability. This vision was to be well served by means of establishment of an independent central bank far removed from all political influence and placed firmly outside the institutional structures of the Union. In the meantime, Giandomenico Majone (2010: 34ff, 162) has denounced this construction as a 'constitutional monstrosity'; nonetheless, as Fritz Scharpf (2011: 5) has summarised the *Bundesrepublik* was not badly served by this re-arrangement. We should remember that Great Britain, the evangelising force for economic change within Europe, followed far more radical programmes at home, but refused to dispense with Sterling (Glasman 1996: 96ff). What then led to the more general European commitment to monetary union? Following Polanyi's analysis, the 19th century market economy did not come into being 'on its own account' but was, instead, a product of the planned realisation of the functional institutions, upon which it relied in order to be able to operate (Polanyi [1944] 2001: 135ff). *Cum grano salis*, the same might also be said for the ending of the welfare/social consensus in the 1970s. The old arrangement was declared to be no longer tenable and a fundamental re-orientation of economic and social policy was set in motion (Glasman 1996). Europe made ready use of the new *zeitgeist*; initially with the intensification of Jacques Delors' 'Single Market programme', within which the institutionalisation of economic rationality became a theme to the tune of which all political dealings were forced to dance.[1] The 'monetarist' Monetary Union, together with its accompanying Stability Pact[2] were to follow this model.

The law also availed itself of this new constellation: the institutional contours of the internal market were laid down with the aid of legal innovations[3] which allowed the law to engage with the evolution of the market in such a manner that the Union might also be deemed to be a 'regulatory state'.[4] Nonetheless, the later claim that this re-regulatory re-structuring by means of preparatory and accompanying jurisprudence encompassed a 'counter-movement' in the terms described by Polanyi (Caporaso and Tarrow 2008) is clearly a false one (Höpner and Schäfer 2010). The only *planning* that was visible within the functionalist synthesis of market and law within the internal market was one which owed its genesis to the policy of *laissez-faire*. However, it is also true that distinct 'counter-movements' were and are detectable, which, in the course of the 'perfecting' of the internal market, have sought to secure – 'through law' – arenas of social and political intervention; counter-movements to which we will return regardless of their at present not so impressive performance.[5]

Our initial concern here, however, is with the function of law within an economic and monetary union which is often seen to be the crowning moment of internal market policy and just as often conceived of as the herald of a federal conclusion of the European

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[1] Note that our notion of rationality is not that of autopoietic societal subsystems as in use in systems theory; terms and concepts are instead taken from Lepsius (1997: 57ff); for application to Europe, see Lepsius (2000: 203ff).
[2] Decision of the European Council on the Stability and Growth Pact, OJ C 236 of 2 August 1997 (Article 12); some details in Joerges (2005: 474ff) and Joerges and Everson (2004). In the Treaty of Lisbon see Article 126 and Protocol No 12.
[3] See details in Joerges et al. (1988: 305ff).
[4] On this concept, see Majone (1996: 321ff).
[5] See the section on de-socialization below.

project (Majone 2011). Once again, the notion of 'integration through law' is often seen as one which will determine the process of the 'constitutionalisation' of Europe. At the same time, however, the German Constitutional Court retained a jurisdiction for itself in its judgment on the Maastricht Treaty, according to which the *sine qua non* for German participation within monetary union remains the material and institutional substitution of legal rules for politics.[6]

This jurisdictional assertion was made in the course of a curious chain of reasoning. The Court first addressed the arguments of the main plaintiffs, in particular the argument that the European Union possessed such wide-ranging competences that Nation States could no longer take action with regard to their own 'fundamental' tasks. Such a situation, so it was argued, endangered the future of *democratic statehood*. This de-democratisation argument was conceived of with specific regard to monetary policy. The Court nonetheless countered, arguing that law had endowed monetary union with a democratic political structure of its own. Insofar as they were compatible with legal structures, law had made of ordo-liberal and monetarist theorems instruments of 'its own', or had given them a 'democratised' legal form: economic integration, so it was maintained, was an autonomous and apolitical process, which might and must take place beyond the reach of member state influence. By virtue of a constitutional commitment to price stability and rules that guarded against inappropriate budgetary deficits, monetary union was correctly structured. Accordingly, all doubts about the democratic legitimacy of economic integration could be denied. This was, without doubt a surprising conclusion: a greater degree of surprise, however, might have been caused by the fact that German public lawyers took little or no notice of the economic-political reasoning of their own Constitutional Court.[7]

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[6] On the following, see early comments by Joerges (1996).

[7] By contrast, critique focussed on the characterisation of the Union as an 'association of states' (*Staatenverbund*), its notification of its future refusal to enforce any legal acts of the Union made beyond the limits of its competences, and, above all, its definition of democracy as a means whereby a 'relatively homogeneous people' (*Staatsvolk*) might give expression to all those facets that bind it – 'emotionally, socially and politically' together. The tone for critique was largely given by Weiler (1995).

The sustainability and acceptability of this legal construct was, however, to prove to be of short duration.[8] Germany, France, the Netherlands, as well as others, failed to respect the rules of the stability pact. The Commission's much vaunted efforts to take action against deficits dwindled into nothing. Why did all of this happen? Why would it all get so much worse? Why is the Union now experiencing an emergency moment of its own, a moment of derogation from Article 122(2) TFEU and provision of euphemistically called solidarity payments,[9] a moment in which the ECB has been forced to disregard its own statutes (Seidel 2010), a moment in which national parliaments have been required to schedule emergency sitting, and a moment in which Greece has been forced to learn that its sovereignty has now been limited? As yet, no explanatory academic reference has been made to Polanyi and his analysis of the 'good' of money[10], nonetheless, it now seems more than appropriate to recall his classification of money as a 'fictitious commodity'[11], as well as his identification of the risks of destruction to the functional conditions for market economies that are to be found within a broader society. The legal constitution of monetary union within the EU 'Europeanised' ordoliberal-monetarist conceptions; the law, however, could not hope ever to substitute for the necessary historical evolution of matchingly Europeanised social preconditions for successful monetary operation. Majone founds his conclusion that the ECB is a 'constitutional monstrosity' in the fact that the Bank is required to pursue its prescribed aim of monetary stability within a political vacuum and might not make adjustments for socio-economic disparities within the Union.[12] As Scharpf (2011) adds, the institutionalised inability to do anything other than react to instability and imbalance with intensified austerity programmes, not

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[8] For more detail on the following, see Joerges (2005).

[9] The German Constitutional Court deliberated on solidarity payment to Greece and the European solidarity funds on 9 June 2011 (*Griechenlandhilfe* and *Euro-Rettungsschirm*), see press release Number 37/211, available at http://www.bundesverfassungsgericht.de/en/press/bvg11-037.html, and the English translation of the judgment on the website of the Bundesverfassungsgericht. The briefs on behalf of the plaintiff, Gauweiler, can be accessed at http://www.jura.uni-freiburg.de/institute/ioeffr3/forschung/gutachten.

[10] See, for example, Amstutz (2011: 233).

[11] "Money … is merely a token of purchasing power which, as a rule, is not produced at all, but comes into being through the mechanism of banking or state finance" (Polanyi [1944] 2001: 72).

[12] See Majone (2010), and in more detail Majone (2012, forthcoming).

only threatens the well-being of European citizens, but also endangers social acceptance for the Union.

De-socialisation

"Labour is only another name for a human activity which goes with life itself, which in its turn is not produced for sale, but for entirely different reasons, nor can that activity be detached from the rest of life, be stored or mobilized" (Polanyi [1944] 2001: 73).[13]

> To allow the market mechanism to be the sole director of the fate of human beings and their natural environment, indeed, even of the amount and use of purchasing power, would result in the demolition of society […] [N]o society could stand the effects of such a system of crude fictions even for the shortest stretch of time unless its human and natural substance as well as its business organization was protected against the ravages of this satanic mill.
>
> (Ibid.)

In Polanyi's prognosis this would prompt the evolution of 'protective countermoves', which he then found in the 19th century:

> While the organization of world commodity markets, word capital markets, and world currency markets under the aegis of the gold standard gave an unparalleled momentum to the mechanism of markets, a seep-seated movement sprang into being to resist the pernicious effects of market-controlled economy. Society protected itself against the perils inherent in a self-regulating market system.
>
> (Ibid.: 76)

Following WW II, he identified counter-movements within the welfare state programmes of 'popular government' which were also designed to prevent the return of the recent fascist past (ibid.: 127ff).[14] Certainly, during a period of 'embedded liberalism' (Ruggie 1982), the European Economic Community and the national welfare/social

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[13] As Glasman (1996: 4) puts it: "Labour is the activity through which people combine their knowledge and energy in order to reproduce their culture and satisfy their needs".

[14] For prominent confirmation, see Judt (2005: 791ff) and now also Judt (2010: 127ff).

state were at first to co-exist peaceably and this notwithstanding the fact that the EEC was conceived of as an exclusively economic project and the sphere of the 'social' was consequently considered to be a purely national matter. This situation was nonetheless not to be sustainable as Europe of the 1980s chose to diagnose its economic ills as sclerosis and institutionalised the programme for completion of the internal market in such a manner that this programme would become the binding reference point for politics.[15] Such consequences were, at the time, anything other than obvious. The internal market programme and, above all, its constitution as a 'regulative state' were not meant to reproduce the battle cry against redistributive politics that had been sounded at national level; rather, much faith was invested in Delors – above all, in his roots within French socialism – and the subsequent hope was that the integration project would also develop a stronger 'social dimension' which would lay the foundation for a *European* social model.[16]

The eastern enlargement process, however, had such a fundamental impact upon the European constellation, that unstinting efforts to intensify the integration project in order to augment its legitimacy similarly proved to be counterproductive, merely reproducing the by now sclerotic European model. Enlargement brought with it intensified socio-economic disparities within Europe. By the same token, then, political efforts to deepen integration – noticeably by means of the promise of a European constitution – were also forced to renew their commitment to a 'European social model'. At the same time, however, it became readily that Europe's 'social dimension' would not function as an equivalent for any one of the national models, and much less would it result in the synthesis of national social models. Even following Maastricht, Amsterdam and Lisbon, Europe still lacked the necessary social competences; a fact which was much less an accident and much more a result and expression of socio-economic disparities and historical and political divergence (see Rödl 2010). A far more sensible approach might thus have been one which admitted that political room for manoeuvre was highly limited, one which re-modelled Europe's social agenda as a simple compatibility agenda, minimising conflicts between national social constitutions and the openness of European markets, or even one which left the

[15] See Majone (2010); Scharpf (2011); and Glasman (1996).
[16] See, for more detail, Joerges (2011b: 10).

social question for another more propitious political moment. This was not to be: enlargement of the European space instead heightened promises of increased European wealth. Massive redistribution along the lines of the German reunification model was not an option. The sole strategy that was available was a market-oriented one.

This strategy was pursued with vigour by the European Commission, together with interested parties in old and new Europe, and – as ever – found its powerful expression within the legal medium. The *Viking*, *Laval* and *Rüffert* judgments[17] are the most characteristic and discussed legal elements of this strategy:

> Article 43 EC is to be interpreted to the effect that collective action […] which seeks to induce a private undertaking […] to enter into a collective work agreement with a trade union […] constitutes a restriction within the meaning of that article.
>
> (*Viking*)

> Article 49 EC and Directive 96/71 are to be interpreted as precluding a trade union […] to force a provider of services established in another Member State to enter into negotiations with it on the rates of pay for posted workers.
>
> (*Laval*, para. 111)

> Directive 96/71, interpreted in the light of Article 49 EC, precludes an authority of a Member State […] from adopting a measure of a legislative nature requiring the contracting authority to designate as contractors for public works contracts only those undertakings which […] agree […] to pay their employees […] at least the remuneration prescribed by the collective agreement in force at the place where those services are performed.
>
> (*Rüffert*, para. 43)

[17] C-438/05, *International Transport Workers' Federation, Finnish Seamen's Union* v *Viking Line ABP, OÜ Viking Line Eesti*, [2007] ECR I-10779; C-341/05, *Laval un Partneri Ltd* v *Svenska Byggnadsarbetareförbundet*, [2007], ECR I-11767; C-346/06, *Rechtsanwalt Dr. Dirk Rüffert* v *Land Niedersachsen*, [2008], ECR I-01989.

This is not simply tortuous English. Instead, it is no less and no more than the judicial toppling of the post-war *acquis* of the common European labour law constitution.[18]

Is the ECJ 'allowed to' refashion the national labour law constitution? Why did this happen? The answer is simple: the Union has proved itself incapable of supplementing its market constitution with a labour and social constitution because its new (eastern) members view market rights as guaranteeing their own development potential; because welfare state jurisprudence has been eroded in the old (western) member states, European law has swung into action. Law and case law played a decisive part in the integration through law project and its constitutionalisation. The acceptance of the project derived from the fact that this newly made law might be understood as a common European project situated far beyond traditional political schisms. With its recent jurisprudence, however, the CJEU has now prised open national constitutions and alienated the national constitutional jurisdiction without, however, being able to offer anything in return other than a neo-liberal European perspective. European law has become political – and with this has undermined the normative integrity of the 'integration through law' project (Everson 2011).

Disenfranchisement

'Land, by the same token, is simply another word for the nature that is not produced by man' (Polanyi [1944] 2001: 73). It is tempting, if not natural for us to translate the fictitious commodity of 'land' into the term, 'environment', and to denote the concept of environmental protection to be one of those measures designed to prevent the inexorable commodification of this resource. To be sure, our reference to the Polanyian notion of 'land' may seem daring. And yet, there is a kernel of validity in our admittedly extensive interpretation: the transformation of atomic energy into the market good of electricity has a fundamental impact upon nature and life. Supranational regulation of 'protection' within the Union is one of the greatest achievements of the integration project. Yet, atomic energy is very deliberately excluded from this achievement. Disdaining titular use

[18] Amongst a wealth of comment, the clearest formulation is to be found in Lyon-Caen (2008).

of the ugly term 'atomic energy', the Euratom Treaty of 1957[19] nonetheless emphasised in its preamble that "nuclear energy is an indispensable aid for the development and invigoration of the market and for peaceful advance". Declaring itself to be 'determined to create the conditions for the establishment of a powerful nuclear energy industry,' the Treaty similarly left the decision for or against the use of this form of energy to individual nation states. The Lisbon Treaty has not deviated from this position, instead re-iterating in Article 194(2) that: "each member state has the right to determine the conditions for the use of its own energy resources, to choose between different energy resources and to determine the general structure for its energy provision".

This is misleading since, in common with many other environmental risks, the dangers posed by nuclear energy cannot be contained within national borders. If we believe that democratic constitutions guarantee the right of citizens to act as the last instance of decision in relation to legal acts that impact upon them, then the cross-border risks of atomic energy might be argued to embody a structural deficit within the territorial organisation of democracy. By the same token, it may similarly be argued that it is the role of European law to compensate for this deficit and that the legitimation of this law derives from its capacity for compensation, from its ability to bridge the gap between 'participation and impact'.[20] Nuclear energy perhaps represents one of the most critical areas with regard to compensatory functions: European law must surely not acquiesce to the structural democratic deficit. Yet, just as is the case with regard to the social deficit, the refusal to transfer decisional competences in the area of nuclear energy derives from insoluble interest conflicts and divergent political-normative conceptions. What can law do, what politics do within such a constellation?

The CJEU was confronted with this problem in the course of conflict between the state of Upper Austria and the Czech Republic on the

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[19] Consolidated version of the Treaty establishing the European Atomic Energy Community', *Official Journal of the European Union*, 2010/C 84/01, 30 March 2010.

[20] The formula ('*zwischen Teilnahme und Betroffenheit*') is to be found in Habermas (1991: 19), and also in Luhmann (1991), albeit that the systems theorist uses the formula not in order to describe a problem within democracy, but rather as a starting and reference point for the sociology of risk. See, also, Luhmann (1995: 141ff).

operation of the nuclear power station at Temelin.[21] The conflict had a long history, stretching back to 1985 (Hummer 2008), and clearly demonstrated tensions between legal-institutional competences and practical-political operational pressures. As late as 2001, AG opined Jacobs that 'according to Community law', member states must be understood as retaining exclusive (or, almost exclusive) competence in technological questions of nuclear safety.[22] Following the Chernobyl disaster and the process of eastern enlargement, the old member states of the atomic community were confronted with nuclear technologies and industries to whom they did not wish to grant this degree of autonomy. An answer was sought in the 'melting process' somewhere between law and politics, and was seemingly found in a technological upgrading of Temelin which satisfied the demands of the European Commission (ibid.: 506).

Nonetheless, such arbitration was to fall on the deaf ears of Upper Austria, who reacted to Temelin with an *actio negatoria* designed to proscribe the potential for cross-border ionising radiation from the plant.[23] The Czech owners of the plant countered, pointing to the legal authorisation of the plant and to paragraph 364(a)(II) of the Austrian Civil Code, which makes enabling provision for monetary compensation for damage suffered following an official authorisation.[24] At this stage, the European context becomes clear: is Austria required to recognise a Czech authorisation? Might Austria assert a successful claim that it would never have granted an authorisation since an Austrian constitutional amendment of 1999 proscribes the establishment and operation of nuclear plants?[25]

This is a complex interest conflict: Austrian and Czech law contradict one another. Europe has no explicit competence which would allow for a clear decision between an Austrian 'no' and a Czech 'yes'. Last

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21 Case-115/08, *Land Oberösterreich* v *ČEZ as*, judgment of 27 October 2009.

22 AG Jacobs, 13 December 2001, Case C-29/99, *Commission* v *Council*.

23 Para. 364(2), allows for neighbouring property owners to begin action to proscribe activities which have an unusual impact across property boundaries.

24 Para. 364(a), limiting actions to claims for compensation only in the case of an official authorisation.

25 Bundesverfassungsgesetz für ein atomfreies Österreich, BGBl. I Nr. 149/1999, available at: <http://www.ris.bka.gv.at/Ergebnis.wxe?Abfrage=Bundesnormen&Titel=Bundesverfassungsgesetz+f%C3%BCr+ein+atomfreies+%C3%96sterreich&VonParagraf=0>.

but not least, the conflict also encompasses 'temporal dimensions', or to use the correct legal terminology – in order to describe contextual alterations in the operational environment of the Euratom Treaty – a possible *lex cessante*: to what degree might the Euratom Treaty of 1957 still be considered to be binding, given that it refers to out-of-date technical data and bases itself on laudations for nuclear energy that have since been fully discredited? The CJEU nonetheless remained unimpressed and re-iterated the European legal *acquis*: the non-discrimination principle, proscribing discrimination upon grounds of nationality, also held good in the realm of nuclear energy. The failure to recognise the Czech authorisation had the same result as discriminatory treatment upon the grounds of nationality'.[26]

Although this was not a judgment made with explicit reference to fundamental political conflict on nuclear energy, it was nevertheless a judgment that demanded more from the opposition to this form of energy than it did from its users, since it imposed a form of 'toleration duty' upon them. The debt of the Euratom Treaty to a traditional international legal model of sovereignty – a model not impinged upon by Article 114(2) – gives rise to an enduring constellation: the whole of the Union must tolerate nuclear dangers for so long as just one member remains attached to this form of energy. This conclusion immortalises the democratic deficit that is found within the structures nation state; a deficit, the compensation of which is the most noble of tasks performed by European law – a compensatory performance that also provides one of the strongest legitimating bases for European law. The new 'Citizens Initiative' laid down in Article 11(4) TFEU might be a means whereby fundamental conflict about nuclear energy might be brought to a 'European' political arena. However, the Citizens Initiative is, in itself, a poor substitute for a European referendum, opening up instead a simple possibility that citizens might make suggestions about themes that they feel require a legal act of the Union in order to change the Treaties.[27] The exact legal impact of the Citizens Initiative remains a matter for discussion: do the formulations of Article 11(4) preclude the possibility that citizens might demand changes within primary European law, including the provisions of the Euratom Treaty? Not

[26] Case C-115/08, para. 72.
[27] The recent Regulation 211/2011 reproduces this formulation in Article 4(2). *Official Journal of the European Union* 2011/L 65/1, 11 March 2011.

only the Commission, but also the Green Party within the European Parliament is of this opinion.[28] If citizens have been denied the right to demand legal changes, even to primary law and inclusive of the 1957 Euratom Treaty, then they have been disenfranchised.

Unfreezing the law-politics relationship through conflicts-law constitutionalism

What should be our response when we observe that the overburdening of law has so far not been sufficiently compensated for by institutional innovations? What alternatives do we have if it seems highly unlikely in view of Europe's political and socio-economic constellation that such steps will be taken in a foreseeable future? We cannot do, let alone accomplish, much in our ivory towers. Our only option is to submit ideas – and it simply seems irresponsible *not to consider* perspectives which do not depend on some big-bang. I am not going now to discuss more thoroughly than in the preceding more implicit remarks the paradigms of legal integration theory – and their exhaustion[29] – or consider the normative merits and political chances of federalist visions. I will instead restrict myself to a very brief re-statement of the conflicts-law approach, its theoretical ambitions and practical limits. Please do not expect me now to provide recipes for the threefold *problématique* discussed in the previous section. That would be pure hubris and far beyond the lawyer's – and the law's! – potential and vocation. The idea of 'conflicts-law constitutionalism' is not about the delivery of so-called 'solutions'. It is instead about a re-configuration of the law and politics relation, which seeks to save the project of 'integration through law' and the idea of law-mediated legitimacy, albeit in an alternative, radical proceduralisation of the category of law.

Conflicts-law constitutionalism

The premises of the approach can be simply summarised: the Member States of the European Union are no longer autonomous. They are, in many ways, inter-dependent, and hence depend upon co-operation. It seems safe to assume that this co-operation will not lead to the establishment of socio-economic homogeneity and/or a

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[28] See <http://www.greens-efa.eu/fileadmin/dam/Documents/Publications/2011-03-15%20ECI%20Broschuere%20fin%20for%20internet.pdf>; see also Krajewski (2010); Joerges (2011c); and more recently Wolf (2011).
[29] See Joerges (2011b).

strong federal entity in the foreseeable future. It seems in view of the histories of European democracies, and their uneven potential and/or willingness to pursue objectives of distributional justice, to respond to economic and financial instabilities, and to cope with environmental challenges highly unlikely that the Europeans will converge in their political perspectives, and, in view of the enormous complexity of their social systems and the diversity of their entitlements, it is inconceivable that they will institutionalise a pan-European welfare system. The future of the European project seems to depend upon the construction and institutionalisation of a 'third way' between or beyond the defence of the nation state, on the one hand, and federalist ambitions, on the other.

If there is a kernel of truth in these premises, we should refrain from conceptualising and portraying European law as an ever growing and ever more comprehensive body of rules and principles of progressively richer normative qualities. What European law has, instead, to learn, especially when it comes to Europe's social dimension, is to live with its diversity and to take the fortunate motto of the otherwise unfortunate Draft Constitutional Treaty seriously. 'Unity in Diversity'[30] is hence Europe's true vocation and, so we suggest, it is one that can be realised through a new type of conflicts law understood as Europe's constitutional form. This suggestion has its technical complexities. Its core analytical assumptions and normative messages, however, are transparent: the idea of a European conflicts law departs from the sociological observations already alluded to and spells out their normative implications. Under the impact of Europeanisation and globalisation, contemporary societies experience an ever stronger schism between decision-makers and those who are impacted upon by decision-making. This schism is a normative challenge to democratic orders. Increasingly, constitutional states are unable to guarantee the inclusion of all of those persons who are impacted upon by their policies and politics within their internal decision-making processes. The democratic notion of self-legislation, however, which postulates that the addressees of a law should be able to understand themselves as its authors, demands 'the inclusion of the other'. The conflicts-law approach builds upon these observations and arguments. As a

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[30] Article I-8 Draft European Constitutional Treaty, Official Journal of the European Union 2004/C 310/1, 16 December 2004.

consequence of their manifold degree of inter-dependence, the Member States of the European Union are no longer in a position to guarantee the democratic legitimacy of their policies. A European law that seeks to restrain such external effects and to compensate for the failings of the national democracies, may induce its legitimacy from this compensatory function. With this, European law can, at last, free itself from the critique of its legitimacy which became ever more intriguing in the last decades. Instead of requesting the Union to cure its democracy deficit, we should understand and develop the potential of European law to compensate the structural democracy deficits of the European nation states.[31]

'*Wo aber Gefahr ist, wächst – Das Rettende auch*'[32]

What difference does it make? This query requires, and deserves, of course, more detailed answers than can be given here even in the substantively moderate, albeit methodologically demanding perspectives of the conflicts-law approach. I will not shy away completely, however, from commenting briefly on all of the three problems which the second section has addressed.

Money

The failures of the whole construction of a Monetary Union, which can, by now, no longer be silenced, have led to hectic activities, opaque bargaining and a treatment of the rule of law which seemed to be far beyond the power of juridical imagination.[33] Why is it, one should first ask, that the otherwise enormously prolific academic constitutionalist community does not speak up? One of the few commentators in Germany who does and seeks to provide affirmative arguments is Christian Calliess.[34] He invokes a serious normative reason, namely, solidarity, understood as a valid legal

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[31] See, in more detail, Joerges (2010; 2011a and 2012).

[32] From Hölderlin [1802] (1949).

[33] Article 122(2) TFEU was so far not a widely known provision and therefore deserves to be cited: "Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken". The financial crisis not qualified as 'natural disaster' but as an 'exceptional occurrence ' beyond the control of Greece, Ireland, Portugal.

[34] Christian Calliess, 'Treue und Solidarität', *Frankfurter Allgemeine Zeitung*, 30 June 2011, p. 6. See also Calliess (2011a).

principle and duty in the EU, to justify the apparent readiness to take the letter of the law very lightly. There are political scientists, even economists and philosophers who share this concern.[35] Solidarity is the overriding principle and duty in the name of which serious normative reason is being invoked in such pleas to take the letter of the law very lightly. The solidarity among the Member States of the EU, as it is actually practiced, may, however, have much more mundane reasons and much less laudable effects (Streeck 2011). What is clearly visible is that its legal implementation will come at a price: solidarity militates in favour of helping the other, but is to be exercised with a view to accomplishing the cure for the other's failures, who must, therefore, be subjected to corrective economic governance ('*nachholende Wirtschaftsregierung*') (Calliess 2001a)[36] by those who help.

Labour

The recent labour law jurisprudence of the ECJ[37] suggests itself as a less dramatic acid test of the viability of the conflicts-law approach. I have discussed this jurisprudence so extensively elsewhere[38] and restrict myself here to one seemingly technical (1) and another admittedly conservative (2) remark.

(1) The most basic of all operations in cases with international dimensions is called 'characterisation'. It is an operation which corresponds to the issue of competences in European law. The conflict with which we are confronted in cases such as *Viking* concerns economic freedoms, on the one hand, and collective labour law, on the other. Antoine Lyon-Caen, in a comment on the ECJ's judgments, has lucidly accentuated the diversity of both bodies of law.

> *Dans les sociétés d'Europe de l'Ouest, le droit du travail s'est constitué par émancipation du droit du marché, dénommé moyennant les variations terminologiques qu'il importe de ne pas oublier: liberté du commerce ici, freedom of trade ailleurs […] Ce n'est pas que des règles sur le travail n'existaient pas avant cette émancipation, mais*

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35 For a critique with instructive references, see Morgan (2011).
36 The term recalls Habermas (1990).
37 See the cases in note 17 above.
38 See, for example, Joerges (2010) and Joerges and Rödl (2009).

> *elles relevaient d'avantage d'une police du travail, partie plus ou moins autonome d'une police du ou des marchés*.[39]
>
> (Lyon-Caen 2008)

It follows from this diversity that the economic freedoms cannot trump collective labour law. Both sets of provisions, which are potentially applicable to the case in question, have their specific legitimacy. But rather than pleading for the supremacy of the former and defending the latter as untouchable, we should ask how the two regimes can be co-ordinated. Such a co-ordinative effort is clearly visible in the Posting of Workers Directive;[40] it also seems obvious that Article 153(5) TFEU (ex-Article 137(5)), which stipulates that "the provisions of this Article shall not apply to pay, the right of association, the right to strike and the right to impose lock-out", can, and indeed should, be read in this light. The reference of the Treaty to national orders should be understood as a principle of respect for labour law and a pragmatic implication of the insight into the enormous difficulties to overcome the diversity of national laws by a uniform European regime.

(2) Does all this mean that the established democracies of old Europe should be entitled to protect the interests of their labour force against the newcomers from the accession states? This question does not address the issue at stake here comprehensively enough. We need to ask whether it is really in the long-term interest of the new Member States to bring cheap labour to old Europe and to destroy the welfarist traditions of their western and northern European neighbours; we need to consider the implications of such moves for the long-term competitiveness of the accession states and their chances for similar developments. To cite Tony Judt once more: Why should we rush "to tear down the dikes laboriously set in place by our predecessors? Are we so sure that there are no floods to come?

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[39] 'In West European societies labour law was constituted as an alternative to the law of the market. It developed terminological distinctions which one must not disregard: *liberté de commerce* here, freedom of trade there […]. To be sure, legislation relating to work had been in place prior to that emancipatory move, but pertinent rules were meant to control work in a way which was more or less akin to laws policing the market or markets in general' (translation by the author).

[40] Directive 96/71/EC concerning the posting of workers in the framework of the provision of services, *Official Journal of the European Union*, 1996/L 18/1, 21 January 1997.

[…] To abandon the labours of a century is to betray those who came before us as well as generations yet to come". It would be misleading to represent the social democratic *acquis* as an ideal world or an ideal past. "But among the options available to us in the present, it is better than anything else to hand" (Judt 2009)[41]. To be sure, 'the social problem' of contemporary societies cannot be equated with the kind of class conflict which generated labour law a long time ago.[42] And yet, it is more than unlikely that the adaption of labour relationships to the requirements of neo-liberal 'flexicurity' will provide satisfactory social conditions and equally difficult to understand why contemporary labour and employment relationships could and should be uniform in an ever diverse European Union.

Land

With respect to the debate in Europe over atomic or nuclear energy I have explained my position above at some length. Let me add: Atomic energy confronts us with fundamental difficulties. It took the Germans decades of political contestation before they concluded 'after Fokushima' that their *Ausstieg* is politically opportune, economically and technologically feasible. There are, however, many reasons for other societies *not* to follow that example – and to continue to debate their validity. Atomic energy is a problem which should not be delegated to expert circles, intergovernmental bargaining or the law, not even to the European Court of Justice.[43] Energy policy needs to be embedded in legitimating political processes. Such processes are unlikely to end in European-wide uniformity. They may, however, promote mutual understanding and the readiness to take serious concerns of neighbouring societies neighbouring societies seriously. How could this be accomplished? The formation of public opinion is under way – and European law has with the new citizens' initiative even a new means to further transnational communication and contestation (Joerges 2011c). Nice in theory, but unlikely to happen in practice?

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[41] See the concluding chapter in elaboration in Judt (2010: 227ff).
[42] See, famously, Dahrendorf (2008).
[43] See my critique of the *Temelín* judgment in Joerges (2012).

Perspectives and threats: The crisis as constitutional moment and the shadow of Carl Schmitt

The European crisis is proceeding at such speed that any effort to come to terms with it academically is likely to be politically outdated before an intervention has had a chance to reach a public beyond the seminar in which it was presented. In all of the conflict scenarios surrounding the three fictitious commodities – money, labour and land – we have witnessed ever more and ever more complex irritations during the last months. 'Money' clearly occupies the centre stage: Europe keeps oscillating in its fight against the crisis between secondary legislation outside European competences, intergovernmentalism in tandem with private governance arrangements, 'soft' modes of governance and hard secondary legislation. Article 136 TFEU has been amended and now provides that euro-area states "may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole". The Council, Commission and Parliament have thereafter produced – at breathtaking speed – an enormous bundle of measures which include new Euro-speak. Following the European Council's 'Euro Plus Pact', which primarily concerned matters outside the EU's competences,[44] Regulation 1466/97 was amended by the introduction of the 'European Semester for Economic Policy' which provides for an annual external assessment of national stabilization programmes in April.[45] The highlight so far is the 'six pack', a bundle of measures providing for the surveillance of fiscal discipline and measures to correct macroeconomic imbalances which was adopted on 4 October 2011 with the approval of the EP and will enter into force in 2011.[46] – The pressure on 'social Europe' is getting more intense than ever (Bruun et al. 2012) while 'land', for the time being, seems to be a

[44] European Council, Conclusions – 24/25 March 2011, EUCO 10/11, Annex 1; see the analysis of Zurek (2011).

[45] Regulation 1466/97 as amended on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Article 2-a. Available at: <http://ec.europa.eu/economy_finance/economic_governance/documents/com2010__526_amendments_en.pdf>.

[46] For an overview see the Conclusions of the European Council of 20 April 2011, EUCO 10/1/11 REV 1, CO EUR 6 CONCL 3 and thereafter in particular Regulation 1173/2011 of the EP and of the Council on the effective enforcement of budgetary surveillance in the euro area of 16 November 2011, OJ L 306, 1 of 13 November 2011.

dormant theme. – The academic legal community has only started to explore these transformations.[47]

In the present context we cannot try to provide any comprehensive account, let alone a viable analysis of the certain and uncertain risks all these occurrences entail. We will instead continue with our observations on the fate of the integration through law project – What did law accomplish? Where did it fail? What is law going to endure? – and pursue these queries from some theoretical distance.

Habermas: Europe as democracy

One cannot be more passionately committed to the European project than Jürgen Habermas (2009; 2011a; 2011b) or Hauke Brunkhorst[48], Habermas' closest ally in the analysis of the role of law and democratisation of the postnational constellation. Both agree in their diagnoses. They see Europe on the road to 'executive federalism' and 'technological (mis)management', which is threatening democracy and the rule of law. However, both also believe that the crisis may be transformed into a democratic constitutional moment.

Habermas has never mentioned the conflicts-law approach in his work on Europe. And yet, I continue to see many affinities between my re-construction of European constitutionalism and Habermas' work including his recent essay (Habermas 2011a). Habermas defines the democratic deficit of the nation state in a specific and very plausible way. Nation states, so the argument goes, are no longer in a position to accomplish what their constituencies expect from democratic rule. The erosion of their power is due to both growing inter-dependence and the dynamics of globalisation. Both aspects are compelling reasons to co-operate transnationally and to transfer competences to supranational institutions. As long as this transfer does not damage democratic procedures, it can operate to rescue democratic constitutionalism. The Union represents this potential. The European project can be re-constructed as a rescue of democratic constitutionalism which is respectful of the democratic credentials of its Member States while, at the same time, institutionalising supranational rule. The peoples of Europe can understand this

[47] See Antoniadis (2011); Bruun (2011); Calliess (2011b); Chalmers (2011); Fischer-Lescano and Kommer (2011); see also Chapter 12 in this report.
[48] Among Brunkhorst's essays see his recent piece in *Leviathan* (Brunkhorst 2011).

supranationalism as a democratic command because it enables them to accomplish what their nation states are unable to achieve. Once more, Habermas operates with the construct of co-originality in order to reconcile what is usually understood as a dichotomy or antagonism. In his vision, we are citizens of the Union and of the respective Member States (67). The Union is therefore neither a state nor a federation, but a *Verfassungsverbund* (Pernice). The construction is certainly fascinating, in particular, because it provides good reasons for a bond of solidarity among the peoples of Europe. It is by no means purely affirmative, but provides critical yardsticks. Habermas not only criticises a broad range of practices and omissions passionately but, in addition, identifies design defects in the European institutional architecture. His prime target is the establishment of a monetary union which lacks the powers to govern the economy effectively.

His harsh critique is hitting a mark: The 'imperatives of the markets' are indeed being transferred to 'national budgets' with 'threats of sanctions and pressure on disempowered national parliaments to enforce nontransparent and informal agreements'. This is a disempowerment not only of the Member States of the Union and their democratic institutions but also of European citizens by their governments acting in tandem with European institutions. Europe has to take a decision, both Habermas and Brunkhorst insist. Europe's citizens and their representatives must choose between non-transparent post-democratic executive federalism and an 'aggressive continuation of the drive for a democratically legalised EU'. The choice is not so difficult in normative terms. What is difficult to see is the potential for the organisation of such a decision. What is equally difficult to imagine is a reconstitution of law as we used to know it and a return to the idea of law-mediated legitimacy.

Europe as *Großraum*: Carl Schmitt[49]

Back in the spring of 1939, hence still half a year before the war against Poland, the *'Reichsgruppe Hochschullehrer des Nationalsozialistischen Rechtswahrer-Bundes'* [Reich section of professors in the National Socialist Association of Lawyers] met in Kiel to celebrate the twenty-fifth anniversary of the Institute for Politics and International Law. This was the setting in which Carl

[49] On the following cf. in more detail and references Joerges (2003).

Schmitt presented his new theory of the *Großraum* order in international law (Schmitt [1941] 1995). The core argument of his key note was that the *jus publicum europaeum,* which had made the sovereign state its central concept, was no longer in line with the *de facto* spatial order of Europe. A specific 'sphere/space' (the *Raum*) had to become the conceptual basis for international law, with the *Reich* constituting the order of that space. Schmitt underlined that his notion of *Großraum* was a "concrete, historical and politically contemporary concept" [*konkreten geschichtlich-politischen Gegenwartsbegriff*] rooted "essentially *not in the state but in the technical, industrial and economic sphere*" (my italics) (ibid.: 306).[50] In a revised version of his Kiel speech, Schmitt referred to debates and theorems on the erosion of the territorial state as the harbingers of the necessity to adapt international law to the factual re-structuring of international relations and the replacement of classical international law by norm systems which one would call governance structures today. He underlined specifically two phenomena, namely, the economic inter-dependencies beyond state frontiers [an emerging '*Großraum* economy'] and the valueless rationality of technology-driven developments, which further the dictatorship of 'technicity' [*Technizität*].[51] In the 2nd edition of his essay Schmitt underlined that "a *Großraum order* will be dominated by particular ideological ideas and principles […] whose guarantor and guardian is a people that has proved itself capable of this task". His characterisation of the new German *Reich* as a *Volk* based *völkisch Großraum* are not easily to reconcile with the dominance of 'technicity' as the dominant 'mode of governance' in the *Großraum.* They may be a somewhat opportunistic concession to Schmitt's opponents in the Nazi party (Joerges 2003: 73ff) and at the same time reflect the type of uncertainty which Schmitt expressed in by adding an epigraph to his paper: "We are like mariners on a continuing journey, and no book can be more than a log book." Be that as it may, the reference to 'particular ideological ideas and principles' which are to give political substance to the ordering of the *Großraum* seems but a helpless gesture, a concealed admission of the unavailability of any alternative to either pure technocratic rule or brute force.

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50 "[…] *bezeichnenderweise nicht im staatlichen, sondern im technisch-industriell-wirtschaftlichen Bereich*".

51 For a discussion of this notion see McCormick (1997: 42-46, 92-105).

This is a benevolent explanation of the emptiness of Schmitt's pronouncements which seem nevertheless rooted in his pre-1933 theory of dictatorship and the quest for commissarial powers in the state of emergency (McCormick 1997: 122-56; Kennedy 2011) and also his earlier writings on Europe.[52] In one essay on 'legislative delegations' which was published only shortly before the Kiel conference, some such links become nevertheless discernible Schmitt (1938) observes a blurring of the demarcations between legislative and executive powers in all of the leading democratic states and an apparently irresistible resort to 'simplified' legislative techniques. These tendencies, he concludes, are indicative of a fading away of the inherited distinction and then cites approvingly a jurisprudential authority of the time (René Capitant), a classic of political philosophy (James Stuart Mill), Aristotle and Thomas Aquinas as authoritative confirmation of his equation of legislative and governmental acts: Legislation has become essentially a governmental activity (Schmitt 1938: 267).

What should all this have to do with the present state of the European Union. Ernst-Wolfgang Böckenförde, formerly a judge of the *Bundesverfassungsgericht* and renowned connoisseur of Schmitt's oeuvre, was among the first to characterise the crisis of the Euro and of Monetary Union as an '*Ausnahmezustand*' (state of emergency) which would suspend the rule of law.[53] This was by no means meant as a complacent acceptance of the crisis management he observed in the spring of 2010, let alone of the blatant disregard of the bail-out clause and the provisions on the mandate of the ECB or of the more euphemistic readings prevailing in pertinent comments. The implicit, albeit clear, references to Schmitt, in Böckenförde, have to date not been noted. But the topicality of the substance of Schmittian notions is intensive and alarming. Politics is operating under unforeseen needs (Calliess 2011b: 38), we read, and the law is stressed in a way which seems inspired by the indeterminacy theorem of critical legal studies movement. Contrary to Schmitt, however, the contours of Europe's new ordering are clearly visible. The 'law' approves and

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[52] On which see McCormick (2003).

[53] Ernst-Wolfgang Böckenförde, 'Kennt die europäische Not kein Gebot? Die Webfehler der EU und die Notwendigkeit einer neuen politischen Entscheidung', *Neue Züricher Zeitung*, 21 June 2010, available at <http://www.nzz.ch/nachrichten/kultur/literatur_und_kunst/kennt_die_europaeische_not_kein_gebot_1.6182412.html>.

implements neo-liberal austerity. This is perceived as a condition for the survival of the European project, and the suspension of democratic autonomy in countries like Greece is a price to be paid for acts of the solidarity they experience. Not only Carl Schmitt can feel confirmed in his views of the *Ausnahmezustand*, but also Karl Polanyi with his analyses of the institutionalisation of market rationality; a 'market without a state' (Calliess 2011a: 282) is inconceivable he observed and the kind of discipline which market rationality presupposes, is never an inherent property of economic developments; market societies come about as products of political planning.[54]

Instead of a conclusion

Is Habermas' intimate enemy succeeding in the battle over the ordering of Europe? In the shadow of the sketched-out scenarios, it may appear naïve indeed to reflect upon further alternatives to the nightmares of commissarial 'technicity' dictatorship on the one hand and the desperate voluntarism of 'aggressive democratisation'. And yet, it would seem somewhat irresponsible *not* to do precisely that and to consider what could be done if no kind of big bang will bring about radical change for the worse or the better. Conflicts-law constitutionalism is a pragmatic and modest alternative. Its strength is its realism, its embeddedness in the existing European project – and its potential to revitalise 'the Political' in Europe through a reconfiguration of the law-politics relationship which the integration through law project needs to tolerate and promote.

[54] See together with Polanyi's magisterial narrative his 'The Economy as Instituted Process' (Polanyi [1957] 2001); see also Joerges (1991), for the English translation see Joerges (1996).

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Chapter 4

A proportionate constitution? Economic freedoms, substantive constitutional choices and *dérapages* in European Union law

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> *Bien entendu, on peut sauter sur sa chaise comme un cabri en disant l'Europe!, l'Europe !, l'Europe ! ... mais cela n'aboutit à rien et cela ne signifie rien.*
>
> Charles De Gaulle, 14 December 1965

> History is that certainty produced at the point where the imperfections of memory meet the inadequacies of documentation
>
> Julian Barnes, *The Sense of an Ending*

Introduction

The European Court of Justice (ECJ) and the General Court of the European Union (hereafter, the European Courts)[1] have come to play a key role as guardians of European constitutionality vis-à-vis national (and supranational) legislatures. In discharge of such a task, the European Courts have become inclined to support (and contribute to the dissemination of) a rather peculiar understanding of

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[1] There is also a third European Court, the Civil Service Tribunal, which basically decides controversies between the institutions of the Union and the supranational civil service. This entails that such a Court rarely decides questions with a constitutional dimension. For that reason I do not pay attention to it in this chapter.

economic freedoms, and one could perhaps say, of fundamental rights in general. According to this conception of rights of the European Courts, priority should be assigned to the rights of capital-holders over the socio-economic rights affirmed in most of the fundamental laws of the Member States of the European Union (including, above all, collective fundamental rights and collective fundamental goods).[2]

This double move entails that the argumentative syntax characteristic of post-war democratic constitutional law (the proportionality review of all norms allegedly infringing core fundamental rights) seems to have been turned upside down and used to justify fundamental decisions which would appear to collide with the substantive content of the post-war European constitutions. This so because the national constitutions of the Member States (as, I would argue, the founding Treaties of the Communities) are underpinned by the characterisation of the state as a Social and Democratic *Rechtsstaat*, aimed at the simultaneous realisation of the civic, political and socio-economic rights of its citizens, something which required playing down and circumscribing the protection afforded to the right to private property.

While the present shape of the case law of the European Courts is the result of a long and protracted process (which in this chapter I date back to –at least– the *Cassis de Dijon* judgment), the Luxembourg judges seemed at first to be really tucked away in a fairyland duchy, as Eric Stein (1981) put it long ago, and later to enjoy an extremely good press with legal and politico-scientific scholars. Everything might have changed forever after the European Court of Justice decided in 2008 *Viking*.[3] Viking was a ferry company incorporated in and run from Finland, which intended to wind up its legal existence in that Nordic country and establish itself in Estonia. There was slight doubt that such a decision was motivated by the prospect of lower wages and a less onerous set of obligations for employers under Estonian labour law. When the Finnish trade unions managed to successfully engage into transnational collective action and block the

[2] Admittedly, the constitutional role of the European Court of Justice is more salient. Not only is it the highest court of the European Union *now*, it was also the only European Court around for most of the history of European integration.

[3] To be more precise, the quarter of *Viking*, *Laval*, *Ruffert* and *Commission v. Luxembourg*. *Viking* is here employed as symbolic of the line of jurisprudence resulting from these four cases.

smooth realisation of the plans of the company, Viking started legal proceedings claiming that its right to freedom of establishment had been breached by the Finnish trade unions. The European Court of Justice, following the lead of Advocate General Maduro, basically agreed with the Finnish company. Both the right to freedom of establishment of the corporation and the right to engage into collective action of the workers were part of European constitutional law. But in the case at hand, the right of freedom of establishment should prevail.

This chapter joins the growing chorus of critics of *Viking* and of the case law of the European Courts, but does so in a peculiar fashion, as it assumes that *Viking* is but another turn of a rather old screw. Instead of focusing on the reasoning of the Court in *Viking* or other isolated cases (and claiming, as has been convincingly done on what concerns *Viking*, that Community law as it stood before the ruling supported a different result in *Viking*; a line of criticism which underplays the extent to which *Viking* was but the natural follow up of the previous case law of the ECJ) or on the (limited) legitimacy of European Courts insofar as they are *supranational* institutions (from which it tends to follow the claim that that *national institutions, perhaps national courts,* should stop acknowledging the authority of the European Courts in an unconditional manner), this chapter takes a more structural view and a more long-term perspective.

The chapter assumes that the proper analysis of the case law of the Court requires distinguishing rather clearly two different problems that are somehow entangled in the debate on the legitimacy of the decisions of the European Court of Justice, and perhaps especially aftermath of *Viking*. These two questions are on the one hand the justification of the *structural* role that European Courts play as guardians of European constitutionality and on the other hand the justifiability of defining the *substantive contents* of European constitutional as they are spelt out in the case law of the European Courts, critically including the superior weight assigned to economic freedoms.

Two different questions, two different answers. There is a case to be made for European Courts playing the role of guardians of European constitutionality and for European Courts discharging such a task with the argumentative syntax of proportionality. But proportionality (because it is a formal and not a substantive principle) cannot not provide legitimacy to a ruling by itself. The justifiability of a ruling crucially depends on the justifiability of the substantive choices made when undertaking the proportionality review. Making use of this critical potential of proportionality, I argue that *Viking* and *Laval* are but two instances of a larger and older pattern, the more recent consequences of a *constitutional dérapage* that can be traced back to *Cassis de Dijon*. It was on that judgment that the European Courts introduced an autonomous, self-standing conception of economic freedoms, detached from the collective of national constitutions. It was by means of expanding and spelling out the implications of such a move that the European Courts developed a new understanding of the four economic freedoms which transcended their characterisation as operationalisations of the principle of non-discrimination on the basis of nationality. That was indeed the road to *Viking* and *Laval* and to the constitutional primacy of the rights of capital holders over socio-economic rights. This leads me to make a plea for the recalibration of the jurisprudence of the European Courts on economic freedoms. In particular, it seems to me that some of the most problematic substantive choices made by the European Courts in their case law should be rendered coherent with the common constitutional law of the Member States and with the case law of national constitutional courts acting (admittedly, implicitly for the time being) as guardians of European constitutionality.

The chapter is divided in three parts. In the first part, I claim that there is a very good case for European Courts playing a fundamental role in the guardianship of European constitutional law, including the review of the European constitutionality of national statutes. Such a case is grounded on the *constitutional* nature of Union law and on the systematic interpretation of the Treaty provisions defining the different procedures before the ECJ and the shape and content of the rulings of the ECJ. However, the European Courts have to take seriously the peculiar constitutional nature of the European Union. In particular, the European Courts have to be conscious of the fact that the deep constitution of the European Union is the collective of national constitutions (the constitutional law *common* to the Member States, as the ECJ phrased it relying on the founding Treaties) and of the fact that the guardianship of European constitutionality must be *shared* between the ECJ and national constitutional courts, because they stand in a horizontal, not vertical and hierarchical, relationship.

In the second part, I present several criticisms concerning the way in which the European Courts have come to discharge their task as constitutional guardian when reviewing the European constitutionality of national statutes. Resort to proportionality as the argumentative syntax of constitutional rulings can only carry the European Courts so far because proportionality is a structural principle, and not a substantive one. Contrary to what a good deal of the European literature seems to affirm, resort to proportionality is not enough to render a decision legitimate. On what concerns substantive choices and substantive legitimacy, proportionality is merely a useful analytical device, which allows us to distinguish more neatly the substantive choices made by the European Courts. Focusing on the case law on direct personal taxation, I conclude that the European Courts have tended to leave unjustified some of the most decisive substantive choices in the shaping of its argument. Not only the European Courts have failed to offer a strong justification in favour of its *new individualistic understanding of economic freedoms*, but it favours economic freedoms by assigning the argumentative burden systematically to any conflicting principle. Similarly, the ECJ sets idiosyncratic proof burdens against national norms allegedly infringing fundamental freedoms, and fails to take seriously the normative structure of the principles colliding with economic freedoms when giving concrete weight to each of them in concrete cases. The third and last part holds the conclusions.

The role of the European Courts in the guardianship of European constitutionality

The first thesis: European Courts as guardians of European constitutionality

The first thesis I sustain in this chapter is that the European Courts play a key role in shaping the law in the European Union. This is so to the extent that they elucidate the substantive contents of European constitutional law (foremost economic freedoms) *and* review supranational and national norms against such a yardstick, thus acting as guardians of the core contents of the European constitution.[4] Or to

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[4] For both historical (the European Court of Justice was for a long time the only European Court, which through its case law clarified the constitutional stature and dignity of Community law) and hierarchical reasons (the decisions of the General Court can in some cases be appealed before the European Court of Justice).

put it differently, European Courts exert an authority to review the degree to which supranational and national laws fit with the fundamental principles of European constitutional law when applying supranational norms to concrete cases and when interpretting in general and abstract terms the provisions of Community law (this is what is hereafter referred as review of European constitutionality). This entails that the European Courts have come to play a constitutional role which is not dissimilar from that characteristic of national constitutional courts formally empowerred to ensure the direct effect of their national fundamental law (such as is the case with the German, Italian or Spanish constitutional courts).

My first thesis is very likely to raise (at least) three sets of objections:

- Is it really the case that the rulings of the European Courts result in the fleshing out of constitutional standards that actually limit the breadth and scope of valid policy options to European legislatures? This question is essentially an empirical one, as its positive or negative answer depends on what is present European constitutional practice;

- Should Community law be regarded as a constitutional legal order? Can the alleged primacy of national constitutions be reconciled with the idea that supranational law contains the normative yardstick against which the validity of national laws is to be assessed? This question concerns the normative foundations of Union law; it requires showing that indeed there European Union law is a constitutional legal order, and one which comprises in one way or another national constitutional orders (and consequently, fleshing out the general lines of a constitutional theory for the European Union);

- Are European Courts justified in claiming a role as guardians of European constitutionality? Even if we are to grant that Community law is a constitutional order, is it one where courts are legitimately empowered to act as guardians of constitutionality? Given the transcendence of that choice, can it be traced back to any open political decision codified into the written law? This question requires us to undertake a careful and systematic reconstruction of the provisions of the founding Treaties dealing with the tasks of European Courts.

Do European Courts actually undertake the review of European constitutionality of supranational and national norms?

Is it really the case that the rulings of the European Courts result in the fleshing out of constitutional standards that actually limit the breadth and scope of valid policy options to European legislatures (both supranational and national)? Is there really such a thing as the review of European constitutionality? This question is one that, as has just been said, has to be answered by reference to present European constitutional practice. It thus requires considering what European Courts actually do and how other constitutional actors (courts, parliaments, governments) react to it.

The European Courts pass judgments on the different procedures referred to in the Treaties (now in the Treaty on the Functioning of the European Union).

Some of these procedures do require the Court to decide on the validity of Community acts, including Community legislation. When the European Courts declare that one (or more) norms enshrined in a Regulation or Directive are void, such a judgment entails for all purposes that the said law is *unconstitutional*.

However, the literal tenor of the Treaties seems not to empower the European Courts to declare the constitutionality or unconstitutionality of national norms. The Court cannot rule on the validity of national norms, but at most, on the *infringement* of the Treaties by Member States (a breach which may result from the contents of the national legal order) or on the general and abstract meaning of a Community norm (which may guide a requesting national court to decide how to solve an eventual conflict between a Community and a national norm). While this is *a formally correct* reconstruction of the case law of the Court, a proper consideration of the normative implications of the rulings of the Court will lead us to conclude that indeed the European Courts review the European constitutionality of national norms. This can be perhaps be better illustrated by two of the best known leading cases of the European Court of Justice, those in *Cassis de Dijon* and *Avoir Fiscal*.

In the leading case on economic freedoms, *Cassis de Dijon*,[5] a German court requested the European Court of Justice to clarify the meaning of 'measures having an equivalent effect to quantitative restrictions of imports' in what was formerly Article 30 of the Treaty of European Community. While, as we will see, the answer to a preliminary request is supposed to be general and abstract, the submitting Court could not but inform the ECJ that its doubts centred on a specific German law which conditioned the sale of liquors to their having a minimum alcoholic graduation. That was indeed the case which was pending before the requesting court, and the one for which that court requested the assistance of the European Court of Justice. The pending case hinged on whether that German law was to be applied to the case or not. French *cassis* was legally on sale in France, but had an alcoholic graduation which was lower than the minimum one legally mandated for fruit liquors in Germany. So the request concerned in formal terms how the concept of measures having an equivalent effect to quantitative restrictions of imports was to be interpreted, that question was inextricably linked, in practical terms, to the very concrete facts of the case, and consequently, to the interaction between a German and a French statute. The Court of Justice limited itself in formal terms to throw light on what a measure having an equivalent effect is under Community law. But in doing so, it could not but touch (even if under the veil of generality and abstractness) on the concrete legislation at stake. The operative part of the judgment is very telling in that regard and is worth quoting at length:

> [The concept of] measures having an effect equivalent to quantitative restrictions on imports contained in Article 30 of the EEC treaty is to be understood to mean that the fixing of a minimum alcohol content for alcoholic beverages intended for human consumption by the legislation of a member state also falls within the prohibition laid down in that provision where the importation of alcoholic beverages lawfully produced and marketed in another member state is concerned.

So the Court stated that a *hypothetical law* doing what the German law *actually did* would constitute a measure having an equivalent effect. In substantive terms, this ruling implied that the German law prohibiting the sale of French *cassis* was in breach of Community law.

[5] Case 120/78, [1979] ECR 649.

Given the direct effect of the Treaty provision on freedom of establishment and the primacy of Community law, the necessary implication of the decision was that the German law was to be set aside. In other words, the normative implications of *Cassis de Dijon* were exactly the same as those of a constitutional ruling of a national constitutional court reviewing the constitutionality of a national statute.

In the leading case on the relationship between economic freedoms and national direct tax laws, *Avoir Fiscal*[6], the European Commission requested the European Court of Justice to declare that by means of giving a different tax treatment on the one hand to dividends paid to insurance companies with a registered office in France and on the other hand to dividends paid to insurance companies with a registered office in another Member State, France had breached the freedom of establishment of insurance companies with registered offices in other Member States (Par. 29). The Court granted the claim of the Commission. Formally speaking the outcome of the case was the declaration that France had breached Community law. But in substantive terms, given the direct effect of the provision of freedom of establishment and the primacy of Community law, the ruling not only required the French State to eliminate these provisions from its *code fiscal*, but also entailed that any private party *should* be offered judicial protection against previous and future applications of that norm for as long as it remained in force. So the normative implications of *Avoir Fiscal* were very similar to those of a constitutional ruling of national constitutional court reviewing the constitutionality of a national statute.

While in both cases the Court limited itself to a restrained judgment (the decision that by means of *this concrete normative provision* and *in this concrete case* France had infringed Community law and the decision that a *hypothetical* law banning the sale of goods which could be legally acquired in another Member State would constitute a measure having an equivalent effect to an import restriction), the normative implications of the two rulings had the same normative effects as rulings formally declaring that the German and the French provisions were unconstitutional and consequently to be set aside. While in *Cassis de Dijon* the Court seems to limit itself to offer a general and abstract interpretation of Community law, the judgment

[6] Case 270/83, [1986] ECR 273.

contrasts a German statute with a concrete Treaty provision (free movement of goods) and establishes a derivative constitutional rule which not only largely determines the concrete outcome of the case at hand, but also places some policy options outside of the realm of what national legislators can do. Similarly, in *Avoir Fiscal* the Court seems to restrain itself to a decision on a very narrow factual basis, but still the European Court of Justice sets a precedent applicable in similar cases. A precedent consisting in a derivative rule which places certain policy options outside the reach of the national legislator.

This is compounded by the fact that the structural principles governing the relationship between supranational and national law (primacy, direct effect and attribution of competences) result in the derivative rules having full legal effect not only within the supranational subsystem, but also within each and every national legal subsystem. We are thus confronted with the typical structure of rulings determining the constitutionality of a norm: a norm being reviewed (the German law, the French law), a constitutional yardstick (free movement of goods, freedom of establishment) and a decision on the breadth and scope of what the legislator can do in compliance with the constitution.

Both the substantive case law of the European Courts and its structural implications (the assumption of a power to review the constitutionality of not only supranational but also national laws against the yardstick of European constitutional norms, hereafter referred as a review of European constitutionality) have come to be accepted by all major national constitutional actors. This is well documented in the literature, such as in Karen Alter's (2001) monograph on the "making of an international rule of law in Europe". While she focuses on the acceptance of the structural principle of supremacy of Union law over national law, that process had a *substantive* dimension which basically concerned the unfolding conception of economic freedoms pushed forward by the European Court of Justice. Similarly, Joseph Weiler's writings on the osmotic relationship between the European Court of Justice and national courts (other than constitutional courts or supreme courts in systems without a formal constitutional court) consider the underlying structural reasons why national courts have contributed to affirm and consolidate the role of the European Courts as guardians of European constitutionality. A role that has not been systematically challenged by national legislators. National political actors may have made open critical remarks of this or that judgment, and been even tempted to be ferociously critical of the European Courts (especially of the European Court of Justice). But they have not acted upon such statements. That does not rule out national legislatures aiming at circumscribing or even circumventing specific rulings. But such a dynamic can also be found in national constitutional orders. The guardianship of a democratic constitution is always an open-ended process, in which it is *We the People* and not *We the Court* that has the last word.[7]

Should Union law be acknowledged a constitutional stature?

It may well be that European constitutional practice has come to be so that the European Courts have successfully arrogated themselves the power to review the constitutionality of supranational and national norms, and that national constitutional actors have acquiesced to such a role. Still, we could ponder wonder *that* should be the case? Is this state of affairs constitutionally sound? Or does that constitutional practice undermine the pre-existing constitutional framework, in particular, the constitutional stature and dignity of Community law? What would remain of the claim of national constitutions to be the supreme law of the land if Union law would be acknowledged a constitutional status? Would that not necessarily entail *downgrading* the stature of national constitutions? Given that the supremacy of national constitutions is said to be based on the intense democratic legitimacy of such constitutions, would not that *downgrading* also entail the *subversion of democratic legitimacy?* And if, at the end of the day, we conclude that Union law *is not* a constitutional order, should then we not rebuff the claim of European Courts to be empowered to take decisions which imply contrasting national norms with a non-existent European constitutional yardstick? Indeed should we not conclude that rulings such as those in *Avoir Fiscal or Cassis de Dijon* would simply be *ultra vires* decisions?

The answer to this question hinges on whether the European Union should or should not be regarded as a constitutional order. In *material* terms, that may be decided by means of considering the institutional

[7] Admittedly, whether the legislature manages to break the muscle of the court, or not, tends to depend on the extent to which the legislative countermove resonates in the electorate. Such a test is for the time being a rather improbable one in Community law.

structure, decision-making procedures and competences of the European Union. If all these three dimensions the European Union resembles a democratic federal state more closely than an international organisation, we would have good reasons to conclude that the legal order which constitutes such institutions, decision-making processes and grants such competences is a constitutional legal order. Still, whether we should grant the European Union the normative acknowledgment of regarding its legal order as a constitutional one depends on the democratic legitimacy of Union law. Determining what is the legitimacy basis of Union law requires proper attention (and adequate reconciliation) of the regulatory ideals of a democratic constitution, of the primacy of the national democratic constitution, and of the structural principles of direct effect of certain Community norms and primacy of Community law. Or, in short, a proper constitutional theory of Community law.

Union law as a *material* constitutional order: Institutional structures, decision-making processes and competences

A systematic construction of the founding Treaties (and the successive amendments to them) allows us to make a good case for the constitutional stature of Union law. This is so because the political community that the Treaties constitute is characterised by the robustness of its institutional structure and of its decision-making processes; and by the breadth and width of the powers which have been transferred to the European Union. Consequently, a legal order that constitutes a polity with such features is to be regarded as a *material constitutional order*.

Even if the Union has (and always had) limited, enumerated competences, the breadth and scope of what the Union does largely corresponds to what one could expect a level of government in a federal structure to do. The founding Treaties envisaged in clear cut-terms *the transfer of the exercise if not the full title of significant public powers from Member States to the European Union*. In the case of the ECSC and the Euratom, this was somehow obscured by the fact that the power being transferred concerned a rather specific and narrow set of issues (even of dramatic importance, as coal, steel and atomic energy were the sinews of war in the 1950s). In the case of the EEC, there was some equivocation resulting from the combination of a detailed set of negative integration measures (aimed at realising a 'common market') with vague references to wider goals of economic and political Union. But in all cases what count as key competences in the political process of a democratic polity were agreed to be transferred to the European level. At the time of writing, not only the Union exerts fundamental regulatory powers concerning the single market and agricultural policy,[8] but monetary policy is in the hands of the very federal system of European central banks (with the European Central Bank at its height, and having opted for an interpretation of its own powers which leaves no doubt concerning the open fiscal implications its decisions have), while Union powers of 'justice and home affairs' affect deeply the relationship between citizens and states as holders of the monopoly of force. Even the area of taxation has not been left untouched. Not only did the ECSC expect the Community to be self-financing through the use of its taxing power over coal and steel industries (thus granting the newly created institutions a limited but revealing power of the purse), but the EEC Treaty implied the full transfer of powers to the Community over customs duties as an unavoidable consequence of the creation of a common external tariff,[9] and a partial but decisive transfer of legislative competence over turnover taxes.[10] To that we must add the transfer of competences on external trade, also a logical part of the creation of a customs union. The road to the single market in the late 1980s led to a growing intervention of the Union on direct taxation, which has been deepened by the case law of the ECJ on personal and corporate income taxation (Menéndez 2009a).

Although the founding Treaties resulted in a rather incomplete and undefined institutional structuring of the Union, the institutional structure resulting from them went well beyond what was (and is) generally associated with an international organisation. The institutional structure of the original Communities included (1) a

[8] Agricultural policy (once the inconclusive provisions of the Treaty were rendered concrete in political practice), which was at the very centre of political debate in the fifties, given the higher economic and social importance of farming at the time (it might be added that a large part of the population was still occupied in the primary sector and that the failure to ensure a decent standard of living to farmers in the interwar period had facilitated the rise of fascists to power).

[9] Still a far from negligible tax, and historically a determinant one. See Milward (1981); Eichengreen (1992: 9).

[10] That in itself implied transferring key taxing powers, which have always been at the very centre of the political constitution of democracies (and of revolutionary democratic politics, from the Glorious Revolution of 1689 to the French Revolution of 1789).

supranational High Authority or Commission with competences much bolder than those of either a permanent secretariat or even a supranational independent administrative agency, and (2) a Parliamentary Assembly (which from early on had the vocation to become a parliament, that is, a body elected by the direct suffrage of the citizens),[11] and (3) a Court of Justice to whose jurisdiction Member States were compulsorily subject. This was further composed by the fact that the Rome Treaties of 1957, while resulting in the multiplication of the number of institutional structures (three Council of Ministers and three Commissions/High Authority, one for each Community) made the Assembly and the Court of Justice *common* institutions to the three Communities, thus laying the basis for a common institutional framework, which was indeed achieved through the Merger Treaty of 1965, and at any rate pointing to a decision to create a wide and encompassing supranational structure *beyond* the concrete Communities being launched to make integration feasible and possible at first. This has been basically achieved by the progressive development of the institutional structure of the Union, either replicating or adapting national institutional structures, or by means of experimenting with new institutional solutions (as has been remarkably the case of comitology).

So much so that at the time of writing, Community decision-making process, even if widely geared towards the transfer of democratic legitimacy from Member States to the Union (as is typical in international structures), also generate *direct democratic legitimacy* (critically, through the decision-making processes in which the European Parliament plays a decisive role, such as the co-decision law-making procedure).

Firstly, The Communities were assigned from their very foundation normative powers, concretely, the power to approve regulations and directives. Such legal norms were not to be regarded as a congeries of technical or specific norms, but were framed by constitutional principles, of which they were expected to be concretisations. Key in that regard is the principle of equality before the law, which in the context of a process of European integration was essentially defined as the principle of non-discrimination (crucially on the basis of

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[11] For an account of the Common Assembly's metamorphosis into the European Parliament, see Rittberger (2005).

nationality, but also on the basis of sex; to which, much later in the process, race would be added).[12]

Secondly, Community law has pervasive effects over all EU citizens and EU territory, as a result of the wide acknowledgement that it stands in a structural relationship to national legal orders marked by the structural principles of *direct effect* and *primacy*. The doctrine of direct effect implies that the legal effects of Community norms are governed by Community, not national norms, even from the perspective *internal* to the national legal order. Primacy, as it emerges from European constitutional practice, implies that Community norms prevail over conflicting national norms, even if the latter are constitutional norms. Controversy remains on whether primacy is indeed absolute or, as seems more frequently accepted, it has limits. National constitutional courts, following the lead of the German constitutional court, have become quite interested in defining such limits by reference to an alleged set of 'core' constitutional substantive contents, competences and now even 'identity', whatever that means. It seems to me that this is a rather confused way of posing the problem, as it assumes that supranational and national constitutional norms are part of clearly distinct legal orders. But what is relevant at this stage is to highlight that even national constitutional courts have abandoned the characterisation of Community law as just a peculiar form of international law and have progressively scaled back the breadth and scope of the so-called 'hard core' of national constitutions, theoretically more than practically *superior* to Community law.[13]

The constitutional dignity of Union law

A synthetic constitutional order

As has just been argued in the previous section, there are very good reasons to acknowledge that Union law has a *material* constitutional

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[12] Article 6 contained a clause on prohibition of discrimination on the grounds of nationality, and Article 119 stated the principle of equal pay for equal work for men and women. For the limited and truncated character of the constitution of anti-discrimination, see Somek (1999).

[13] The characterisation of Community law as public international law has been rather resilient in the doctrine. See for example Wyatt (1982). And indeed Treaty amendments keep on being characterised as mere matters of ratification of international treaties in many Member States (indeed most during Lisbon resulting from the characterisation of the process by the European Council).

stature. The founding Treaties of the European Union constituted a polity with institutional structures, will-formation processes and powers which clearly set it apart from classical international organisations, and make it rather similar to a federal polity. Consequently, it makes full sense to characterise Union law as a constitutional legal order. Not only in a purely material sense (which is rather banal, as all legal orders have a constitution in this sense), but in a stronger, more restrictive sense, as one which identifies the polity and the legal order as proper and characteristic of a full-blown political community. But the democratic conception of constitutional law is even more demanding. Democratic constitutional norms, as all the constitutions of the Member States of the European Union claim to be, are characterised not only by their *material stature*, but also by their *normative* dignity, that is, by their enjoying a high and intense democratic legitimation.

Can that be fairly said of European constitutional law? Is a supreme and directly effective Community law democratically required? In particular, in the absence of an explicit act of democratic constitution-making, or of legitimacy-carrying transformations which could justify in democratic terms the mutation of an international order into a constitutional one,[14] how can we explain that Community law is now widely regarded as a constitutional one? And should we indeed accept such a transformation?

This constitutional *riddle* is due to a large extent to the inadequacy of the theoretical lenses through which Union law is reconstructed and assessed. If one reconstructs the law of the European Union, assesses its democratic credentials or tries to understand its institutional transformation through the lenses applied to an international organisation, to a revolutionary constitutional polity, or for that matter to an evolutionary constitutional polity, one ends up submerged in paradoxes and inconsistencies, above all the *riddle* concerning the mutation of an international order into a constitutional one. And thus one is confronted with a major dilemma: Union law has constitutional stature, European constitutional practice

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[14] Certainly the 'limited judicial *coup d'état*' hypothesis will not wash. Who are the judges to undertake these changes? How could that have happened within years of the core Member States of 'little Europe' undergoing transformative processes of constitution-making?

acknowledges it, but there is no good normative foundation for acknowledging constitutional dignity to Union law.

This dilemma is thus not to be sorted out by denying the constitutional dignity of Union law, but by means of seriously reconsidering the constitutional theory with which we approach Union law. By this I do not mean the usual (and a trifle post-modern) claim that European integration being a new phenomenon we should put forward a radically new theory to understand it; which indeed boils down to repudiating centuries of democratic political and constitutional thinking.[15]

My claim is much more limited. The basic normative components of democratic constitutional theory are fully relevant when reconstructing and assessing Union law. Democratic constitutional law plays a key role in the stabilisation of democratic power by means of the proper combination of constitution-making, constitutionalisation and ordinary decision-making processes. Still, democratic constitutional theory should take into account the specific nature of the European Union, and in particular, the fact that the European Union is a polity made of constitutional polities which aimed at integrating through constitutional law. Democratic constitutional theory should be sensitive to the (1) peculiar shape of the process of European integration, and (2) the way in which constitution-making and constitutionalisation processes have been combined through the history of European integration. Together with John Erik Fossum, I have claimed that democratic constitutional theory can be rendered sensitive to the genuine peculiarities of Union law by fleshing out a constitutional theory of integration through constitutional law, which, for a better name, we have labelled as 'constitutional synthesis' (Fossum and Menéndez 2011). The core of the theory can be summarised in three premises, which are the following.

The *first premise of constitutional synthesis* is that the constitutional law which frames and contributes to steer the process of European integration is neither revolutionarily established in a 'Philadelphian' constitutional moment, nor the outgrowth or accumulation of 'Burkean' constitutional conventions and partial constitutional

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[15] I am thus no post-modernist, or what is the same for these purposes, no believer in the radical novelty of the European Union.

decisions *à l'anglaise*. On the contrary, constitutional synthesis is characterised by the central structuring and legitimising role played by the constitutions of the participating states (*seconded* to a new role as part of the collective constitutional law of the new polity),[16] or by the regulatory ideal of a common constitutional law, which is progressively recognised as the constitution of the new polity, and whose normative consequences are fleshed out and specified as the process develops further. To put it differently, instead of a revolutionary act of constitution-making, or the slow growth of constitutional conventions, constitutional synthesis is launched by an act which implies the secondment of national constitutions to the role of common constitutional law. This makes synthetic founding much more economical in political resources than revolutionary founding, and, at the same time, it is much quicker than evolutionary founding. The price to be paid is that, instead of an explicit set of constitutional norms, the founding Treaties reflect a scattered set of norms, while the bulk of the common constitutional law remains implicit, *a regulatory ideal* to be fleshed out as integration progresses.

European constitutional law was composed of, and, to a large extent, keeps on being composed of, the *common constitutional law* of the Member States. The establishment of the European Communities was thus akin to a foundational moment; but, contrary to what is the case in a revolutionary constitutional tradition (such as the French or the Italian one), the constitution of the Union was not written by *We the European People*, but was defined by implicit reference to the six national constitutions of the founding Member States. In this way, the French, German, Italian, Dutch, Belgian and Luxembourgian

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[16] The idea of a supranational constitutional law which is the result of seconding national constitutions was hinted at by the European Court of Justice in Case 11/70 *Internationale*, par. 4 when claiming that the lack of a written bill of rights in the primary law of the Union came hand in hand with an unwritten principle of protection of fundamental rights, which was filled in by reference to the 'constitutional traditions common to the Member States' properly spelled out in the context of European integration ('the protection of such rights, whilst inspired by the constitutional traditions common to the Member States, must be ensured within the framework of the structure and objectives of the Community'). In doing this, the Court was following a line of reasoning pioneered by Pierre Pescatore (1970). On the technical aspects of legal synthesis, it must be stressed that a critical comparative approach has underpinned the case law of the ECJ since its very inception, see Lenaerts (2003). On the constitutional aspects of the idea of constitutional synthesis, see Menéndez (2009b).

constitutions were *seconded* to the role of being part of the constitutional collective of Europe. National constitutions started living a 'double constitutional life'. They combined their old role as national constitutions and the new role as part of the *collective* supranational constitution.[17]

Constitutional synthesis is grounded on the national constitutional provisions which not only authorise, but also mandate, the active participation of national institutions in the creation of a supranational legal order as the only way of fully realising the principles which underlie the national constitution(s). Thus, the 'opening' clauses of post-war constitutions, and the explicitly European clauses of the more recent ones are constructed as reflecting the self-awareness of the national constitution(s) about the limits of realising constitutional values in one single nation-state. Constitutional synthesis claims that there is a substantive identity between national constitutional norms and Community constitutional norms. In other words, European integration pre-supposes the creation of a new legal order, but not the creation of a new set of constitutional norms; a key source of the legitimacy of the new legal order is, indeed, the transfer of national constitutional norms to the new legal order. However, the process, by necessity, has major constitutional implications for each Member State. Firstly, the accession of a state to the European Union marks a new constitutional beginning for that state. Contrary to what is the case in most constitutional transformations, constitutional change is not mainly about the substantive content of the fundamental law, but concerns the *scope* of the polity (there is an implicit re-definition of who we acknowledge as the co-citizens of our political community) and the very *nature* of the new polity (as it actually aims at re-founding both the national and the international legal orders by means of transforming sovereign nation-states into parts of a cosmopolitan federal order). Secondly, the very essence of the process of constitutional synthesis is that of the progressive ascertainment of common constitutional standards which may eventually result in marginal changes in national constitutional norms *to align them* with the con-

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[17] This could be illustrated by using the image of the 'field' as a metaphorical device. Indeed, the founding of the Communities implied that national constitutions abandoned their constitutional solitude as constitutions of the self-sufficient nation-state and placed themselves in the common European constitutional field. Constitutional autarchy was thus replaced by constitutional openness, co-operation and reflexivity.

tents of Community constitutional law, which, in turn, is reflective of what is actually *common* to the Member States. In this regard, it should be noted that Community constitutional law is not defined by reference to individual sets of constitutional norms, but to what is common to *all* national constitutional norms. In those cases in which national constitutional norms point to different normative solutions, synthesis is not achieved by finding a common minimum denominator, but by means of considering which of the national constitutional norms is more congenial to Community law. This is to be decided by considering the underlying arguments for or against the competing national constitutional solutions, and, in particular, by considering the extent to which the national norm can be 'Europeanised', both in the sense of fitting with European constitutional law as it stands (as already synthesised in the Treaties, the amendments to the Treaties or the legislation and case law of the Union), and with its consequences being acceptable in the Union as a whole.[18]

The *second premise of constitutional synthesis* is that the supranational legal order comes hand in hand with a supranational institutional structure. But the latter is only partially established at the founding, takes time to be rendered functional in a process in which different national institutional cultures and structures try to leave their mark at the supranational level, and its structure is necessarily rendered more complicated as new institutions and decision-making processes are added in order to handle new policies. This entails that constitutional synthesis can be described as the combination of normative synthesis and institutional development and consolidation, two processes that have very different inner logics. While normative synthesis exerts a centripetal pull towards homogeneity, institutional consolidation is a more complex process with strong built-in centrifugal elements – it serves as the conduit through which the constitutional plurality of the constituting states is wired into the supranational institutional structure.

[18] If all national constitutional norms converge, as in most cases they do, the common norm is easy to establish. The strong affinity between national and Community constitutional norms is due to the history of European integration, to the fact that all Member States are parties to the European Convention on Human Rights; moreover accession to the European Union is conditioned to candidate states indeed fitting in the constitutional paradigm defined by the common constitutional traditions.

Institutional consolidation concerns the outgrowth and consolidation of the institutional structure of the supranational polity. Its logic is not exclusively *normative*. Institutions are mainly about law, but not exclusively about law. Institutions are organisations infused with value. They occupy buildings, make use of objects with empirical existence, and are represented by very material (when not venial) beings. Institutional organisations cannot be brought into existence by a normative regulatory ideal; they have to be created, staffed and funded, and develop their own institutional identity. In a constitutional union of already established constitutional states, this process is complicated by three factors. Firstly, constitutional synthesis pre-supposes the combination of a single constitutional order with a pluralistic institutional structure, to the extent that supranational and national institutions are not hierarchically organised or ranked. Secondly, constitutional synthesis at the regional-continental level of government (*i.e.*, in between global organisations and nation-states) tends to proceed in a far from crowded institutional space. In contrast to the constitution of a nation-state, which *de facto* relies upon an existing institutional structure, constitutional synthesis requires the creation of new institutional structures. This usually entails that institution-making proceeds in a fragmentary fashion, that the synthetic polity starts with bits and pieces of an institutional structure, instead of with a complete one. Thirdly, the derivative character of the synthetic polity implies that the *institutional void* is only formally a *void*, as the creation of supranational institutions consists of the *projection* of national institutional structures and cultures to the supranational level. But because such structures and cultures are much more idiosyncratic than national constitutional laws, the probable result is that the creation of supranational institutions is the site of a bitter contest between different national institutional structures and cultures.

Upon such a basis, the *homogenising* logic of normative synthesis contrasts with the manifold pluralistic proclivities proper of institutional consolidation. This tension is aggravated over time, and a crisis emerges when the relationship between the two processes is polarised. As normative synthesis proceeds, it fosters some institutional convergence. But the synthetic process can also feed institutional pluralism and conflict, and thus produce a constellation incapable of solving institutional conflicts among the different levels of government.

The *third premise of constitutional synthesis* is that the regulatory ideal of a single constitutional law comes hand in hand with the respect for national constitutional and institutional structures. This entails that, while supranational law is one, there are several institutions that apply the supranational law in an authoritative manner. The peculiar combination of a single law and a pluralist institutional structure results from the just mentioned fact that there is no ultimate hierarchical structuring of supranational and national institutions, and is compounded by the pluralistic proclivities of institutional consolidation at supranational level.

The fact that the synthetic constitutional path is one in which participating states retain their separate existence, as well as their separate constitutional and institutional identity, implies that constitutional synthesis is a peculiar breed of pluralistic constitutional theory. On the one hand, it *is not* pluralistic to the extent that it endorses the monistic logic of law as a means of social integration through the *regulatory ideal of a common constitutional law*. The integrative capacities of law (its role as a complement of morality in the solving of conflicts and the co-ordination of action by means of determining, in a certain manner, what the common action norms are) require law to be as conclusive as possible. Were law to be as inconclusive as morality, it would not add much to our practical knowledge, and it would not be capable of operating effectively as a means of social integration. Both autonomy and the motivational force of law require that we assume that law gives one *right* answer to all the problems to be solved through it. Legal argumentation breaks down if we assume that the same case can have different, even contradictory solutions. This may be the case *empirically*, but, from an internal perspective of law, this cannot be endorsed as part of the social practice of integration through law. Democratic legal systems are further pushed into this peculiar form of 'monism' by the normative requirements of the principle of equality before the law.

On the other hand, constitutional synthesis is pluralistic in a double sense. First, the regulatory ideal of a common constitutional law co-exists with the actual plurality of national constitutional laws. The constitutional moment in synthesis only results in the endorsement of a regulatory ideal, and in the bits and pieces of the set of common constitutional norms. Most constitutional norms remain *in nuce*, or better put, in several drafts, as many national constitutions participate in the process of integration. The regulatory ideal of a common constitutional law is fleshed out in *actual* common constitutional norms (and, in general, in common legal norms) only very slowly (and not without setbacks and backlashes). Furthermore, the regulatory ideal of a common constitutional law comes hand in hand with a pluralistic institutional setting. As already indicated, instead of a hierarchically-structured institutional set-up, a synthetic polity is characterised by the existence of a plurality of institutions all of which legitimately claim to have a relevant word in the process of applying the 'single' constitutional legal order. This is, in my view, the proper implication to draw from the 'differentiated, but equal' viewpoints thesis. Indeed, constitutional synthesis has not led (and is not expected to lead) to Member States losing their autonomous political and legal identity (which has been coined, in the European constitutional jargon, as the national constitutional identity).[19] This is so *thanks to*, and not *despite of*, integration. The constitutional pluralism that comes hand in hand with constitutional synthesis is both rendered possible *and* stabilised by the new institutional structure and the growing substantive convergence between national constitutional orders. Constitutional synthesis could be seen as the political and legal counterpart to the common market of old (not the single market of the Single European Act!) in the objective of rescuing the nation-state (Milward 1992); in our view, it is more proper to consider it as a means of re-configuring and re-defining the state, and, thereby, at the very minimum, detaching the state from the nation; and perhaps even disposing of the idea of the sovereign state completely (Scheuerman 2009; Brunkhorst 2009).

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[19] The term 'national constitutional identity' entered the European debate in the famous ruling of the German Constitutional Court *Solange I*, 1974 WL 42441 (BverfG (Ger)), [1974] 2 C.M.L.R. 540, par. 22: 'Article 24 of the Constitution must be understood and construed in the overall context of the whole Constitution. That is, it does not open the way to amending the basic structure of the Constitution, which forms the basis of its identity, without a formal amendment to the Constitution, that is, it does not open any such way through the legislation of the inter-State institution'. It was then propelled to the supranational level in Maastricht (resulting in Article 6.3 of the Treaty of European Union, where the principle of respect of national identities in general terms was affirmed). And in the Constitutional Treaty and in the Treaty of Lisbon, this principle was spelled out by reference to constitutional identity. On the academic debate following the Constitutional Treaty, see von Bogdandy (2005); Rosenfeld (2005); Reestman and Besselink (2007). In more general theoretical terms, see the interesting reflections of Jaconsohn (2006).

Thus, constitutional synthesis articulates two key insights of the pluralist theory of Community law when (1) it stresses the open character of the process of constitutional synthesis (which accounts for the fact that no institutional actor has been acknowledged the power to solve, in an authoritative and final manner, conflicts between norms produced through Community and national law-making processes), and (2) it highlights the pluralist source of European constitutional law, the actual result of the process of constitutional synthesis of national constitutional norms. This not only provides the basis for the claim to the democratic legitimacy of Community law (transferred from the national to the European constitutional order when national constitutional norms become the core constitutional framework of the Union), but also reveals the complexity of constitutional conflicts in the European legal order, as they are, at the very same time, 'vertical' conflicts between Community and national law, and 'horizontal' conflicts between national constitutional laws, aspiring to define the common constitutional standard.

However, the theory of constitutional synthesis reconciles pluralism with the normative defence of a monist re-construction of the European legal order, in part on account of the social integrative capacity of European law and the fostering of equality before the law across borders, in part on account of the substantive identity of European and national constitutional law. Moreover, it offers a limited, but comprehensive, explanation of the sources of stability of the European legal order, which, at the same time, accounts for the progressive weakening of the said sources.

Equipped with the 'synthetic' constitutional theory of European integration, we can realise why and in which sense the Union has been since its very establishment a constitutional polity and Community law a constitutional legal order. The path of democratic constitution-making followed by the Union was an innovative (even if not sui-generis) one. Indeed, that of synthetic constitutionalism. A constitutional animal neither constituted in a democratic revolutionary fashion through an act of constitution-making reflected in a written fundamental law, nor resulting from a protracted process of normative and institutional evolution punctuated by critical turning points where the evolved norms and structures get infused with democratic sanction. Thus a peculiar and innovative constitutional animal: a synthetic constitutional animal.

The key features which seem *prima facie* to require denying the constitutional nature of the Union reveal themselves as compatible with the constitutional dignity and stature of Community law. The tension between the international form and the constitutional substance and the lack of specific provisions empowering the ECJ to act as a constitutional court is but a mark of the synthetic nature of European constitutional law. The aspiration to combine the regulatory ideal of a single law guaranteeing equality to its recipients, and a pluralistic institutional structure, where the final word on the substantive content of the common law is shared, rather than monopolized, is congenial with the establishment of what is substantially a constitutional structure through an international legal form (the founding and amending Treaties). Similarly, the assignment of a role in the guardianship of European constitutionality to the ECJ is not reflected in an explicit constitutional provision, but results from the construction of specific Treaty provisions *in the light* of the substantive constitutional nature of Community law.

Can European Courts claim to have a mandate to be the guardians of European constitutionality?

Even if we were to accept the constitutional character of Community law, it would not necessarily follow that we should necessarily acknowledge that the European Courts are competent to undertake the review of constitutionality of legislation (especially on what concerns national statutes, not to speak of national constitutional norms). The assignment of the power of constitutional review to courts, or to be more precise, to those hybrid organs that constitutional courts are, is far from being a common feature of the fundamental law of the Member States of the European Union. Granted, the institutional setup of many Member States *does* include a constitutional court. It could further be said that the number of such Member States has tended to grow over time, and that even those legal orders whose historical evolution seemed more at odds with the judicial review of the constitutionality of legislation (such as France and the United Kingdom) are now close to accepting it in one way or the other. Still, judicial review of legislation is not foreseen in the fundamental laws of all Member States. And even if it were a common piece of the national constitutional edifices, it would not necessarily follow that such a power should be granted to the European Courts. So the question remains a relevant one: Where in the founding Treaties can we find a basis for this role of European Courts?

The short answer is that the Treaties of the European Union mandate the European Court of Justice and the Court of First Instance (hereafter the European Courts) to ensure that the law is observed in the 'interpretation and application of the Treaties' (Art. 19 TEU, originally Art. 164 TEC).

In discharge of such a task, the Treaties mandate the European Courts to review the 'legality' of the legislative acts of Community institutions (Art. 263 TFEU), something which entails the empowerment to review the European constitutionality of Community norms.[20]

But leaving aside this specific mandate, a too literal interpretation of the specific provisions dealing with each procedure before the European Courts may leads us into the belief that the Treaties require the European Courts either to *interpret* Treaty provisions and/or secondary Community norms in a general and abstract manner, abstaining from any judgment on the normative validity of any national norm, or to apply Community norms to concrete cases, and thus deciding on the proper legal qualification of specific acts and decisions, which excludes passing judgment on the general validity of any norm. However, as I will argue in the following paragraphs (and as I have already indicated considering the normative implications of *Cassis de Dijon* and *Avoir Fiscal*), the discharge of both tasks requires doing something *more* than that, resulting in the task of interpretation requiring the consideration of the concrete normative and factual context; and the task of application resulting in the need to clarify the proper construction of certain norms. The fact that the European Court is required to discharge both tasks *simultaneously* increases the chances of the line between these two tasks becoming blurred.

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[20] The literal text of the article reads 'The Court of Justice of the European Union shall review the legality of legislative acts, of acts of the Council, of the Commission and of the European Central Bank, other than recommendations and opinions, and of acts of the European Parliament and of the European Council intended to produce legal effects vis-à-vis third parties. It shall also review the legality of acts of bodies, offices or agencies of the Union intended to produce legal effects vis-à-vis third parties'.

In a number of procedures the European Courts seem to be required to apply Community law; in particular, to review the legality of specific actions or omissions of the Member States or of the institutions of the Union by reference to European laws. In these instances, European Courts are expected to produce a ruling with an operative part consisting in the legal qualification of a certain fact (the act or omission of a Member State or a European institution). This would seem to indicate that the decisive part of these rulings would be the finding of fact of whether a given act is or is not in compliance with "the law". In these cases, the task of European Courts comes rather close to that entrusted to national courts when reviewing the legality of the actions and omissions of the (national) public administration. This is largely the case of the infringement procedure concerning Member States (ex. Articles 258 and 259 TFEU) and acts of the institutions of the Union (ex. Art. 263 TFEU) in breach of Community law (or failure to act of Union institutions ex Art. 265 TFEU). A specific application is the procedure on the non-contractual liability of the European Union (ex. Art. 268 TFEU).

The application of the law to concrete cases clearly will not infrequently hinge upon how the law to be applied is to be interpreted. Indeed, applying any legal norm, quite obviously including European Community norms, consists in ascertaining the specific and concrete normative consequences that a general norm has in a particular case. While any modern legal system can only function properly if in most cases such normative contents are known in advance of the act of application and remain rather uncontroversial, *hard cases* in which such substantive content is controversial may be very marginal in general statistical terms, but constitute a sizeable majority of the cases that are decided by courts (the remaining majority of cases being those on which the facts of the case are disputed). Whether a Member State or a European institution is in breach of Community law by means of having done or omitted to do something depends on what are the concrete normative implications of the general norms of Community law. Indeed, a good number of cases before the European Court of Justice and the General Court hinge on the proper normative breadth and scope of the substantive provisions of Community law and of the overriding interests that justify in the fullness of argumentation what *prima facie* seems a breach of Community law. Many infringement procedures turn on the breadth and scope of one or the other economic freedom.

To apply Community law to one concrete case, one indeed needs to have established the actual content of Community law, and that in its turn may require interpreting Community law. That is the same as saying that in order to properly *apply* Community law, the European Court of Justice is not infrequently required to *interpret* Community law. In these frequent instances, the ruling will not only apply a given Community norm at the case at hand, but will also contribute to the specification of the substantive contents of Community norms, and either directly or indirectly, to the shaping of the fundamental principles of Community law by determining the content of derivative constitutional rules.

Consider again the ruling in *Avoir Fiscal*. On the surface of the text of the judgment of the Court, its normative effects seem to be limited to declaring that this very concrete French law, applied to this very concrete case, constitutes an infringement of Community law. However, the actual normative implications of the judgment are certainly wider. To determine whether the French Republic was in breach of Community law, the European Court of Justice had to clarify the normative implications of the principle of freedom of establishment in this concrete case. This required the ECJ to engage into the interpretation of the principle and the clarification of its normative content in view of the facts of the case. As a result, the ruling not only contains a decision applying the law to a specific set of facts, but also a normative precedent, a derivative constitutional rule that should be applicable in all similar cases.

European Courts are also assigned a special authority when it comes to elucidate the interpretation of supranational law. In these cases, they are instructed to explore and expose the normative consequences of Community norms, but they are barred from applying such an interpretation to the resolution of a concrete and specific case. Interpretative judgments would thus typically be expected to contain a general and abstract construction of one or several fundamental provisions of the Treaties *without* engaging in the task of elucidating their normative implications in concrete cases. This is clearly the case of preliminary judgments (ex. Art. 267 TFEU), of judgments on procedures where the annulment of supranational legislation is sought (Art. 230 TFEU), and of opinions concerning international agreements to be entered into by the Union (Art. 218.11 TFEU).

The interpretation of Community norms at the request of national courts proceeds under a very peculiar setting. While the European Court of Justice is expected to limit itself to explore in general and abstract terms the normative content of a Community norm or set of norms, the request always arises in a specific legal controversy. While the degree to which the actual facts of the case are known to the Court would rather depend on the way the national court would frame its request, it is certainly the case that national courts have an incentive to feed the European Court with the details of the case (I would even say with *their* specific reconstruction of the facts) so as to ensure that the reply of the European Court would be actually helpful in solving the case at hand, or even would be more likely to be in line with the answer that the national court would prefer to obtain. This results in a predictable tension between the generality and abstraction which is formally required from the European Court of Justice and the degree to which it actually knows the facts and the effectiveness of its decision depends on considering such specific factual context when providing its interpretation of Community law.

Consider again *Cassis de Dijon.* The submitting court informed the ECJ that in the case at hand, a German supermarket (Rewe) had had trouble selling a French liquor, on account of the fact that the German authorities insisted on applying a national law that required that any *cassis* had a minimum alcoholic graduation that the French product did not have. It was clear that the rationale of the German law was to avoid the consumers being fooled by the arbitrary labelling of goods by exporters and/or retailers. To avoid confusion, German law reserved the use of the label *cassis* to goods meeting the expectations of the average German consumer (the teutonic person in the Clapham omnibus, if one is allowed to use a rather old fashioned expression). That, however, failed to consider whether free movement of goods had placed beyond the realm of the constitutionally possible that specific legislative choice.

Formally speaking the ECJ limited itself in its ruling to offer a general and abstract interpretation of the provision on free movement of goods enshrined in the Treaties (as was seen in the long excerpt reproduced on p. 76 above). However, the rationale of the *ratio decidendi* of the case goes further: a ban on *any* product that was legally sold in *any* other Member State of the Communities would constitute *prima facie* a disproportionate infringement on the constitutional principle of free movement of goods. Consequently, any national norm putting obstacles to the sale of goods legally available in another Member State would be considered as a breach of a key European constitutional norm, and thus void unless there were countervailing reasons which could justify this infringement. While the ruling is phrased in general and abstract terms, it is hard to imagine how the German court could avoid the conclusion that the German law prohibiting the sale was to be set aside, as this blank selling prohibition was incompatible with Community law.

Finally, the very fact that European Courts are required to do these two things at the same time was likely to result in the progressive blurring of the dividing line between interpretation and application of law. Such a dynamic is not unique to the European Court of Justice, and indeed can be said to be typical of the "hybrid" European constitutional courts established in the post-war period, such as the German, the Italian or the Spanish one. Entrusted once and at the same time with the task of undertaking the general and abstract review of constitutionality in the Kelsenian fashion and with the task of applying the Constitution to concrete cases in the US fashion, those courts have ended up combining those tasks in a rather unorthodox fashion. This is rather underlined by those instances in which the courts are confronted at rather the same time with an 'interpretative' and an 'applicatory' procedure which at the end of the day hinge on the very same constitutional questions. A clear instance of that is indeed the Bachman case, which was decided by the ECJ the very same day that it sorted out. Or by the fact that the *Viking*, *Laval* and *Ruffert* cases are part of the same line of jurisprudence as *Commission v. Luxembourg*.

It must be noticed that the lack of an explicit empowerment of the European Courts to undertake the review of European constitutionnality has a result that such a review cannot not be *directly* sought by the plaintiffs in any procedure before the European Courts, with the sole exception of those procedures in which the parties can request the annulment of a supranational norm. In all other cases, and very particular, on all instances where the European constitutionality of national norms is at stake, the Court retains a discretion to produce a judgment which entails the setting aside of the national norm. European Courts have made a rather strategic use of such discretion, in particular on preliminary requests, by pitching their interpretation of Community law at different levels of generality and abstraction.

The second thesis: The shared guardianship of European constitutionality

The second thesis of this chapter is that the peculiar nature of Union law, and in particular, the very distinctive constitutional path it has trailed – that of constitutional synthesis – results in both (1) a very idiosyncratic relationship between supranational and national constitutional law, but also in (2) a very characteristic bond between the ECJ and national constitutional courts (or supreme courts where no specific constitutional court exists as such), which definitely excludes the hierarchical superiority of the ECJ, and thus, necessarily entails a shared and collective exercise of the guardianship of European constitutional law instead of a *solo* discharge of the task by the judges sitting in Luxembourg. Instead, the ECJ stands in a complex (and clearly non-hierarchical) relationship with national constitutional courts, which are also properly said to be part of the 'collective' that guards constitutionality and shapes the yardstick of European constitutionality. The very reasons that underpin the assignment of a key role to the ECJ in making effective the constitutional norms of the European Union also limit the authority of the ECJ.

Firstly, the regulatory ideal of a single constitutional order under which Europeans can be equal under the law is not to be achieved by means of writing a supranational constitution anew and imposing it *on top of* national legal orders, but by turning all national constitutions into a collective constitutional law. This constitutive feature of Union law explains why the tension between the primacy of Community law and of national constitutions is more apparent than real; the tension is indeed very much eased once we properly identify the very consistency of European constitutional law as what is common to national constitutions (and once we take properly into account the several factors and procedures which account for the remarkable axiological and even institutional similarities between the constitutions of the founding Members of the Union, and of the states which have successively joined it). Such a supranational constitutional order will be poorly served by assigning to the ECJ an exclusive role as guardian of European constitutionality, neglecting the key contributions which *should* be made by national constitutional courts as reflective of long-standing national constitutional traditions.

Secondly, Union law aspires to be a single legal order, but not one supported on a single and hierarchically organized institutional structure. The genuine institutional pluralism of Community law also applies to the task of constitutional guardianship, and excludes that the ECJ and national constitutional courts stand in a hierarchical relationship. That is what, rather imperfectly, is captured in the fashionable reference to a 'dialogue' between courts.

It is important to notice that the fact that the process of European integration still follows the synthetic path (as a result of the failure to transcend it through an act of democratic constitution-making and as a consequence of the resilience of the established institutional and decision-making process vis-à-vis the attempts to reconfigure it according to the grammar of governance as an alternative means of social integration) implies that the regulatory ideal of a common constitutional law remains the key bedrock of the European constitution. This is closely related to the persistence of an institutional configuration shaped by the imperative of ensuring *the transferring of democratic legitimacy from national political processes to the supranational one* and by *a horizontal relationship* between the supranational and national institutions. This creates a very peculiar constitutional setting, in which not only *constitutional law* as the higher law of the land becomes a resource to context the legitimacy of statutes *from within the legal order* (as is typical in all constitutional systems) but also where there may be a plurality of *constitutional laws* competing for the role of being *the* constitutional law.

The second thesis of this chapter will prove to be especially relevant when considering the justifiability of the substantive choices that underlie the proportionality review of national legal norms against the yardstick of European constitutionality. The pluralistic nature of Community law makes advisable that the European Courts ground their substantive choices on the substantive choices made by national constitution-makers and legislators, as systematically constructed by national courts. Something that the European Courts have been less willing to do since they started interpreting economic freedoms as transcendental faculties, substantively detached from the common constitutional law of the Member States.

How European Courts review European constitutionality

In the first section of this chapter, I have argued that the role of the European Courts as guardians of European constitutionality is grounded on a systematic interpretation of the Treaties to the extent that the latter are seen as part and parcel of a constitutional legal order. With that we have, however, only shown that review of European constitutionality by the European Courts is structurally justified. The line of arguments rehearsed in the previous section do not say much about the further question of whether the specific way in which the European Courts discharge such a task renders their decisions justified. To reach that further conclusion, we would have to show that the European Courts are not only empowered to undertake the review of European constitutionality, but also that they do so in a manner that could be regarded as proper by and large. And that, rather obviously, depends on *how* the European Courts *actually* review the European constitutionality of legal norms. That is the object of the second part of this chapter.

The *actual how* is to be considered in two steps. Firstly, we should consider the *structure* of the judgments in which the European Courts undertake the review of European constitutionality of legal norms. Such a framework is basically constituted by the argumentative framework of the principle of proportionality. This implies a major similarity between how the European Courts discharge their constitutional task and how national constitutional courts undertake theirs. As a consequence, resort to proportionality gives to the review of European constitutionality a formal resemblance to the review of national constitutionality.[21] Secondly, we should also consider the substantive arguments with which the European Courts fill in the

[21] It is far from surprising that this is the structural framework in which the ECJ undertakes the review of European constitutionality. The grammar of proportionality has been the dominant one in European post-war constitutional argumentation. Its extension or projection to the supranational level is thus to be expected once Community law started to be constructed in a constitutional key. Institutional actors probably regarded this solution as rather congenial, as the 'natural' (in the sense of obvious) one, and one which will contribute to smoothing the acceptance of the constitutional status and primacy of Community law. Indeed where such constitutional grammar had not been developed (as was in the case of the UK) the progressive affirmation of that constitutional grammar will contribute to reticence and resistance vis-à-vis the process of European integration.

principle of proportionality. This requires us considering not only the substantive contents of the yardstick of European constitutionality, of the core principles which define the policy options which Community law deprives legislatures from choosing, but also (1) the specific conception of the substantive principles that make up the yardstick of European constitutionality, and very especially, of economic freedoms, that the European Courts have come to flesh out in their case law; (2) the way in which the European Courts assign argumentative burdens when there is a conflict between basic constitutional principles; (3) the criteria the European Courts follow in assigning proof burdens of the facts relevant to apply the adequacy and necessity tests at the core of proportionality; (4) the specific guidelines the European Courts use to assign specific weight to conflicting constitutional principles when undertaking the review of strict proportionality.

The relationship between the formal argumentative structure and the substantive choices is mediated by the third thesis of this chapter. As I argue at length under the sixth thesis below (p. 113ff), proportionality is only a *formal* principle, which defines an argumentative structure, but which does not by itself determine the substantive content of any decision. Contrary to what it is sometimes assumed in the literature on Community law, proportionality can thus only contribute to a rather minor extent to justify any ruling or decision (it is not a comprehensive and self-sufficient *legitimising* principle, resort to which guarantees institutional actors that their decisions should be regarded by its addressees as justified). Proportionality can and should indeed be used in a rather different fashion, as an analytical tool which renders visible the implicit substantive choices underlying a judgment, thus allowing the addressees of the decisions to assess by themselves the justifiability (and thus legitimacy) of the ruling.

Proportionality as the structural framework of the review of European constitutionality

The basic argumentative structure of the constitutional rulings of the European Courts

The third thesis of this chapter is that the structural argumentative framework within which the European Courts justify their rulings on the European constitutionality of both supranational and national norms is the principle of proportionality. Whether the European Courts do explicitly follow the structure of proportionality or not, their *constitutional* rulings are open to be reconstructed with the help of the principle (as I will illustrate by returning to *Cassis de Dijon* and *Avoir Fiscal*). Proportionality constitutes the *deep* argumentative syntax of the review of European constitutionality. Full proof of this argument would require reconstructing each and every judgment rendered by the European Courts, and showing that their *deep structure* corresponds to the argumentative syntax of proportionality. In this chapter, I will limit myself to consider the reconstruction of *Cassis de Dijon* and *Avoir Fiscal* to illustrate how that reconstruction proceeds, and take for granted that all other judgments can be equally reconstructed. That is of course an assumption and not a proof. But not only undertaking such a complete reconstruction would be tedious and result in an even lengthier chapter (perhaps a long monograph on its own, which would make an even less attractive read than this chapter), but seems to me unnecessary. On the basis of an admittedly incomplete exposure to the case law of the European Court of Justice on economic freedoms, I am still to find a case that does not fit this pattern.

The fourth thesis of this chapter is that the argumentative syntax of proportionality requires the European Courts to follow five steps: (1) determine the constitutional principles which underlie the legal norms in apparent conflict; (2) assign argumentative burdens, by means of identifying a *prima facie* infringing norm and a *prima facie* infringed norm (the latter enjoying the argumentative burden); (3) test the adequacy of the infringing norm to realise its underlying principle; (4) the necessity of the infringing norm to realise its underlying principle; (5) determine the specific weight that should be assigned to each of the conflicting principles in the case at hand, and on the basis of that, solve the conflict by assigning *final* preference to one principle over the other, by means of a derivative rule that settles the dispute between the two conflicting norms by setting one aside in favour of the other.

This implies adding to the standard understanding of the principle of proportionality as a three-stepped argumentative framework in the theory of legal argumentation two additional steps; to be more precise, what the systematic analysis of Community law renders visible and advisable is the convenience of rendering explicit these two first steps, which tend to be rather non-controversial in the national constitutional setting, but which have a major and eventually decisive influence when confronted with a less settled constitutional law, such as European Union law is.

The review of the European constitutionality of a legal norm presupposes that there is a *prima facie* or *apparent* conflict between a supranational or national legal norm and a norm of European constitutional law, or what is the same, that a supranational or national legal norm *seems* to be in breach of European constitutional norm. This conflict is always amenable to be reconstructed as a conflict between two principles, the principle of European constitutionality which underpins the norm of Community law *allegedly* infringed and the constitutional principle underpinning the *allegedly infringing* supranational or national legal norm. Thus, in *Cassis de Dijon*, we had an *alleged* conflict between a German statute and Article 30 of the Rome Treaty, which was underpinned by a conflict between the principles of free movement of goods and of the protection of the consumer (which could be argued was already a principle of European constitutional law, and indeed has come to be acknowledged as such explicitly, both by the European legislator and by European Courts). In *Avoir Fiscal*, we had a conflict between a particular French norm included in the French tax code (regulating the assessment of the tax debt in the corporate income tax) and article 52 of the Rome Treaty. That conflict was underpinned by an apparent clash between the principle of freedom of establishment and the principle of autonomous and democratic configuration of national tax systems (and perhaps also, or alternatively, the substantive principle of tax fairness or even progressivity).

Once the two principles underlying the norms in apparent conflict are identified, the Court has to assign the argumentative burden and the argumentative benefit in the case.

What I mean by that is the choice of the norm which is to be regarded prima facie as *infringing* and the norm which is (consequently) to be considered as prima facie *being infringed.*

The allocation of that burden basically depends on two factors. Firstly, on a pre-understanding of what is the *normative* center of gravity of the case, if one is allowed to borrow a concept developed in intra-state conflicts of law, or what is the same, of which of the conflicting principles is more relevant *prima facie* in the concrete factual and normative setting of the case. Was *Cassis de Dijon* mainly about free movement or was it about consumer protection? Which of the two clashing principles was more deeply affected, or more obviously relevant, in this context? Secondly, the assignment of the argumentative burden depends on the abstract weight acknowledged to each principle in previous constitutional, legislative and judicial decisions. Such sets of decisions *restrict* the remaining discretion of Courts when assigning argumentative burdens. Is there sufficient authority to consider that in *Cassis de Dijon* preference should a priori be assigned to free movement of goods over consumer protection?

The commutative principle does necessarily apply to legal argumentation. Whether we start considering whether it is justified to breach principle X to realize principle Y, or whether we consider whether it is justified to breach principle Y to realize principle X, maybe far from irrelevant. So how we allocate the argumentative burden might be of essence.

The first two steps in the argumentative framework of proportionality lead to an implicit but rather detailed conceptualisation of the legal principles in conflict. It goes without saying that constitutional principles, both in the European and in the national constitution, are abstract and general, and as such, open in principle to different conceptualisations. The difference between European and national constitutional law lies on the density of the previous authoritative decisions that define and shape the conception of such principles. When a national constitutional court has to review the constitutionality of a given norm, it tends to have to come to terms with a very dense web of previous authoritative decisions which contribute to the detailed conceptualisation of the principles involved. In particular, national courts are guided by both the constitutional debates preceding key constitutional decisions (explicit constitution-making processes in 'revolutionary' constitutional traditions – such as the French, Italian or to a rather large extent, Spanish one – and key constitutional moments in 'evolutionary' constitutional traditions – such as the British or to a rather large extent, German one) and by the political debates preceding the passing of new legislation, in which the relationship between the new norms and constitutional norms might be of relevance. The European Courts have less guidance at their disposal from such sources. The peculiar constitutional path through which the European Union has evolved (see pp. 83–93

above) entails that contestation over the proper conceptualisation of basic constitutional principles is rendered endemic by the structural fact that Union law is the constitutional framework in which a (growing) number of constitutional legal orders integrate. While the constitutional principles are largely the same in all legal orders, the way in which such principles relate to each other and are thus conceptualised is far from homogeneous. At the same time, the synthetic constitutional path of European integration entails that European Courts are not to find much guidance from key constitutional debates (given the absence of constitution-making processes and the scarcity of constitutional moments which can be said to be akin to decisive ones in evolutionary constitutional traditions). While the peculiar way in which legislation proceeds at the European level restrains the authoritative guidance to be derived from legislative debates, even from such debates in the European Parliament.

The structural differences in the density of the previous authoritative decisions defining the conception of basic constitutional principles explains why these two steps in the argumentative framework of proportionality seem rather uninteresting at the national constitutional level, but prove to be potentially decisive at the European level. As we will see *infra* (p. 131) the European Courts assign *always* the argumentative preference to economic freedoms when reviewing the European constitutionality of national norms. The sheer invariability of this rule, despite the fact that European constitutional law is composed of other constitutional principles, and outstandingly, of the principle of protection of fundamental rights, turns both the specific conceptualisation of economic freedoms and the assignment of argumentative burdens highly problematic steps. These two steps are indeed at the core of the tension between European and national constitutional law.

The third argumentative step requires us to assess the adequacy of the *allegedly infringing* norm to realise the principle which underlies it. In *Cassis de Dijon* we have to consider whether fixing minimum alcoholic graduation standards and banning the sale of products which do not meet these standards *will actually* protect the consumer against being misled by the name of the product into buying something different from what he wanted to purchase (a question which is implicitly answered in a positive manner by the ECJ). In *Avoir Fiscal*, we have to determine whether the power to treat differently insurance companies depending on where they have their registered office would contribute to the realisation of the principle of autonomous determination of the tax system (and/or tax fairness of tax progressivity) (again answered in the affirmative implicitly by the ECJ).

Fourthly, we have to determine the *necessity* of the allegedly infringing norm, or what is the same, whether there is no other normative alternative which would also realize the principle underlying the allegedly infringing norm while not affecting the allegedly infringed principle (or infringing it to a significant lesser extent). In *Cassis de Dijon* the ECJ claims that there are indeed other normative alternatives which allowed a better reconciliation of the principles in conflict; thus the German law is to be regarded as in breach of Community law. In *Avoir Fiscal* it seems to be the case that the ECJ accepts that the differentiated treatment is necessary to realize the *conflicting* principle.

Finally, we have to weigh and balance the conflicting principles, so as to decide which should carry more weight in this concrete case. That operation was not necessary in *Cassis de Dijon*, as an outright ban was regarded as unnecessary; in the terms I have just rehearsed. However, it was decisive in *Avoir Fiscal*, the ECJ arguing that freedom of establishment should trump democratic configuration of the tax system and/or the principle of (national) equality or (national) tax progressivity.

These five steps constitute the complete, deep form of proportionality as a syntactic structure. In actual practice, we may take for granted or regard as unnecessary some of these five steps (as we have indeed just seen on what concerns the first and the second step in the practice of national constitutional courts). Whether this implies that we have followed in an inadequate or incomplete manner the principle of proportionality, or whether it simply means that some of these steps do not need to be gone through because the answer is rather obvious is something that cannot be determined but in the light of the facts in each concrete case. But I want to stress here is that no structural differences can be established on the basis of how many of the limbs are used by Courts. In that regard, perhaps it is pertinent to anticipate that the *Wednesbury* review developed in British administrative law and the standard German constitutional proportionality review are *both* instances of application of the structural principle of proportionality to legal reasoning. The difference is not structural, but as we will see, revolves around the different substantive assumptions made in each case. Similarly, the fact that in a given judgment a Court seems to obviate some of the 'steps' in the proportionality syntactic structure should not lead us to the precipitated judgment that there are structural differences between different proportionality judgments.[22]

The limited justificatory power of proportionality

The fifth thesis of this chapter is that the claim that proportionality plays a key role in justifying the rulings in which the European Court of Justice reviews the European constitutionality of national laws is confounded (and unfounded). This is so because the principle of proportionality is a *formal* principle, a basic principle of legal reasoning that by itself cannot reveal the right answer to a concrete and specific legal dispute. Each and every concrete decision depends on substantive choices that proportionality can only make more explicit. The mere *formal* character of proportionality derives rather immediately from the fact that the use of the principle of proportionality in legal reasoning does not depend on its being *positivised*, on its being explicitly referred to by the legislator, as on its being a principle of general practical reasoning. Whether or not judges can find a positive mention to proportionality, the will ample use of the structural framework characteristic of the principle once they are confronted with the typical questions which arise once the state assumes a wide set of *positive obligations*, once the state starts to actively shape its economic and social environment through law.

The principle of proportionality is a structural principle of general practical reason which has become increasingly *legalised*, put to use in legal argumentation. But no matter how much used and resorted to in legal discourses, proportionality is properly described as the *structural syntax* of general practical reason through which we solve conflicts between colliding principles. In particular, proportionality forces us to consider *all relevant* interests at stake, to ponder on both the abstract and the concrete importance each of them has, and finally

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[22] Thus the standard distinction between 'Proportionality I and Proportionality II' in the case law of the ECJ should be interpreted as calling our attention to the different substantive assumptions made by the ECJ when reviewing the constitutionality of Community and of national norms. The distinction between Proportionality I and Proportionality II is used by Tridimas (2007) and Craig (2008).

to make a considerate judgment in the fullness of reasoning. As David Beatty points, 'proportionality requires judges [but really here we could say anybody taking a decision] to assess the legitimacy of whatever law or regulation or ruling is before them from the perspective of those who reap its greatest benefits and those who stand to lose the most' (Beatty 2004: 160).In brief, '[proportionality] makes it possible to compare and evaluate interests and ideas, values and facts, that are radically different in a way that is both rational and fair' (ibid.: 169) as David Beatty claims in his book-length analysis of proportionality. This is indeed the core intuition behind Alexy's treatment of proportionality in *A Theory of Constitutional Rights*, as Mattias Kumm has reminded us: 'The proportionality test provides an analytical structure for assessing whether limits imposed on the realization of a principle in a particular context are justified' (Kumm 2007: 136).[23] Proportionality as a syntactic structure of general practical reason is put to use in *legal argumentation*, by means of 'filling in' the formal structure with arguments relevant from the standpoint of the specific legal system in which the principle is applied.

This *borrowing* is closely related to the *constitutional turn* of modern law, which in its turn implies a radical reconsideration of the law as a means of social integration, and of the societal tasks to be trusted to the state as the embodiment of collective action. In particular, once law is charged with integrating society not mainly by means of solving specific conflicts but by means of coordinating action with a view to achieve collective goals, law tends to be written by reference first and foremost to legal principles, not to narrow legal rules. Indeed, as Alexy reminds us in *The Theory of Constitutional Rights*:

> [There] is a connection between the theory of principles and the principle of proportionality. This connection is as close as

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[23] Kumm goes on to support a rather formalistic understanding of proportionality, which in my view will fail to overcome Habermas' firewall objection. However, Habermas' objection is addressed to a specific understanding of how proportionality is to be applied in legal reasoning, one that does not take seriously that the abstract weight assigned to certain principles (foremost, the interdiction of torture and cruel and inhuman treatment) does away with the need of weighing and balancing characteristic of the third prong or step in proportionality review. The very central importance of such unqualified rules should make us doubt the convenience of approaching the application of law as a matter of weighing and balancing, and similarly, to describe principles as optimisation commands (both terms, optimisation and commands being objectionable).

> it could possibly be. The nature of principles implies the principle of proportionality and vice versa. That the nature of principles implies the principle of proportionality implies the principle of proportionality means that the principle of proportionality with its three sub-principles of suitability, necessity (use of the least intrusive means) and proportionality in its narrow sense (that is, the balancing requirement) logically follows from the nature of principles.
> (Alexy 2002: 66)

Notice that it follows in *logical*, not *legal* dogmatic terms. And it follows logically because the structure of proportionality requires that before we take a decision, we consider in a rigorous and disciplined matter what is normatively at stake.[24]

This accounts for the fact that *proportionality* reviews tend to pop up in all legal systems once the development of the social and democratic state results in growing powers being assigned to state agents. Once law becomes an empowering device, and not a restraining device of state action, the democratic discipline of state power is carried through legal principles that are established to *programme* state action. As state action unavoidably collides with other legal principles, we need a structural framework with the help of which to think these problems. That framework is proportionality as a structural principle.[25]

Similarly, it is rather predictable that the use of proportionality will tend to be more explicit where decisions have to be taken by actors who lack a homogeneous legal culture, whether on account of

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[24] Both Alexy and Beatty would further add that a constitution cannot exist without reference to proportionality as an optimising principle (of the realisation of constitutional principles) (Beatty2004: 163). But perhaps we can suspend our disbelief on this regard, as it may well be, as Habermas claims, that such understanding of principles fails to give proper due to some specific norms in modern legal systems, such as the prohibition of torture, which *should not* be regarded as being subject to being *optimised*. But that is not of essence in our previous discussion. What matters is that proportionality is not a positive principle, but a structural principle of legal reasoning.

[25] Assuming that state power is democratically legitimated, and so are principles. Keep in mind manipulative use of principles. Consider in that regard Radbruch's claim (2006); and on the other hand Bodenheimer's reflections on the subversion of law through positive law (1962).

different disciplinary backgrounds (public vs. private law) or of different national backgrounds. Thus there is nothing strange in the leading role of constitutional courts in post-war Europe or in the ECJ and the ECHR in the explicit use of proportionality review.

Furthermore this entails that the assumption that the principle of proportionality has become incorporated into positive European constitutional law as a transfer from German public law,[26] thus reflecting the influence of German law upon Community law (as part of the incoming tide of national legal systems fails into Community law) is misconceived. While resort to proportionality in the case law of the Court of Justice may have been explicitly advocated by German jurists, the trigger of its use is to be found in the very nature of the legal questions with which the Luxembourg judges were confronted. Indeed, the use of the principle of proportionality became wide-spread in France and in the United Kingdom[27] as soon as French and British administrative law had to come to terms with the growing power of the state under the Social *Rechtsstaat*. The difference laid not so much on the *structure* of the legal train of reasoning, as on the

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[26] Indeed, its 'transplant' into Community law would have in the fullness of time resulted in the incoming tide of Community law 'implanting' the principle of proportionality in the national public laws of the Member States.

[27] In the leading ruling of the French Conseil d'État in Benjamin (19 May 1933), available at: <http://www.legifrance.gouv.fr/affichJuriAdmin.do?oldAction=rechJuriAdmin&idTexte=CETATEXT000007636694&fastReqId=1286398039&fastPos=1>: *'Considérant qu'il résulte de l'instruction que l'éventualité de troubles, alléguée par le maire de Nevers, ne présentait pas un degré de gravité tel qu'il n'ait pu, sans interdire la conférence, maintenir l'ordre en édictant les mesures de police qu'il lui appartenait de prendre ; que, dès lors, sans qu'il y ait lieu de statuer sur le moyen tiré du détournement de pouvoir, les requérants sont fondés à soutenir que les arrêtés attaqués sont entachés d'excès de pouvoir'*. In the leading ruling of the British King's Bench in Wednesbury (*Associated Provincial Picture Houses v Wednesbury Corporation* [1947] 1 KB 223): 'What, then, is the power of the courts? They can only interfere with an act of executive authority if it be shown that the authority has contravened the law. It is for those who assert that the local authority has contravened the law to establish that proposition [...] What then are those principles? They are well understood. They are principles which the court looks to in considering any question of discretion of this kind. The exercise of such a discretion must be a real exercise of the discretion. If, in the statute conferring the discretion, there is to be found expressly or by implication matters which the authority exercising the discretion ought to have regard to, then in exercising the discretion it must have regard to those matters. Conversely, if the nature of the subject matter and the general interpretation of the Act make it clear that certain matters would not be germane to the matter in question, the authority must disregard those irrelevant collateral matters'.

substantive assumptions made in one case or the other. Indeed, when we consider that proportionality is a structural principle of general practical reasoning that is frequently "filled in" with legally relevant arguments, we come a long way to explain how proportionality has become pervasive in basically all modern legal systems,[28] even if the principle has not been explicitly positivised in the Constitution or in statutes of a constitutional relevance and importance.

Finally, the nature of proportionality is corroborated by the fact that the principle is used in all legal discourses, from discourses of application of the law to constitution-making discourses, which by definition are not governed by authoritative legal norms.

The difference lays not so much on the structure of the argument, but on the extent to which *authoritative law* weighs on the actual decision. In *constitution-making discourses*, proportionality is substantially filed by reference to prudential, ethical and normative considerations, but not necessarily by arguments referring back to authoritative legal arguments (if that arguments are authoritative in that situation is because of their normative value, not because of their legal authority). In *judicial discourses*, proportionality is filled to a rather large extent by what is taken to be the body of *authoritative legal decisions* making up the legal order. In *legislative discourses*, proportionality has to be filled by reference to constitutional authoritative decisions, but not by reference to previous laws and judicial decisions.[29]

It follows from the structural character of the principle of proportionality that, contrary to what is widely assumed (Beatty

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[28] Although there is also a specific *politics* of proportionality, but that has to do more with the confusion of the structural and substantive dimensions of proportionality, and indeed with the very substantive contents with which proportionality judgements are filled).

[29] Indeed, it may only be slightly exaggerated to claim that most of legal norms are the products of decisions taken with the help of the structure principle of proportionality. This should help us reconsider what happens when a decision is taken following the principle of proportionality in a simplified, incomplete manner. That is usually constructed as reflecting a deeper of more superficial decision-making process, or if proportionality is used to review not to decide, a stricter or more lax standard of review. In substantive terms, however, that implies also a specific attitude towards the extent to which we can rely for our judgment on past decisions, and the extent to which the proportionality judgments implicit in them are to be trusted or, on the contrary, are to be reconsidered.

2004: 160-1),[30] the *form of the syntactic structure* of proportionality can only play a modest legitimising role. Taking a decision following the syntactic structure of proportionality (or even if some other form was used, writing rulings capable of being reconstructed by reference to that structure) is a necessary, but insufficient condition for the legitimacy of the decision. In particular, compliance with proportionality can only guarantee the *formal* correctness of the decision taken after following the four steps which compose it in the terms that I considered. This minimal legitimacy is indeed the kind of legitimacy that follows from the *Wednesbury* review: that the decision is not foolish in the sense that its aim makes sense and that no obvious alternative solution that could reconcile the two principles at stake was available. It cannot provide a thicker legitimacy without borrowing it from the substantive principles with which the structural principle is filled in. In other words, proportionality cannot guarantee the *substantive correctness* of the decision, which critically depends on the substantive correctness of the arguments with which the principle is "filled in".

The justifiability of the substantive choices made by European Courts (the *alternative* use of proportionality)

The sixth thesis of this chapter is that the principle of proportionality provides us with the analytical tools to subject any of the judgments of European Courts to a more thorough critical review.[31] Proportionality renders easier to determine which are the concrete substantive choices underpinning a ruling, and consequently, also makes easier to assess the normative correctness of the decision (a judgment which largely depends on the coherence between the substantive choices underlying the ruling and the substantive choices that stem from a systematic construction of the legal order).

Proper attention to the *structural* nature of the principle of proportionnality as a syntactic structure of general practical reasoning should lead us to distinguish very clearly between the

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[30] He claims this is because proportionality certifies the neutrality of the arguments of the courts, and as such can be seen as a *metalegitimating principle*. See also Kumm (2007) and Tridimas (2007).

[31] That is, it seems to me, the core point of Alexy's *Theory of Constitutional Rights*. To develop a sophisticated analytical approach so as to render as explicit as possible what is most of the time done implicitly, or even worse, done in such a muddled way that what is a substantive argument is presented as a structural one.

formal requirements of practical reasoning and the *substantive* elements with which we fill in the syntactic structure, and to which I have just referred. The correctness of a legal argument depends not only on following the structure of proportionality, but in getting the substance right. Indeed, in that distinction, in rendering us capable of making that distinction, resides the key analytical value of the principle of proportionality. It allows us to distinguish what parts of the decision are required by the very structure of legal reasoning (as a special case of general practical reasoning), which parts of the decision are dependent on substantive assumptions made in a rather uncontroversial way in previous legal decisions (essentially, through acts of constitutional significance and importance) and which parts depend on substantive assumptions made by the decision-maker. In particular, attention should be paid to the actual foundation of assumptions on the argumentative and proof burdens, the specific conceptions of each legal principle and the abstract weight assigned to each of them.

In particular, I will consider (a) the definition of the yardstick of European constitutionality; (b) the unqualified assignment of the argumentative benefit to economic freedoms; (c) the conceptualisation of economic freedoms as the operationalisation of a transcendental economic freedom; (d) the unrealistic assumptions which render possible to assume that there are less stringent alternatives to national measures which infringe economic freedoms; and (e) the distortion of the degree of non-satisfaction of national constitutional principles trumped by Community economic freedoms.

While there is no exhaustive approach to the case law, it is perhaps pertinent to say that most of the cases here referred to concern the interplay and conflicts between supranational economic freedoms and national personal taxes. In addition to some substantive reasons which could perhaps be cited to ground such choice, the more contingent reason that these are the cases which the present author is more familiar with was determinant of the selection.

The yardstick of European constitutionality and the specific conceptualisation of economic freedoms

The first set of substantive choices with which the syntactic structure of proportionality is filled in is that concerning the elucidation of the constitutional principles which underpin the two apparently colliding norms. As we already saw, this step, together with the assignment of the argumentative burden, requires to and results in the conceptualisation of the principles at stake, in particular the consideration of the concrete faculties they comprise.

This conceptualisation poses two sets of problems, related to two implicit substantive decisions made by the European Courts when undertaking it.

The first concerns the definition of the yardstick of European constitutionality. Because there is no written European constitution, but we have a regulatory ideal of a common constitutional law only partially fleshed out in the founding Treaties plus the set of national constitutional norms, the yardstick of European constitutionality is not formally established in a single authoritative constitutional document. This implies that the European Courts have a role to play in fleshing out the constitutional yardstick, a role in which they make substantive choices the justifiability of which is to be open to scrutiny.

The second concerns the characterisation of the principles which make part of the yardstick of European constitutionality. Even if we assume that the European Courts have rightly decided that the substantive principles which make up the yardstick of European constitutionality are the four economic freedoms, the principle of non-discrimination on the basis of sex and the principle of protection of fundamental rights, there are very good reasons to consider how the European Courts conceptualise each of these constitutional principles by means of fleshing out derivative constitutional norms that concretise the implications of each principle in specific factual and normative settings.

Defining the yardstick of European constitutionality

As the reader has just been reminded, the synthetic path through which the European Union was constituted and has evolved into a full-blown constitutional polity entails that instead of a single and authoritative written European constitution, European Union law is based on the regulatory ideal of a common constitutional law, only partially fleshed out in the founding Treaties plus national constitutions.

As a result, the yardstick of European constitutionality is not formally established in a single authoritative constitutional document. Instead, the European Courts played a key role in rendering explicit the implicit constitutional yardstick. This role is at the core of the process of *transformative constitutionalisation*, the internalisation by constitutional actors (especially, national constitutional actors) of the constitutional character of European Union law.

This process is marked by its four main features.

Firstly, it was rather belated. While the Court had enunciated the core structural principles governing the relationship between Community law and national constitutional law in the early 1960s (paramountly in the two leading cases of the case law of the ECJ *par excellence*, *Van Gend en Loos* and *Costa*), it was only in the 1970s that such structural principles were filled in with constitutional substance. The leading case on the protection of fundamental rights (*Internationale)* was decided in 1970 (a year after the first tentative affirmation of the unwritten principle of protection of fundamental rights in *Stauder*), and the leading case on the direct effect of economic freedoms was *Dassonville*, decided in 1974.

Secondly, the yardstick of European constitutionality is two-fold. On the one hand, we find the principle of protection of fundamental rights, which as has just been said, was for a long time an 'unwritten' constitutional principle, in the sense that it was not explicitly affirmed and stated in the Treaties, but was derived from a systematic interpretation of the fundamental norms of the Union, with clear and explicit reference to the idea of a common constitutional law as the deep constitution of the European Union. While the principle ceased being an 'unwritten' one once the preamble of the Single European Act contained an explicit reference to it,[32] the Union kept on having a judicially (sometimes wittily

[32] 'Determined to work together to promote democracy on the basis of the fundamental rights recognised in the constitutions and laws of the Member States, in the Convention for the Protection of Human Rights and Fundamental Freedoms and the European Social Charter, notably freedom, equality and social justice." Article F of the Treaty of Maastricht made fundamental rights part of the text of the primary law of the Union: "[T]he Union shall respect fundamental rights, as guaranteed by the European Convention on Human Rights and Fundamental Freedoms […] and as

characterised as 'praetorian') defined bill of rights until European institutions solemnly proclaimed the Charter of Fundamental Rights in 2000.[33] On the other hand, we find the economic freedoms plus the principle of undistorted competition. The Court turned these Treaty provisions into key components of the yardstick of European Constitutionality by means of affirming that the articles in which they were enshrined were to be acknowledged direct effect. [34]In formal terms, thus, the role played on national constitutional texts by the norms affirming a 'constitutional core' (as the eternity clause in the German constitution, the norms distinguishing different review procedures and making more onerous to amend certain provisions of the Constitution in other constitutional traditions; or the norms defining the set of fundamental rights whose protection citizens can directly seek from the constitutional court) is played in Community law by the criteria which make of a Treaty provision a directly applicable one.[35]

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they result from the constitutional traditions common to the Member States, as general principles of Community law'.

[33] The Court enlarged the breadth and scope of substantive principles by going beyond the literal text of the Treaties and considering the *deep contents of European constitutional law*, namely, the constitutional law common to the Member States, and in particular, fundamental rights. The more the Union was acknowledged as the holder of full public powers, the more there was a pressure to counterbalance the exercise of such powers by protecting fundamental rights. In addition, major political events on both sides of the Iron Curtain accelerated the process of constitutionalisation in this regard. The Prague Spring of 1968 undermined the Soviet propaganda concerning the purely 'bourgeois' character of civil rights. Rights were more than ever to be part of Western cold-war diplomacy. (Besides which Czechoslovak protestors would have indeed profited from having their rights respected). At the same time, the upheaval and unrest of May 68 in France and in other Western countries made urgent the need to find a discourse to challenge the materialistic and alienating critique of Western welfare states. Cf. Pescatore (1968, 1970); Weiler and Lockhart (1995). In developing the set of rights protected under Community law, it is important to stress that the Court engaged in the weighing and balancing of different types of constitutional rights from an early date.

[34] Schermers and Waelbroek (2001: 183-5) concluded ten years ago that such articles were (in the numbering relevant at that time) 12; 23; 25; 28,29,and 30 (free movement); 31(1) and (2); 39-55; 81(1); 82; 86(1) and (2); 88(3); 90, first and second paragraphs; and 141. This basically means that the positive argumentative burden is assigned to the four economic freedoms, undistorted competition and non-discrimination on the basis of sex.

[35] The 'economic' side of the substantive constitutional yardstick was only very preliminary developed in the early case law of the ECJ on customs (as in *Van Gend en Loos*) and in the old Article 95. But it was fleshed out in earnest from mid-1968 onwards, that is, once the fourth stage towards the common market was completed.

Thirdly, there is an apparent marked division of labour between the two arms of the yardstick of European constitutionality. On the one hand, review of the European constitutionality of Community secondary norms tends to proceed by reference to the principle of protection of fundamental rights, and only rarely by reference to the four economic freedoms. This is the lasting legacy of the fact that under the traditional Community Method, the Council of Member States was required to unanimously support a given legislative proposal for its becoming Community law in force. Even if procedurally speaking a decision of the Council (even if unanimous) was rather different from a decision taken in an Intergovernmental Conference, the fact of the matter was that a unanimous decision of the Council came close to a decision supported by a constitutional will. So in fact the ECJ tended to look for inspiration to construct Treaty provisions on secondary legislation and not the reverse. Even if qualified majority making and co-decision have changed things, the fact still is that the degree of legitimacy which a regulation or directive carries with it makes the ECJ very cautious when undertaking review on the basis of economic freedoms. Very different considerations apply when it comes to the protection of fundamental rights. Here it is not only the case that the main reference point cannot be the decisions of the Council of Ministers (a body of an open executive nature), but the substantive contents of national constitutions. On the other hand, review of the European constitutionality of national norms proceeds by reference to economic freedoms, while the protection of specific fundamental rights has traditionally been used, and only to a rather limited extent, as a reference point when shaping the canon of exceptions to economic freedoms. This is the result of the fact that the principle of protection of fundamental rights was not enshrined in the original Treaties, but derived by the ECJ from the constitutional law common to the Member States, and consequently, regarded as limiting not the power

From that date onwards, the ECJ considered that three of the four economic freedoms (and the principle of undistorted competition) were so defined in the Treaties as to merit to be acknowledged direct effect once the transitory phases were over. The fourth freedom (the free movement of capital) was so circumscribed and limited in the original drafting of the Treaties as to be considered as not having direct effect. That would remain being the case until the 1988 Directive (ad intra) and the Maastricht Treaty (1991) radically changed the Community legal discipline and consequently the status of this freedom, which within a decade moved from cindirella to über-freedom.

of the Member States (already constrained by each of the fundamental rights constitutional traditions which are part of the European collective).

Fourthly, this does not do away with the fact that the yardstick is not only two-fold but Janus-faced for the simple reason that the key constitutional issue, in Community law as in all other constitutional legal orders, is how these two sets of principles relate to each other. While this conflict was present all through the process of European integration, the case law of the European Courts remained rather unproblematic until the late seventies. Indeed, the European Courts solved this conflict in line with the basic constitutional choices of post-war national constitutions. It is worth keeping in mind that the first cases on the protection of fundamental rights concerned in many occasions the conflict between the right to private property and the collective goals pursued through common agricultural policy. By means of giving preference to the latter, the European Courts may have been furthering European integration; but in doing that, they were solving the conflicts in a way congenial to the characterisation of private property in the social and democratic *Rechtsstaat*. In fact, the key leading cases concerned conflicts in which Community law fostered collective goods and interests, and plaintiffs claimed that it was in breach of their right to private property.[36] However, once the European Courts affirmed an autonomous and self-standing conception of economic freedoms, once they favoured a different conceptualisation of economic freedoms, the tension at the core of the yardstick of European constitutionality could only mount over time. This is a typical, almost millenarian conflict at the core of fundamental rights protection.[37] *Viking* and *Laval* are but late chapters in a long saga from this perspective.

I will come back to the one of the aspects of the tension between economic freedoms and fundamental rights at the core of European

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[36] Typically, Case 4/73 *Nold* [1973] 491 and Case 44/79 *Hauer* [1979] ECR 3727, where the right to private property was invoked against regulatory powers on coal retailing and on use of agricultural land.

[37] What is revealing is that it is substantively identical to the ones which have been at the heart of public debate in the last years, with the revealing difference that what conflicted with collective goods was a Community protected economic freedom, and that the Court solved the conflicts according to a different normative logic.

constitutional law when considering the way in which the European Courts assign specific weight to conflicting principles.

What is worth highlighting now is that the criteria that determine whether a given principle is part of the yardstick of European constitutionality have been distilled by the European Courts from the set of European constitutional materials (from the constitutional law common to the Member States, the deep constitution of the Union, and from the text of the Treaties, which have rendered partially explicit the integrated common constitutional law). In this process of distillation, the European Courts have exerted their discretion through *substantive choices*, the justifiability of which cannot be grounded on the principle of proportionality, but must be grounded on substantive reasons.

The development of a jurisprudential bill of rights entails not only defining which rights are *fundamental* (something on which there is far from being complete agreement among the Member States) but also how different fundamental rights are to relate to each other (as indeed, the Social and Democratic *Rechtsstaat* is based on the reconciliation, but on the full convergence, of the ideals of the rule of law, the democratic state, and the social/welfare state). The solemn proclamation of the Charter of Fundamental Rights and its later formal incorporation to the primary law of the Union should be regarded by the European Courts as authoritative decisions relieving them of many of these discretionary choices. However, as I will argue in the coming paragraphs, the Charter renders even more visible the problematic character of the assignment of the argumentative benefit to economic freedoms (p. 131ff) and the criteria which the European Courts follow when assigning specific weight to European constitutional principles (p. 136ff).

Similarly, the definition of the criteria according to which to determine whether a Treaty provision is to be regarded as directly effective or not is not to be found in the Treaties, but must be derived from a systematic and rather teleological construction of the constitutional materials of European Union law.

Still, it seems to me that the definition of the yardstick of European constitutionality advocated by the European Courts is by and large well grounded. The very idea of integrating constitutional states through constitutional law requires placing the fundamental rights characteristic of the social and economic *Rechtsstaat* at the very centre of the yardstick of European constitutionality. While it is hard to contest that the case law led by *Internationale* was causally motivated by the challenge to the primacy of Community law and consequently to the institutional authority enjoyed by European Courts, the affirmation of the unwritten principle of protection of fundamental rights was clearly required by the regulatory ideal of a common constitutional law of democratic states integrating through constitutional law. The prominence of economic freedoms has a clear literal basis on the founding Treaties. And while much could be said (and should be said) on the peculiar conception of the economic freedoms supported by the Court (see next subsection), the centrality of the project of the internal market and the principle of non-discrimination on the basis of nationality, leading to the opening of national economies, is hard to contest.

Conceptualising the components of the yardstick of European constitutionality, especially economic freedoms

In the previous section, I have claimed that the yardstick of European constitutionality is basically composed of (1) the fundamental rights which were first elucidated by the European Courts in its case law ("filling in" the unwritten principle of protection of fundamental rights) and have been recently enumerated in the Charter of Fundamental Rights of the European Union; (2) the economic freedoms at the core of the socio-economic constitution enshrined in the Treaty establishing the European Economic Community, and now reproduced in the Treaty on the functioning of the European Union. And I also concluded that there were good reasons why the yardstick of European constitutionality should be defined in these terms, even if such reasons were not always, and not even mostly, fleshed out by the European Courts in their rulings. However, it is still the case that general constitutional principles are formulated at a high level of generality and abstraction. As I also argued, there are very good reasons why the concretisation of these principles, the progressive development of a specific conception of each of them, is a more problematic task under Community law than under national constitutional law. So what can be said of the way in which the European Courts have conceptualised the components of the yardstick of European constitutionality?

The conceptualisation of fundamental rights remains unproblematic to a rather large extent, if only because the number of cases in which the European Courts had engaged in the detailed specification of fundamental rights has been limited. As was already indicated, fundamental rights have been considered upon by the Court only when reviewing the constitutionality of Community norms, not of national ones. And when doing so, the European Courts have tended to be rather attentive to the substantive choices stemming from the common constitutional traditions and from the case law of national constitutional courts. This is something reflected, as was already said, in the preference assigned to fundamental collective goods realised through public policies over the right to private property, or on the restrictive approach followed when it comes to define the extent to which legal persons (namely corporations) can be regarded as holders of fundamental rights. This pattern could also be recognised in the controversial *Kadi* decision. The decision of the Court of Justice (in contrast to that of the Court of First Instance) did not only affect the structural principles governing the relationship between international law and Community law, but also the substantive content of certain basic civil rights.

In contrast, the conceptualisation of economic freedoms offered by the European Courts is highly problematic. Three observations are due in this regard. Firstly, that while economic freedoms have always been defined by reference to the normative ideal of "an internal market", what has been understood by the latter has changed over time. The historical reconstruction of Community law is revealing of the fact that the original understanding of the internal market as a common market has been superseded by the characterisation of the internal market as a single market. The net outcome has been to turn economic freedoms from concretisations and operationalisations of the principle of non-discrimination on the basis of nationality (which entailed that the substantive content of economic freedoms depended on each national legal order) to concretisations and operationalisations of a self-standing and transcendental ideal of economic freedom. Secondly, that this shift implies a substantive choice which does not logically follow from the idea of the single market. Thirdly, that this shift has only been partially endorsed by successive constitutional amendments to the founding Treaties.

Firstly, there has been a marked change in the conceptualisation of economic freedoms. Under the common market conception of the Treaties, economic freedoms aimed at operationalising the right of a resident or economically active non-national to be treated in the same way that nationals are dealt with. A right which is more likely to be infringed than that of citizens for the very simple reason that European non-nationals are denied the right to vote in national elections, and as a consequence, lack in most cases direct means to influence the actual content of legislation.[38] Under the single market conception of the Treaties, economic freedoms are transformed into self-standing constitutional norms, the substantive content of which is to be determined by reference to a transcendental ideal of freedom. The right holders of economic freedoms are no longer non-nationals, but actually all European citizens, including nationals, as the very aim of the single market is to get rid of all borders and distinctions, including reverse discrimination and purely internal situations. Any *obstacle* to the exercise of *any* economic freedom of *anybody*, including a non-discriminatory one, would constitute a breach of Community law. Breaches of economic freedoms are thus no longer limited to discriminatory normative patterns (which implied the anchoring of the European yardstick of constitutionality to the national one, because non-discrimination is a formal, not a substantive, principle) but are now extended to cover any 'obstacle' to the realisation of the economic freedoms (something which by definition could not be determined by reference to national constitutional standards).

The shift from the common to the single market conception of economic freedoms in particular and of the internal market in general is to be traced back to *Cassis de Dijon*. As we already saw, in that case the European Court of Justice reviewed the European constitutionality of a German statute setting minimum alcoholic contents of fruit liquors. By setting this statute aside, the ECJ established a derivative constitutional rule according to which goods in compliance with any national regulatory standard should allowed unhindered access to all national markets, as all national regulatory

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[38] Their right not to be discriminated through the enjoyment of Community fundamental rights and economic liberties compensates the democratic pathology stemming from the mismatch between the circle of those affected by national laws and those entitled to participate in the deliberation and decision-making over national laws. This is perhaps the core implication of Weiler's principle of constitutional tolerance (2001).

standards would realise a functionally equivalent regulatory function. Indeed, the Commission derived from the derivate constitutional rule affirmed in the *Cassis* ruling the wider paradigm of *the* mutual recognition of laws, which it claimed rendered unnecessary positive European regulation before incorporating specific goods or sectors to the *common market*.[39] This jurisprudential move was fully confirmed when the line of jurisprudence in *Cassis* was extended to the other three economic freedoms.[40]And the shift was normatively crowned in the ruling in *Martínez Sala*, as the European Court of Justice started to refer to citizenship as the new fundamental principle which economic freedoms operationalised under this new paradigm (and in the process, identifying European citizenship with a set of economically based, even if not economically conditioned, faculties) (Somek 2008; Menéndez 2010). *Viking* and *Laval* are but concrete applications of this new understanding of economic freedoms.

Secondly, the 'obstacle' conception of economic freedoms is not the 'logical development' of the 'discrimination' conception, but rather a different one, based on a rather different socio-economic and constitutional vision. Just consider the following four major structural implications.

For one, the obstacle conception implies a transcendental yardstick of European constitutionality, emancipated from national constitutional law, and mysteriously derived by the Court from the rather dry and concise literal tenor of the Treaties. This *dis-anchoring* is at the core of the 'legitimacy' crisis of the European Union, and calls for either a rolling back of integration to render the old constitution of discrimination sustainable, or a federal leap through democratic constitution-making.

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[39] Cf. 'Declaration of the Commission concerning the consequences of the judgment given by the European Court of Justice on 20 February 1979 ('Cassis de Dijon'), OJ C 256, of 30 October 1980, pp. 2 and 3.

[40] Key leading cases were Case C-76/90, *Säger*, [1991] ECR I-4221; Case C-55/94, *Gebhard*, [1995] ECR I-4165; Case C-415/93, *Bosman*, [1995] ECR I-4921; and after the entry into force of Directive 88/361 on free movement of capital, Case C-163/94, *Sanz de Lera*, [1995] ECR I-4821. On the literature, see de Castro Oliveira (2002); Hatzopoulos and Do (2006); Wymeersch (2002); Mohamed (1999); Landsmeer (2001); Flynn (2002); Andenæs et al. (2005). An overall interpretation congenial to the one hinted at here can be found in Somek (2008).

For two, the re-calibration of economic freedoms has resulted in a massive growth of the horizontal effect of European constitutional principles. Areas of national law which had not been much Europeanised through supranational law-making (such as personal tax law) or which seemed clearly outside the scope of the Treaties (such as non-contributory pensions) were *absorbed* into European constitutional law, with national policy decisions being progressively subject to a review of their European constitutionality. This is why we are confronted with vertical conflicts proper, in which the collision between supranational and national law is not the result of a horizontal conflict among national constitutional norms competing to define the common, collective standard, but rather results from a conflict between an autonomously defined supranational constitutional standard and national ones (even most or even all national constitutional standards, viz. the kind of situation underlying *Viking* or *Mangold*). Indeed, *Cassis* implies doing away with the idea of a constitutional space in which economic freedoms do not mediate the constitutional validity of any national legal norm. Indeed, the idea of a *diagonal* conflict (as in Christian Joerges' theory of constitutional conflicts) is either quaint and obsolete if one embraces *Cassis*, or else it constitutes an implicit vindication of the old understanding of economic freedoms as principles of non-discrimination.

For three, the engine of integration shifted from the law-making process (precisely at the time at which that was becoming potentially democratic with the direct election of the Members of the European Parliament) to the constitutional adjudication process into which preliminary requests were progressively transformed into the path of review of the European constitutionality of national statutes. If one endorses *Cassis de Dijon* and *Centros*, one is endorsing not a process of juridification (as these are matters which are within the realm of the law anyway) as a process of judicialisation.

For four, as the shape of economic freedoms as constitutional standards became progressively specific, the negative move in mutual recognition was harder to combine with the positive move of re-regulation, because the combined effect of European constitutional decisions by the European Court of Justice was to foreclose the realm of national legislative autonomy. *Centros* is, indeed, a poignant case. The 'optimistic' interpretation put forward by Joerges seems to me rather naïve. The best illustration of how far the judgment reinforced the structural power of capitalists and weakened the taxing and regulatory grip of the state as *longa manus* of the public interest is provided by the 400% increase of the number of 'shell' companies constituted in England after *Centros*, most of which were German.[41] It should be added that the more the Court has developed its jurisprudence, the more it has foreclosed the actual realm of re-regulatory discretion on the side of the Member States. This is, in my view, fully illustrated by the tragic and rather foolish case law of the Court on personal taxation (see Menéndez 2010), where the much-maligned harmonisation has, to a large extent, progressed thanks to the iron fist of market adaptation accelerated by the ECJ. The price of substituting politically led harmonisation by market-led harmonisation is always paid in the hard currency of (a lesser modicum) of distributive justice, in flat contradiction with the basic principles of the *Sozialer Rechtsstaat*.

Thirdly, it is to be doubted that this new paradigm of economic freedoms can be grounded on positive constitutional choices.

While the leading case on the matter (*Cassis de Dijon*) could be said to reflect the ongoing transformation of the understanding of economic freedoms in certain national constitutional orders (above all, the British, and to a lesser extent, the German one as the result of the drift of the ordoliberal model towards a neoliberal understanding under the specific circumstances brought about by the two oil crises and the turbulence in the international monetary system), it did *anticipate*, and not *follow*, the changes introduced in the Treaties by the Single European Act and the Treaty of Maastricht. Moreover, the latter two Treaties made explicit that the European Union aimed at the realisation of an internal market, and seemed to endorse the legislative changes resulting from the legislative programme put together in the White Paper on the Single Market.

The Single European Act and the Treaty of Maastricht *do not* contain an unequivocal endorsement of the *obstacles* conception of economic freedoms. Firstly, it is still the case that a different chapter is devoted to on the one hand economic freedoms and on the other hand the other four economic freedoms. And that in between these two, we find the chapter consecrated to the common agricultural policy.

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[41] The figures are taken from Becht et al. (2008).

Secondly, the Treaties do still affirm the 'neutrality' of Community law on what concerns national choices on the legal regime of the right to private property. Thirdly, the amending Treaties are presented as means to further align the European Union to the constitutional ideal of the social and democratic *Rechtsstaat*, something that is especially reflected in the provisions on social policy enshrined in the Maastricht Treaty. And fourthly and above all, none of the amending Treaties alter the constitutional identity of Member States as social and democratic *Rechtsstaats*, something which seems difficult to reconcile with the characterisation of economic freedoms as concretisations of a self-standing and transcendental understanding of economic freedom.

All this leads to the sixth thesis of this chapter, namely, that the 'obstacles' conception of economic freedoms, according to which the latter are to be regarded as operationalisations and concretisations of a transcendental and self-standing ideal of (individualistic and economic) freedom is neither a logical development of the founding Treaties, nor is fully endorsed by the amendments to the Treaties, not even the Single European Act and the Treaty of Maastricht. Such a conception should be reconsidered and revised in the case law of the European Court of Justice. It does not only severe a basic source of legitimacy of Community law (the transfer of legitimacy through the key role played by the common constitutional law as the deep constitution of the European Union) but runs the risk of placing Union law at constitutional odds with national constitutional law, to the extent that the latter keeps on being inspired by the normative goal of reconciling the rule of law with the democratic and the social state. The Court should indeed take seriously the pluralistic basis of Community law, and keep in mind that its role as guardian of European constitutionality is one in which it has to be especially attentive to the substantive content of the constitutional law common to the Member States, and which it shares with national constitutional courts. Where the European Courts to persist in putting forward this peculiar understanding of economic freedoms, it is more than likely that national constitutional courts would act on the basis of their legitimate role as part of the collective of guardians of European constitutional law.[42]

[42] A most benign manifestation of such a role would follow the path of the German Constitutional Court in several of its 'European' judgments, including the Lisbon

Two cases that illustrate the deep constitutional problems associated with the 'obstacle' conception of breaches of Community law are *Schwarz* and *X*.

Schwarz[43]revolved around the pretence of a German couple to be granted a deduction from their income tax liabilities on account of the cost of sending their children to Cademuir International School, a private (and expensive: 23,400 sterling pounds full board a year in 2004/2005, or circa 34,281 euro) school in Scotland. The Schwarzs may have obtained the deduction if the school was established in Germany, and had been certified by the tax authorities. Germany claimed that even if the policy was articulated through a tax norm, the policy remained education. Deduction was necessarily linked with supervision by the state, which in turned ensured the achievement of a set of goals, including non-segregation by income of the parents. The Court, as will be considered again *infra*, disregarded the way in which the German authorities characterised the issue, and seizing the high constitutional ground to claim that the German tax norm was restrictive not only of the freedom to provide services of Cademuir (and in general, in the Commission proceedings of all providers of education for fees) but also of the right to citizenship of the children, which were discriminated against for the sole reason of making use of their right to be Europeans and move (Pars 129 and 130). In the romantic language of the ECJ:

> In so far as it links the granting of tax relief for school fees to the condition that those fees be paid to a private school meeting certain conditions in Germany, and causes such relief to be refused to payers of income tax in Germany on the ground that they have sent their children to a school in another Member State, the national legislation at issue in the main proceedings disadvantages the children of nationals solely on the ground that they have availed themselves of their freedom of movement by going to another Member State to attend a school there.[44]

judgment. A rather less benign result would ensue if national constitutional courts would limit themselves to act as guardians of the national constitutional law.

[43] Joined cases C-76/05, *Schwarz* and C-317/08, *Commission v. Germany*, [2007] ECR I-6849.

[44] Par. 92 of the Judgment. See also par. 66: 'Legislation such as that under Paragraph 10(1)(9) of the EStG has the effect of deterring taxpayers resident in Germany from

But if one drops the romantic language, what the Court is saying is that European citizenship implies the right of extremely well-off parents not so much to send their children to study to an exclusive British school, [45] (a right which seems to me predates by far Community law: I am not aware of a prohibition to send children to study abroad in any European state in the recent European history), but also to be granted a tax deduction on account of the fees thus paid. But can we really accept that a fundamental right is at stake when we are discussing whether somebody who could pay a fee of 30,000 euro plus in 2004 is to obtain a relatively modest tax rebate from the authorities? Can this be said to be a core content of the right to European citizenship?

Even more telling is the Freudian lapse of the Court in joined cases *X and Passenheim-Van Schott*.[46] In this case it was discussed whether a recovery period of taxes which was longer when concerning income obtained abroad was or was not contrary to Community law. In X, Belgian authorities had spontaneously forwarded Dutch authorities information on capital holdings in a Luxembourgian bank. Mr X happened to be among those holding capital without informing the authorities, and thus, without paying the taxes due. Mrs Passenheim-Van Schott was a widow who decided to make full disclosure to Dutch authorities of capital which her late husband and herself held in a German bank. In both cases the plaintiffs protested the pretence of the tax authorities to extend recovery to twelve years, instead of the five years which would have been applicable had the capital been held in The Netherlands. While the Court ended up finding that the longer recovery period was justified because it did not only contribute to the effectiveness of fiscal supervision (Par. 52) but was not disproportionate because Directive 77/799 does not require an

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sending their children to schools established in another Member State. Furthermore, it also hinders the offering of education by private educational establishments established in other Member States, to the children of taxpayers resident in Germany'.

[45] And not long-lasting, alas! The school closed down in September 2006 due to financial difficulties, after severe doubts have been raised on the press concerning the actual quality of the education and of the care and protection children received at the school. Her Majesty Educational Inspectors were not especially enthusiastic in the first inspection of 2004 and were far from fully satisfied one year afterwards. Indeed the Court knew that this had been the case by the time both the Advocate General delivered the case and of course the Court gave its judgment.

[46] Joined Cases C-155/08 and C-157/08, [2009] ECR I-5093.

automatic exchange of information,[47] it did find that the longer recovery period was *prima facie* restrictive of free movement of capital, on the basis of a very peculiar argument, which is worth reproducing:

> The application to taxpayers resident in the Netherlands of an extended recovery period in regard to assets held outside that Member State and their income therefrom is such as to make less attractive for those taxpayers to transfer assets to another Member State in order to benefit from financial services offered there than to keep the assets, and obtain financial services, in the Netherlands.

Indeed, this seems to imply that economic freedom includes the right to minimize the chances of being caught avoiding taxes, which cannot be curtailed by the competence of the Member State to graduate the length of recovery period by reference to the intrinsic difficulty of monitoring compliance, on the basis of the information which is available to them.

Argumentative burdens

We have already considered that proportionality as the syntactic structure of constitutional argumentation is structured in five steps. And I already argued that a key move in the process of filling the formal structure of proportionality with substance so as to reach a decision through its application concerns the assignment of the argumentative burden. In this section I will focus on a feature of the review of European constitutionality of national norms, the choice of the ECJ to always assign the argumentative benefit to economic freedoms, and the argumentative burden to the principle or principles colliding with the economic freedom.[48]

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[47] And it is correct to assume that it will be hard to spot concealed tax information held abroad than in the Member State. See par. 72 of the judgment: 'the fact remains that, in regard of assets and income which are not the subject of a system for the automatic exchange of information, the risk for a taxpayer that assets and income which have been concealed from the tax authorities of his Member State of residence will be discovered is less in the case of assets and income in another Member State than in the case of domestic assets and income'.

[48] Or eventually, with the principle of non-discrimination on the basis of sex by reference to Article 157 TFEU or to citizenship to the extent that it gives rise to autonomous rights.

The *argumentative benefit* granted to economic freedoms was rather inconsequential as long as economic freedoms were understood as operationalisations of the principle of equality, and thus were substantially defined by national standards. This was so because the national standards of protection of economic freedoms were the result of weighing and balancing economic freedoms with other constitutional principles, so that the *renvoi*to national constitutional standards implies that the argumentative benefit is based on a previous balancing undertaken at the national constitutional level. Indeed, when national norms enter into conflict with economic freedoms as operationalisations of the principle of non-discrimination, what is put into question is exclusively the personal scope of application of the national norms, not their inner normative logic.

Things change considerably once we conceptualise economic freedoms as self-standing, transcendental standards defined at the end of the day by the European Courts. This is so because the Community conception of economic freedom replaces the national standard, and as such, does away with the crafted balance reached at the national level. But if that is so, there is no obvious reason why we should assign an *argumentative* favour to economic freedoms.

Such an argumentative *favour* is contrary to a coherent characterisation of Community law as a constitutional order. If Community law is to be understood as the means through which constitutional states integrate by reference to constitutional norms, there is a very good case to follow the consistent practice of national constitutional courts. The assignment of the argumentative burden depends on the different abstract weight assigned to the constitutional principles in conflict (something which is determined by reference to the fundamental law itself, and by the interpretation consolidated in statutes and previous judicial decisions) and by the 'normative' center of gravity of the case (which is determined by determining on a case by case basis what is the central question at stake).

It is doubtful whether the argumentative preference of economic freedoms could be grounded on the fact that economic freedoms were positively enshrined in the Treaties while the principle of protection of fundamental rights was not. Since the affirmation of the principle of protection of fundamental rights in *Stauder* and *Internationale*, even more so since the solemn proclamation of the

Charter of Fundamental Rights in 2000, and definitely so since the full incorporation of the Charter to the primary law of the Union, such an assumption is at any rate highly dubious. At any rate, it cannot be sustained by claiming that the literal tenor of the Treaties limits the *yardstick* of constitutionality of Union law to economic freedoms (plus undistorted competition and the prohibition of discrimination on the basis of sex).

Indeed, the full acknowledgment of the constitutional nature of the Treaties *after the formal incorporation of the Charter* would require a deep reconsideration of the assignment of the argumentative burden.

This was hinted at in the opinion of the late AG Geelhoed in *American Tobacco*. Geelhoed revisited in his opinion the relationship between economic freedoms and social goals in Community law. He argued that at the stage of development at which it was a decade ago (following the solemn proclamation of the Charter in 2000), Community law did not aim exclusively at the creation of a single market, but there were also other fundamental legitimate goals of Community action, such as the protection of public health. The basis of the competence of the Union might still be grounded on the realisation of the basic economic freedoms,[49] but this did not entail that the *actual* exercise of Community competences was to be exclusively aimed at market-making.[50] Indeed, some of the social goals constitute basic preconditions for a single market. This prompts the late AG to hint at a radical change in the structure of the review of European constitutionality. Instead of focusing in a first step on whether a given national provision distorts the common market, and only in a second step on whether such a measure can be justified by

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[49] Case C-112/00, Opinion delivered on July 11, 2002, Par. 100: 'The issue boils down to the following: if a (potential) barrier to trade arises, the Community must be in a position to act. Such action must, as I construe the biotechnology judgment, consist in the removal of those barriers. Article 95 EC creates the power to do so'.

[50] Par. 106: 'In other words, the realisation of the internal market may mean that a particular public interest – such as here public health – is dealt with at the level of the European Union. In this, the interest of the internal market is not yet the principal objective of a Community measure. The realisation of the internal market simply determines the level at which another public interest is safeguarded' (my emphasis).

reference to some legitimate public goal, some paragraphs of the opinion invite a shift of the argumentative burden.[51]

The recent opinion of Advocate General Cruz in *Santos Palhota and Others*[52] might be hinting at something similar. The AG considers in particular the impact that the changes introduced by the Lisbon Treaty, and above all the incorporation of the Charter of Fundamental Rights, must have in the solving of conflicts between freedom and establishment and fundamental collective goods. Cruz argues explicitly for recalibrating the specific weight to be assigned to the principle allegedly infringing a Community freedom in the fifth step of the proportionality argument (when considering proportionality *strict sensu*), but seems to be favouring implicitly a thorough reconsideration of the way in which proportionality is applied in line with the new literal tenor of the Treaties. It is worth quoting at length:

> As a result of the entry into force of the Treaty of Lisbon, when working conditions constitute an overriding reason relating to the public interest justifying a derogation from the freedom to provide services, they must no longer be interpreted strictly. In so far as the protection of workers is a matter which warrants protection under the Treaties themselves, it is not a simple derogation from a freedom, still less an unwritten exception inferred from case-law. To the extent that the new primary law framework provides for a mandatory high level of social protection, it authorises the Member States, for the purpose of safeguarding a certain level of social protection, to restrict a freedom, and to do so without European Union law's regarding it as something exceptional and, therefore, as warranting a strict interpretation. That view, which is founded on the new provisions of the Treaties cited above, is expressed in practical terms by applying the principle of proportionality.[53]

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[51] Par. 229: 'The value of this public interest [public health] is so great that, in the legislature's assessment other matters of interest, such as the freedom of market participants, must be made subsidiary to it.'

[52] Case C-515/08, opinion of 5 May 2010.Available at: <http://curia.europa.eu/juris/liste.jsf?language=en&jur=C,T,F&num=515/08&td=ALL>.

[53] Par. 53.

Proof burdens

The third set of implicit substantive choices made by the European Courts in the application of the principle of proportionality concerns the standards of proof of the facts on which (to a lesser extent) the adequacy and (to a large extent) the necessity of the prima facie infringing norm are to be assessed.

Whether a measure is adequate or not to achieve a certain objective, and, very especially, whether there is a feasible alternative rule which reconciles better the two fundamental principles in conflict, depends to a rather large extent on the assumptions we make about the external (empirical) world. Such assumptions do not follow from the principle of proportionality, but depend on substantive decisions on how we pass judgment on the probability that a future event will come to happen.

It would be expected of the European Court that it will apply the same criteria to consider the likelihood of events whether they support the adequacy and necessity of the infringing norm or they work on the opposite direction.

However, that is not always the case. It can indeed be argued that in many occasions, the review of European constitutionality is biased in favour of economic freedoms and against the principles colliding with economic freedoms. This is so because the European Courts lower the threshold to proof the probability of a fact happening in the future when that fact contradicts the adequacy or necessity of the infringing principle; and do the opposite (raising the threshold of proof) when the fact supports the adequacy and necessity of the infringing norm.

This can be illustrated by considering (1) the standards applied by the European Courts when considering whether the 'effectiveness of fiscal supervision' justifies limiting one economic freedom; (2) the standard applied by the European Court of Justice to determine whether a corporate structure is an artificial arrangement aimed at tax evasion.

The 'effectiveness of fiscal supervision' was one of the first 'rules of reason' or 'overriding interests' to be acknowledged by the ECJ as justifying the infringement of an economic freedom even if not explicitly stated in the Treaties.[54]

The Court has turned the principle almost ineffective by applying unrealistic proof standards to Member States invoking the principle. Firstly, the ECJ has systematically rejected that the curtailment of economic freedoms can be justified by any evidence of a revenue loss. No revenue loss is by itself proof that economic freedoms have to be curtailed. Secondly, the ECJ once and again has rejected the argument that the monitoring of tax compliance is hampered by "informative" deficits concerning economic transactions on other Member States, and thus restricting economic freedoms *ex ante* was justified. Member States have once and again stumbled on the rock of Directive 77/799, despite the fact that the Commission itself has recognised once and again the limited effectiveness of cross-border tax administrative cooperation,[55] and that indeed the Community seems now to be heading to automatic exchanges of tax information.

Similarly, a very peculiar set of (highly artificial) factual assumptions concerns the rationale which moves tax lawyers to create complex corporate structures and incorporate companies in a multitude of jurisdictions where they have no observable business.

The ECJ has claimed that a breach of an economic freedom is justified if it is intended to avoid that "*wholly* artificial arrangements" (my italics) are employed to reduce the tax bill.[56] This has been confirmed

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[54] Indeed even before that personal taxation was subject to review of European constitutionality in *Avoir Fiscal*. It was in the leading judgment on *Cassis de Dijon*, precisely in the ruling in which "rule of reason" exceptions were first referred to, that the ECJ coined the justification (see par. 8 of the ruling).

[55] See for example the Commission Communication (2006) 254 on a European strategy to combat tax fraud, available at <http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/control_anti-fraud/combating_tax_fraud/COM(2006)254_en.pdf>; and the related initiatives at <http://ec.europa.eu/taxation_customs/taxation/tax_cooperation/reports/index_en.htm>.

[56] Case C-264/96, *ICI v. United Kingdom*, [1998] ECR I-4711, par.26: 'As regards the justification based on the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the

in *Lankhorst*,[57] *Marks and Spencer*,[58] *Halifax*[59] and *Cadbury Schweppes*,[60] and has been further developed in *X*.

Still, the residual justification is not only limited, but the phrase 'wholly artificial arrangements' is indicative of a rather peculiar understanding of economic and legal realities. In line with the structural implications of *Centros* and Inspire Art on freedom of establishment, the ECJ has said that 'the fact that the company was established in a Member State for the purpose of benefiting from more favourable legislation [my note: thus including tax legislation] does not in itself suffice to constitute abuse of that freedom'. It is only an abuse when what is being used is a mere 'letter box corporation'. Only that seems to qualify as a 'wholly artificial' institutional structure. [61] *A contrario*, partially artificial structures, or for that purpose, any structure that is not 'wholly artificial' should be considered as the exercise of economic freedoms, and consequently the justification could not be invoked. Can this be regarded as *factually* accurate?

Assigning concrete weight to principles in conflict
The strange case of coherence of the tax system

The fourth set of problematic substantive choices with which the principle of proportionality is filled concerns the specific weight assigned to colliding legal principles in the concrete case. Or what is the same, the set of substantive choices with which the principle of proportionality *stricto sensu* is filled in.

It is rather obvious that the principle of proportionality does not provide an objective (mathematical?) formula by the application of which we can solve concrete conflicts. In his recent work, Alexy has indeed stressed that what proportionality can do is to render explicit

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United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment'

[57] C-324/00, *Lankhorst*, [2002] ECR I-11779.

[58] C-446/03, *Marks & Spencer*, [2005] ECR I- 10837.

[59] C-255/02, *Halifax*, [2006] ECR I-1609.

[60] C-196/04 *Cadbury Schweppes*, [2006] ECR I- 7995.

[61] Opinion of AG Mengozzi in C-298/05, *Columbus*, [2007] ECR I-10451, pars 182 and 183: actual physical existence plus financial activity are enough to pass the test.

the weighing exercises which are undertaken. This basically corresponds to what he calls the 'Law of Balancing':

> The law of balancing shows that balancing can be broken down into three stages. The first stage involves establishing the degree of non-satisfaction of, or detriment to, the first principle. This is followed by a second stage in which the importance of satisfying the competing principle is established. Finally, the third stage establishes whether the importance of satisfying the competing principle justifies the detriment to, or non-satisfaction, of the first.
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> (Alexy 2002: 401)

While discretion is impossible to eliminate, the law of balancing allows us not only to understand the actual shape of the decision-making process (especially on what concerns its last limb), but also to detect instances in which predetermined substantive choices are cloaked under the appearance of the proportionality principle *stricto sensu*.

The case law of the European Courts on economic freedoms is biased in favour of economic freedoms in this regard on a double account.

Firstly, the European Courts tend to take for granted that any curtailment of an economic freedom results in a serious breach of Community law, thus always assuming that the weight of economic freedoms is to be high.

Secondly, the European Courts distort the weigh and balance assigned the principle underlying the infringing norm by means of appraising it from the perspective of the realisation of the single market. Instead of taking *seriously* the point and purpose of the principle underlying the norm allegedly infringing the economic freedom, European Courts appraise and reconstruct that principle as if the realisation of a single market was the only or overriding goal of European integration. But that not only was *never the case* but is even *less the case* after the recognition of the unwritten principle of fundamental rights protection, and definitely not the case after the formal incorporation of the Charter of Fundamental Rights of the European Union. That was indeed the key argument made by AG Cruz in *Santos Palhota,* as already indicated.

Perhaps the clearest example of this kind of bias is to be found in the jurisprudential development of the overriding public interest in the coherence of the tax system as justifying the infringement of one or several economic freedoms.

The European Court of Justice accepted in *Bachmann* that the coherence of the tax system could justify a prima facie breach of the freedom to provide services. In doing that, the ECJ seemed to take seriously the *systemic, multilateral* and *redistributive* character of tax fairness, resulting from the very character of taxes as the legal operationalisation of the solidaristic obligations that members of a political community have to each other. The systemic character of tax fairness entails that whether there is a proper allocation of the tax burden cannot be determined by means of considering individual tax systems, but by means of assessing the distributive implications of the tax system as a whole. The multilateral character of tax fairness means that the just allocation of the tax burden depends on the *relative* economic capacity of each taxpayer, and not on the benefits that each of them enjoys through the public provision of goods and services. And the redistributive character of tax fairness requires that the tax burden is allocated with a view not only to provide revenue to support the public provision of goods and services, but also to reduce economic inequalities, so as to ensure the full realisation of social and economic rights, and to make the socio-economic structure compatible with the social and democratic *Rechtsstaat*.

Since Bachmann, however, the ECJ has steadily narrowed down the understanding of coherence of the tax system, and moved to consider that the infringement of an economic freedom would only be justified if *compensated* by a tax benefit enjoyed the same taxpayer on regards of the very same tax figure. However, that narrow and peculiar understanding of what coherence of the tax system is flatly contradicts the referred *systemic, multilateral and redistributive character of tax fairness.* It reverts to a consideration of coherence at the level of each tax figure, considers tax fairness in rather commutative terms, and pays no attention to the redistributive purpose of a democratic tax system. Consequently, the restricted characterisation of 'coherence of the tax system' does not take seriously the coherence of national tax systems as a key part of the social and democratic *Rechtsstaat*, as indeed they are defined in the constitutional law of the

Member States, and understood in the jurisprudence of national constitutional courts.

Mr Bachmann (and the Commission)[62] contested the European constitutionality of Belgian tax norms governing the deductibility of certain premia (relating to insurance against a variety of risks, including sickness and old-age). In concrete, the plaintiffs argued that the contested Belgian tax provisions were in breach of both free movement of workers and freedom of establishment, because they subjected deductibility to the condition that premia *were paid in Belgium*. And this for two reasons. First, it was more than probable that the cohort of taxpayers denied the right to deduct insurance premia will be mostly formed by nationals of other Member States (who would have already contracted insurance before moving into Belgium); and that even if some Belgians will also be denied benefits, they were likely to suffer less economic damage than non-nationals (as they were likely to return to Belgium, and thus receive the benefits free of Belgian taxes). Thus, the contested norm posed obstacles which were likely to have some deterring effect on prospective 'movers', and for sure entailed a less beneficial treatment for those who had actually moved into Belgium having previously contracted insurance in another Member State.[63] This was said to be enough as to ground the claim that the right to free movement of persons had been breached. Second, the Belgian tax provision placed insurance companies not established in Belgium in a less competitive position than that enjoyed by companies established in the country; rational taxpayers would add the 'lost' tax deductions to the cost of the premium when deciding which policy to subscribe. The case concerned thus both the right of taxpayers as individuals to deduct insurance premia when assessing their income tax liabilities and the right of insurance companies as entrepreneurs to provide their services all through the Community.[64]

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[62] Joined Cases C-204/90, *Bachmann*, and C-300/90, *Belgium*, [1992] ECR I-249.

[63] As either the prospective mover had to accept the eventual cost of not being able to deduct his contributions, or the economic cost of cancelling her policy every time she moved.

[64] And although it was not explicitly said in the judgment, the ruling had potential far-reaching implications for the public finances of Belgium, and some other Member States (especially Italy and Greece) with high levels of public debt, by then still (partially). By the time the case was brought before the Court of Justice, the said States still imposed on the insurance companies established in their territory the obligation to subscribe public debt as part and parcel of their safe assets and reserves.

Both the Advocate General and the Court were persuaded by the arguments made by the plaintiffs and declared that indeed the contested Belgian provisions infringed the economic liberties of the plaintiffs. Nonetheless, and to the surprise of many, they did not believe that this was the end of the argument. Indeed, they ended up finding that the norm was a necessary, adequate and proportional means to ensure the 'coherence of the [Belgian] tax system', a newly formulated 'rule of reason' exception to economic freedoms.[65] By this it seems that it was essentially meant that the European constitutionality of national tax norms could not be established in isolation; but had to consider in a systemic way all the norms which assess the economic ability to pay which derives from a given economic operation (in the case at hand, all the norms applicable to the taxation of the insurance contract over the whole life of the contract, from its signature to its 'maturity'). This was especially so given the fact that there is no overarching Community framework governing the interactions of national tax systems, and this entails that each system could opt for different solutions.

The Court implied a definition of the 'cohesion' exception which left open its precise views on its structural features. By appealing to the idea of 'cohesion' of the 'tax system' and not only of the 'tax figure' or specific tax at hand, the Court seemed to open up the possibility of making prevail the collective interests articulated in different tax policy choices, or different objective or temporal elements in the treatment of a given tax base, over the subjective economic freedoms enshrined in the Treaties. In particular, the language of *Bachmann* seemed to consider not so much, or at least not only, the effects that the norms had upon the concrete individuals (Bachmann and those whose complaints have moved the Commission to open infringement proceedings) but the systemic *rationale* behind the way in which they were treated. This 'objective' language is at play in Bachmann, perhaps more clearly in the following paragraphs:

> The cohesion of such a tax system, the formulation of which is a matter for the Belgian State, presupposes, therefore, that in the event of that State being obliged to allow the deduction of

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[65] On the origin of 'rule of reason' exceptions, originating in *Cassis de Dijon*, see Lenaerts and Van Nuffel (2004: 165-6).

> life assurance contributions paid in another Member State, it should be able to tax sums payable by insurers.[66]

In the case at hand, determining whether the breaching legislation was nonetheless justified entailed assessing the relation between the rules governing the deduction of premia and the taxation of the benefits when the contract reached maturity. In particular, whether national norms could be justified as means of ensuring the coherence of the national tax system was to be determined by assessing whether the differentiated regimes applicable to 'nationals' and 'transnationals' were nonetheless equivalent in economic terms (or what is the same, whether the overall economic implications of the rights and duties imposed upon 'national' and "transnational" citizens were equivalent).[67] The Court concluded that this was indeed the case with the Belgian tax system in the case at hand. On the one hand, taxpayers who subscribed a policy with an insurance company established in Belgium were entitled to deduct premia every year from their tax liabilities; but were also required to pay income tax on the benefits they eventually received. On the other hand, taxpayers who subscribed a policy with an insurance company which was not established in Belgium could not deduct premia, but were not required to pay any Belgian tax when receiving the benefits. Both systems were different, but equivalent. If 'transnational' citizens would be entitled to both a deduction and not to pay taxes to the Belgian state upon receiving the benefits, this will destabilise the Belgian tax system (by undermining its coherence, to use the very phrase coined by the ECJ).

It follows that in a tax system of this kind, the loss of revenue resulting from the deduction of life insurance contributions, a term which includes pension insurance and insurance against death, from the total taxable income, is offset by the taxation of pensions, capital sums or surrender values payable by the insurers. In cases where the deduction of such contributions was not allowed, those amounts are exempt from tax.[68]

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[66] *Commission v. Belgium*, 16.

[67] Second, whether the financial sustainability of national public finances would be imperilled unless the discriminating measure was regarded as justified.

[68] See especially par. 22 of the judgment.

Without denying the explicit relevance of other factors in getting to the final decision,[69] it is plausible to reconstruct the ruling in light of the institutional and democratic implications of the decision. Although both the request for a preliminary ruling and the infringement proceedings of the Commission originated in 'transnational' citizens who were far from happy with suffering what they regarded as a discrimination with negative economic effects, the circle of those affected had the Belgian tax norm been quashed by the European Court of Justice would have been much larger than in other cases. Indeed, it is not far-fetched to claim that 'national' citizens would have been affected mostly, both in numbers and in depth. Had a norm such as the Belgian one been declared unconstitutional, and the right to deduct extended to premia paid to non-established insurers, more and more 'national' citizens would have considered subscribing such kind of policy. In the short run, this would have required the Belgian state to reconsider overnight how to fund a sizeable part of its public debt, funded until then in part by insurance companies, obliged to invest part of its reserves in the acquisition of public debt. In the long run, it may have created structural pressures to alter the general framework of the taxation of pensions, especially if a sizeable number of 'nationals' would decide to transfer their residence upon retirement, for which they would have an extra incentive: to avoid being taxed by tax authorities who had acknowledged them the right to deduct the premia.[70]

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69 Indeed, the rather underdeveloped stage of Community law on what regarded the provision of insurance services, or the looming implications that a different result would have had for the sustainability of Belgian public debt (and with it, the prospects of a central Member State being part of the eventual third stage of the Monetary Union).

70 A good deal of the ensuing confusion with the notion of 'coherence of the tax system' may derive from the fact that the Court wished two strike two objectives simultaneously: to retain the larger breadth and scope of economic freedoms, now 'capturing' in their constitutional next national tax norms; and to avoid erecting itself in a constitutional judge of national tax norms. While in *Daily Mail* it opted from excluding from the very definition of freedom of establishment the legal prerogative to change the seat of the company without being forced to wind the company up, thus avoiding expanding the breadth and scope of freedom of establishment beyond the situations in which companies actually extended their economic activity across borders, it avoided affirming that the Belgian national tax law actually did comply with Community law. It could have done so claiming that while the tax treatment of transnational citizens was not exactly the same as that of purely 'national' citizens who had never exercised their rights to free movement, or had done so without relevant economic consequences, the two regimes were equivalent. Had the Court

For three years, the Court did not really reconsider what breaches of economic freedoms 'coherence of the tax system' could justify as an overriding public interest. In the meantime, the said ruling was very discussed and actively criticized by legal scholars.[71] The coherence justification may have played a role in *Schumacker*, but the ECJ shifted the argumentative ground suggested by the parties, and decided the case on the ground that Community law required considering non-resident trans-frontier workers as residents for tax purposes. It was only in August 1995, when deciding *Wielockx*,[72] that the ECJ started to review *Bachmann*, and in doing so, to narrow the scope of the justification. Slowly but steadily, this "rule of reason" justification was narrowed down by developing a three-pong test for its application:(1) there should be a direct link between the tax constitutionally suspect and a tax advantage; (2) tax charge and tax advantage should be part of the normative framework of the same tax; (3) the taxpayer being charged and being assigned the benefit should be the same.

In *Wielockx*, the Court confronted another case in which what was at stake was the taxation of pension plans. The facts were somehow different from those in *Bachmann* for two main reasons, related to the fact that Mr Wielockx was self-employed (while Bachmann was a dependent worker). First, Dutch legislation contemplated the possibility that self-employed persons simultaneously constituted a pension reserve and enjoyed a tax incentive, while the assets so earmarked remained available to the company as company assets (and thus could be used by the company as a source of funding). Second, Mr Wielockx was national and resident in Belgium, but his company was established in the Netherlands. This entailed that even if Mr Wielockx would not be subject to personal income tax in the Netherlands after retirement, he will not be able to get hold of any benefit if the Dutch company did not pay them; thus the residual effectiveness of the power to tax of the Netherlands was in this case

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done so, it would have to revise its blank rejection of similar claims made by national governments in previous and later cases (and even by some Advocates General). Still, the implications of an eventual ruling declaring that the Belgian tax provision was unconstitutional in a European sense would have had consequences not only and not mainly for transnational citizens (putting an end to what seemed to be negative economic consequences for them amounting to a minor discrimination)[70] but basically for the whole structure of the insurance business in the Union.

[71] See the case notes of Wolf-Henning Roth [30 (1993) *Common Market Law Review*, pp. 387-95] and Luc Hinnekens and E. Schelpe [(1992) EC Tax Review, pp.59-62].

[72] Case C-80/94, [1995] ECR I-2508.

higher than that of Belgium in *Bachmann*. It is important to notice that Advocate General Léger made a quite wide interpretation of the *Bachmann* exception, which would cover a national tax law correlating the double advantage of tax deductibility and availability of the fund to the company to the taxability of the retirement benefits.[73] If Léger found that the Dutch tax norm was contrary to Community law was not because of that constitutionally justified correlation, but because the Dutch tax system did not impose such correlation all across the board. The network of Double Taxation Conventions signed by the Netherlands implied that the Dutch had opted for ensuring the 'cohesion' of its tax system by means of negotiating mutual concessions with other Member States (Par. 54). Still, the Court was much more laconic and less clear on the grounds why it found the Dutch norm contrary to Community law. In its ruling the Court seemed to hint at the requirement that the taxpayer whose economic freedom was being curtailed will be 'compensated' by a specific tax advantage, especially when it claimed that 'Fiscal cohesion has not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions' (Par. 24). Still, the reasoning of the ECJ seems to have been influenced by the same train of reasons that grounded the opinion of the Advocate General. To the extent that the Netherlands had signed bilateral conventions in the context of which mutual concessions were made concerning the power to tax contributions and pensions, the Dutch government was in *Wielockx* in a different position than the Belgian government in *Bachmann.* Coherence of the Dutch tax system was no longer protected by a bilateral equivalence at the level of each taxpayer, but was 'shifted to another level, that of the reciprocity of the rules applicable in the Contracting States'.[74]

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[73] Par. 46. He added in the following paragraph; 'Since Bachmann it has been clear that, in the name of the principle of the cohesion of the tax system, a Member State is free to base the tax regime applying to a particular type of pension on a principle of correlation between the deductibility of the contributions (granted for social reasons or to promote the financing of undertakings) and the taxation of the pensions (necessary for budgetary reasons)'.

[74] Also par. 24. And then in par. 25, the Court concluded: 'Since fiscal cohesion is secured by a bilateral convention concluded with another Member State, that principle may not be invoked to justify the refusal of a deduction such as that in issue'.

In *Svensson and Gustavsson*,[75] decided three months later, the Court was of a clearer mind. In its ruling, it clearly introduced the first prong of what would become the three-pronged coherence test: the 'direct link' between the tax constitutionally suspect and another tax advantage.[76] Moreover, the Court came to affirm that such a link had to be a revenue link, and not merely a 'policy' link, something which implicitly pointed to the third prong of the 'coherence' test, namely the identity of the taxpayer.[77] Still, it may be said that this case could still be interpreted as not determining which way the concept should be constructed; it could still be thought that the connection between the two policies was too far-fetched; whatever the historical context in which the decision was taken, the granting of such reduced rates was part and parcel of the definition of the economic ability to pay of all taxpayers, and there was no longer (if there ever was) a good reason to claim that the additional expenditure effort should be paid by financial establishments themselves.[78]The subjective turn consisting in the identity of the taxpayer was confirmed in *Asscher*, *ICI*[79] and *Saint Gobain*[80]. In particular, in *Asscher* coherence was reinterpreted as requiring that the taxpayers whose economic freedoms were

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[75] Case C-484/93, [1995] ECR I-3955.

[76] Par. 18 of the Judgment: In those cases there was a direct link between the deductibility of the contributions and the tax on the sums payable by the insurers under death and old-age insurance policies, a link which had to be preserved in order to preserve the integrity of the relevant fiscal regime, *whereas there is no direct link whatsoever in this case between the grant of the interest rate subsidy to borrowers on the one hand and its financing by means of the profit tax on financial establishments on the other'* (my italics).

[77] The Court constrained the breadth and scope of such coherence, by claiming that it was irrelevant whether the concrete history behind the granting of interest rate subsidies (limited to credits taken from nationally established banks) was associated with the existence of a taxing of the profit of financial establishments (which by definition was only applied to *national* financial establishments). Given that the wide majority of taxes in modern polities are not earmarked, the principle results in the narrowing down the potential breadth of 'coherent' tax norms to those which 'compensated' a discriminatory or restrictive tax levy with a peculiar tax benefit to the one and the same taxpayer.

[78] The rejection of the defence of cohesion in 55/98 *Vestergaard* may be taken as reflecting the distinction the Court made between cohesion and the effectiveness of fiscal supervision. It may have opted otherwise, cohesion becoming the larger exception within which the latter would be one part. But it did not so, and what the Court ruled here implied an invitation to Member States to keep the two defences clearly separated (see par. 24 of the judgment)

[79] Par. 29 of the judgment.

[80] Par. 70 of the judgment.

restricted received a proper compensation. There was to be a tax tit for tat, so to say, for coherence to be available as a justification.[81]

Still, it may be said that this case could still be interpreted as not determining which way the concept should be constructed; it could still be thought that the connection between the two policies was too far-fetched; whatever the historical context in which the decision was taken, the granting of such reduced rates was part and parcel of the definition of the economic ability to pay of all taxpayers, and there was no longer (if there ever was) a good reason to claim that the additional expenditure effort should be paid by financial establishments themselves.[82]

In *Baars*,[83] the Court introduced the second prong of the coherence test, namely the requirement that the both the tax disadvantage and advantage concerned one and the same tax.[84] This implied that coherence was not to be established only at the economic level, but also at the formal level. This was confirmed in full clarity in *Skandia*, where the Swedish and Danish argument made an explicit appeal to the fact that the tax regime, even if formally affecting different taxes

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[81] *Asscher*, par. 60: 'The application of a higher rate of tax does not provide any social security protection'.

[82] The rejection of the defence of cohesion in 55/98 *Vestergaard* may be taken as reflecting the distinction the Court made between cohesion and the effectiveness of fiscal supervision. It may have opted otherwise, cohesion becoming the larger exception within which the latter would be one part. But it did not so, and what the Court ruled here implied an invitation to Member States to keep the two defences clearly separated (see par. 24 of the judgment).

[83] Case C-251/98, [2000] ECR I-2787.

[84] See par. 39 and 40 of the Judgment: [39] 'First, there is no double taxation of profits, even in economic terms, because the tax at issue in the main proceedings is not charged on the profits distributed to shareholders in the form of dividends but on the assets of the shareholders through the value of their holdings in the capital of a company. Whether or not the company makes a profit does not in any event affect liability to wealth tax; [40] Second, in *Bachmann* and *Commission v. Belgium*, cited above, there was a direct link between the deductibility of pension and life assurance contributions and the taxation of the sums received under those insurance contracts, and it was necessary to preserve that link in order to safeguard the cohesion of the tax system in question. There is, however, no such link in the present case, which concerns two separate taxes levied on different taxpayers. It is therefore irrelevant, for the purposes of granting shareholders a tax allowance in respect of the wealth tax, that companies established in the Netherlands are subject to corporation tax in the Netherlands and that companies established in another Member State are not'.

and taxpayers, did concern the tax regime of old age and insurance pensions of the very same taxpayer.[85]

The restrictive movement became full circle in *Verkooijen.*[86] The participating Member States in *Verkooijen* still fought their corner by reference to a wider interpretation of the coherence justification, sensitive to the multilateral and collective dimension of tax law. By doing so, they seemed to be convinced that there was still room for the Court to reconsider its case law. But from this ruling onwards, Member States started in earnest to consider which other overriding interests could be invoked to shelter national personal tax laws from a too radical review of European constitutionality.[87]

The final coda did come in *Weidert and Paulus*,[88] where the Court seemed to abandon the extraordinary decision in Bachmann to find that openly discriminatory tax laws could be justified by reference to 'rule of reason' exceptions. In *Weidert and Paulus*, the ECJ claimed that coherence, as all exceptions to economic freedoms, should be interpreted narrowly. Indeed, it could be argued that this rendered explicit what the ECJ had been doing implicitly since *Wielockx*.

Coherence was thus narrowed down as it was reinterpreted. From an exception, which seemed to allow Member States to uphold a collective good (the *coherence* of the tax *system* as a whole being hardly open to be reduced to the coherence of the taxes charged upon concrete individuals), it was redefined into a guarantee of consistent taxation for each and every taxpayer. This entailed two shifts:

1. From its objective definition to its subjective assessment, or what is the same, from coherence as the way in which the tax system

[85] See par. 31 and 33 of the Judgment.
[86] Case C-35/98, *Verkooijen*, [2000] ECR I-4073.
[87] The case was also significant because the very same Advocate General (La Pergola) wrote two opinions on the case. While this double opinion-making was caused by some difficulties around the construction of national provisions, the first opinion was more amicable to a wider, more collective-oriented conception of coherence of the tax system; in the second, the Advocate General argued by reference to the prong test which have been forged in the case law that we have just considered. The Court did follow the second opinion, and thus consecrated the narrowing down of the coherence of the tax system justification.
[88] Case C-242/03, [2004] ECR I-7379.

allocates burdens and benefits among taxpayers, to coherence in the way each Community citizen is treated by each national tax;

2. From coherence defined in the context of the social functions of the tax system to a narrow coherence limited to exquisitely equivalent treatment of each taxpayer.

The very narrow reading of the justification was spectacularly confirmed in *Meilicke*,[89] where the ECJ did not only reject that the national tax law could be justified, but did not even acknowledge the grave economic and legal implications of affirming the unconstitutionality of the German law. While the figures were in dispute, and seemed to have been inflated by the German exchequer in the first stages of the proceedings, it was calculated that the unconditional declaration of European unconstitutionality of the national law would cost the German exchequer up to a quarter of a point of the national GDP. Still, the Court refused to consider limiting the temporal effects of the ruling, a standard technique resorted by national constitutional courts to avoid dramatic negative effects (see Letelier 2011). Not even after asking a second opinion from a second Advocate General on the matter. Indeed, AG Stix Hackl managed to contribute to the 'privatising' turn of 'coherence', or in general overriding public interests, by claiming that the limitation of the temporal effects of a judgment of the ECJ would only make sense if a limitation would enhance the legal security of taxpayers as private actors.[90]

Conclusions

In this chapter, I have claimed that the European Courts have come to play a key role as guardians of European constitutionality (first thesis of the chapter). This come controversially clear in the aftermath of the *Viking* saga of judgments. However, I have argued that the power of European Courts to undertake the review of European constitutionality of legal norms, including national legal norms, is well grounded on positive law. It follows from the systemic interpretation of the founding Treaties (and now from the Treaty on the functioning of the European Union). When such Treaties are rightly appraised as the founding block of a constitutional legal order, one is bound to conclude the Treaty provisions which define the task of the European

[89] C-292/04, *Meilicke and others*, [2007] ECR I-1835.
[90] Par. 67 of her opinion.

Courts (to ensure that the *law*, and not merely the *Treaty*, is observed) and which articulate the different procedures before the European Courts empower the European Courts to become guardians of European constitutionality. However, the very arguments which support the constitutional nature of Community law also reveal the peculiar constitutional nature of European integration as a process of constitutional synthesis. And from the synthetic nature of European constitutional law follows not only that European constitutional law has a substantive pluralistic basis (with the constitutional law common to the Member States –the common constitutional traditions in the terms usually employed by the European Courts – being the 'deep' constitutional law of the Union) but also that the guardianship of European constitutionality is shared by the European Courts and national constitutional courts (or supreme courts in those Member States where there is no constitutional court) (the second thesis of this chapter). This should lead the European Courts to be especially attentive to national constitutions as they constitute part of the substantive contents of European constitutional law and to the rulings of national constitutional courts, as key interpreters not only of each national constitutional tradition, but also increasingly (even if implicitly) of the constitutional law common to the Member States.

There is a well-grounded *structural* case to be made for European Courts reviewing the European constitutionality of national norms. But is this task to be properly discharged? In the second part of the chapter, I claimed that the past and present practice of the European Courts has been to employ more or less explicitly the argumentative syntax of the principle of proportionality (third thesis of the chapter). By doing this, European Courts have basically followed the practice of national constitutional courts. However, two caveats must be added. The first one is that the critical reconstruction of the case law of the European Court of Justice reveals that the standard three-stepped reconstruction of proportionality (adequacy, necessity and proportionality) pays insufficient attention to two previous and occasionally decisive steps, namely, the elucidation of the constitutional principles underlying the colliding norms and the assignment of the argumentative benefit and burden. In these two steps, courts contribute to the concretisation (conceptualisation) of the conflicting principles and determine how the conflict is to be understood, from which principle, so to say, are we going to start the argument (third thesis of the chapter). The second is that proportionality is a formal principle; this necessarily entails that resort to proportionality guarantees the formal correctness of the decision but cannot ensure the substantive correctness of the decision. That cannot but depend on the substantive justifiability of the substantive choices with which the formal argumentative syntax of proportionality is 'filled in'. Indeed, far from being a *legitimising* principle, proportionality must be understood as a critical analytical tool, equipped with which we can reveal the substantive choices made by a court, and assess whether they are properly grounded on previous legal authoritative decisions, on good substantive reasons put forward by a court, or on the contrary, are largely unjustified (fourth thesis of the chapter).

Making use of the critical potential of proportionality I approach the case law of the European Court of Justice on economic freedoms. This leads me to four key problems in the fleshing out of European constitutional law in the jurisprudence. Firstly, I find that the while the affirmation that economic freedoms constitute a key part of the canon of European constitutionality is well-grounded, the European Court of Justice has shifted its characterisation of economic freedoms from operationalisations of the principle of non-discrimination on the basis of nationality and building blocks of a common market to concretisations of a self-standing and transcendental economic freedom and vanguard of the single market. Such a shift may seem to have been endorsed (even if, *ex post casu*) by the Treaty amendments introduced by the Single European Market and the Treaty of Maastricht. However, I claim that it remains hard to reconcile with the synthetic constitutional identity of the European Union and impossible to square with the constitutional identity of the Member States as social and democratic *Rechtsstaats*. Indeed, it seems to me much more plausible to conclude that the jurisprudence of the European Courts took a *wrong turn* when it shifted from one conception of economic freedoms to the other, or what is the same, that *Cassis de Dijon* and the later jurisprudence expanding the 'obstacles' conception of breaches to economic freedoms are properly characterised as part of a 'constitutional *dérapage*' in the development of Community law. Secondly, I find extremely problematic the tendency of the European Court of Justice to invariably assign the argumentative benefit to the economic freedoms and the argumentative burden to the principle underlying the colliding norm. That is difficult to reconcile with the fact fundamental rights have long been acknowledged to be part of the yardstick of European constitutionality, and become formally and undeniably so after the formal incorporation of the Charter of Fundamental Rights to the primary law of the Union. The opinions of AG Geelhoed in *American Tobacco* and of AG Cruz Villalón in *Santos Coelho* could be so constructed as to become precedents of a more flexible and balanced approach. Thirdly, I have serious objections to the standards which the European Court of Justice employs to determine the probability of events when assessing the adequacy and necessity of the norms colliding with an economic freedom. While the ECJ assumes without paying much attention to any evidence that all breaches of economic freedoms would result in a *grave infringement*, it eventually sets a too high threshold to prove the adequacy and necessity of infringing norms. This was exemplified by the fully unrealistic assumptions the ECJ makes on the alternative means on the hands of Member States to ensure the effectiveness of fiscal supervision (flatly contradicted by the several legislative initiatives of the Commission, only partially successful, to increase the degree of tax assistance, especially in the form of automatic exchange of tax data).Fourthly, the European Court of Justice tends to fail to approach on its own terms the principles underpinning the norms colliding with economic freedoms. The breadth and scope of these principles is not only defined in the most restrictive manner, but the inner normative logic of these principles tends to be neglected. This was exemplified by considering the peculiar characterisation of the overriding national interest in the coherence of the national tax system.

Having argued all that, it might not be completely improper to conclude with a plea for the recalibration of the case law of the European Courts. There is a very good case for the European Courts playing a key role in the guardianship of European constitutionality. The European Court of Justice was reasonably successful in the way it discharged this task in the first decades of European integration. Not only the rulings were very attentive and indeed deeply informed by the pluralistic nature and institutional setup of the European Union, but the Court avoided pushing too far its autonomous characterisation of the norms of Community law. The paradigmatic shift which followed from *Cassis de Dijon* led not only to a major structural change in the conception of economic freedoms, but also to paying much lesser attention to the pluralistic nature of European integration. The argumentative benefit assigned to economic freedoms, coupled with a tendency to distort the understanding of other colliding principles when assigning concrete weight to them and resort to biased criteria to determine the probability of future events have stressed if not severed the fundamental link between national and European constitutional law. The price of the wider autonomy in the short run may be a loss of legitimacy in the long run. The Court runs a double risk in that regard. As a supranational institution, it is not in a position to search for cover in the direct legitimacy of European decision-making processes, as such direct legitimacy is still very thin. As a judicial institution, it is in a position to limit the realm of what is politically possible, but not of taking constructive political decisions, not even when the cumulative effect of its case law is the full disempowerment of all levels of government.

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Chapter 5

Weakening the fiscal state in Europe
The European Union's failure to halt the erosion of progressivity in direct taxation and its consequences

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Introduction

The principles of progressive taxation emerged with the evolution of theories of political economy, a considerable time before their implementation in political practice. Adam Smith proposed that '[i]t is not very unreasonable that the rich should contribute to the public expense, not only I n proportion to their revenue, but something more than in that proportion' (Smith 1904: 493). Smith's proposition was mirrored significantly in the writings of 19th century socialist thinkers, whereas 'liberal' political economists like John Stuart Mill recommended a single-rate proportionality in income taxation after conceding that 'incomes below a certain amount should be altogether untaxed' (Mill 1970: 182). The evolution of taxation policies in the 19th century, which imposed higher rates on higher levels of personal annual income, in fact had as much to do with the fiscal needs of the state – in its conduct of increasingly costly civic and military affairs – as it did with the emergence of perceptions of tax justice. The growing demands placed upon the state by the increasing complexity of systems of production and distribution and by increasing urbanisation persuaded both economic and political elites of the virtues of public goods, financed and operated on the basis of favourable economies of scale, and of progressive taxation as an efficient means of financing those public goods that would benefit the processes of capital accumulation and social stability. The shift to progressive systems of direct taxation was further justified in economic theory by notions of the diminishing marginal returns of incremental rises in income, where the propensity to consume falls with the rise in disposable income. Revenues from progressively rising rates of income tax were thus seen in large measure as a means of maintaining the dynamic equilibrium of demand for and supply of goods and services produced by private businesses.

This utilitarian view of progressive taxation only begins to be reinforced by ethical arguments at policy level with the popularisation of *redistributive* systems of Keynesian or social democratic welfarism which emerged in the 1930s and in particular after the Second World War. The historical background of the class compromise of the 'Golden Age' (Hobsbawm 1994; Harman 1999) – namely the carnage of two world wars, the social and political damage inflicted on capitalism by the Great Depression, the political advance of socialism in both the advanced economies of Europe and in the decolonised countries of the developing world – helped to legitimise steep curves of progression in income tax and high marginal rates along with a significant increase in social transfers and other measures of redistribution in education, healthcare and housing. The compromise was sustained by the demonstration of the demand effect of rising real incomes on the turnover of industry and commerce, i.e. of the favourable effects of the *secular* redistribution of national income (qua gross wages ratio) and of *political* redistribution from capital to labour, reflected in the net capital and wages ratios. As a consequence, all the states of the Organisation for European Economic Co-operation (OEEC) and later of the Organisation for Economic Co-operation and Development (OECD) operated fiscal systems marked by progressivity in personal income tax, relatively high rates of corporation tax and relatively high tax ratios as a proportion of GDP. While the steep curves of progression and high marginal rates of income tax created an impression of punitive tax burdens on high earners, contributing to the emergence of the 'tax exile' emigrating to low-tax jurisdictions, the *effective rate of taxation* was considerably mitigated by the accumulation of generous allowances and offset facilities (e.g. degressive or accelerated depreciation provisions) in the income tax statutes of most European states. The Federal Republic of Germany is arguably the best example of higher-than-average top marginal rates – initially imposed by the occupation authorities in 1949 – accompanied by extensive allowances which narrowed the tax base and lowered the effective rate of income taxation to average levels; Germany's complex network of taxation statutes[1] also generated the most extensive body of academic taxation literature in the world, over 70 per cent of global tax scholarship, according to popular myth!

Apart from early evidence of inter-state tax competition via the allowance system, the contradictions and inefficiencies of a tax culture which required armies of tax advisors to reduce tax liabilities, using millions of 'man-hours' to out-manoeuvre the revenue authorities, were evident even before the paradigm shift to supply-side neo-liberalism. Thus neo-liberals were able to popularise the tax reforms of the 1980s and 1990s by deploying the rhetoric of rationalisation, transparency and simplicity as well as with the appeal of lower taxation for all (e.g. Conservative Party 1979; 1987). When the tax competition debate got into full swing, however, the intellectual justification of low-tax jurisdictions invoked both the 'scientific' evidence of increased fiscal efficiency – the core of the so-called 'Tiebout-hypothesis'[2] – and, more absurdly, human rights

[1] The German tax system includes long-standing arrangements of generous tax relief for shipping investments which, up until the recent container ship crisis, offered high returns for large investors.

[2] Tax competition was, according to Tiebout (1956), 'welfare-enhancing' because it promoted the avoidance of waste in the provision of public goods. The hypothesis asserts therefore that the greater cost-efficiency and lower taxation levels of one jurisdiction will attract households to relocate from the less efficient to the more efficient territory. This 'model' remained largely ignored by both economists and policy-makers until the 1970s. However, against the background of large accumulations of 'petro-dollars' in the bank accounts of oil-producers, the Tiebout hypothesis was rediscovered as the basis for and expanded notion ('model') of international tax competition between sovereign states seeking to attract inward investment by the Organization of the Petroleum Exporting Countries (OPEC) countries and global corporations and/or maintain the loyalty of currently resident companies and 'high worth individuals'. The trouble with the original Tiebout hypothesis and all subsequent 'refinements' and expanded applications is that the arguments are littered with untenable assumptions and crass syllogisms. At the root of this intellectual mess is the implicit proposition that the behaviour of macro-economic actors (*qua* sovereign states) can be equated with that of micro-economic actors (companies, households). This is manifestly not the case.

considerations, as cited on the website of the US 'Coalition for Tax Competition'.[3] The campaign against tax competition and tax havens by non-governmental organisations (NGOs) like the Tax Justice Network, while persuasive and empirically well founded, found a very limited echo among the policy-makers of the advanced industrial states. The OECD's study of potentially harmful tax competition (1998) expresses a clear ambivalence towards the location competition involving tax regimes; while identifying corporate abuse of tax avoidance opportunities, the OECD emphasises that "globalisation has had a positive effect on the development of tax systems" (OECD 1998: 14 [par. 23]); capital market liberalisation has unequivocally "improved welfare and living standards around the world by creating a more efficient allocation and utilisation of resources" (ibid. [par. 22]). The OECD study thus implicitly endorses the Tiebout hypothesis and limits its perception of 'harm' to a narrower range of practices, than the Tax Justice Network, stressing the need for low tax jurisdictions to ensure transparency and improved information flows and to monitor corporate malpractice in the area of transfer-pricing. The OECD's recommendations mirror those of the European Union (EU) in its *Code of Conduct* from 1997 which was directed at the removal of obstacles to the optimal functioning of the Single Market, which included the abuse of preferential tax regimes by mobile corporations. However, as the analysis below indicates, the significance of the 1997 Code and the OECD's recommendations was largely neutralised by the EU's strategic decisions AND non-decisions of the same year. The impact of the Code (which in any case

[3] A press release by the Coalition for Tax Competition from 2005 quotes Daniel Mitchell of the Heritage Foundation in an extraordinary statement which arguably stretches the semantic envelope of human rights beyond breaking-point: "Low-tax jurisdictions not only promote better economic policy by serving as an escape hatch for over-burdened taxpayers, they play an equally vital role in protecting minorities from oppression. By arguing that extra-territorial tax enforcement should take precedence over every other concern, the Tax Justice Network and its allies are putting at risk millions of people. Whether they are business owners from Venezuela, ethnic Chinese in Indonesia, Jews in France, or homosexuals in Saudi Arabia, there are people all around the world who are victimized by corrupt and/or despotic governments. Without the ability to protect their assets in so-called tax havens, these people would be at even greater danger. Does the Tax Justice Network not care about the human rights of persecuted minorities?" (quoted in Coalition for Tax Competition, 2005).

included a wider range of guidelines apart from tax issues) was arguably as ineffective in practice as the EU's rhetorically active Competition Directorate which has proven utterly powerless to prevent the historically unprecedented waves of M&A (mergers and acquisitions) activity and of capital concentration in Europe in the 1990s and in the current decade.

The practical consequences of tax competition in Europe: The weakening of progressivity

The erosion of progressivity in taxation and its corollary of greater distributional injustice was made easier in Europe by the intellectual capitulation of the social democratic Left to the seductive charm of neo-liberal supply-sidism. The shift away from redistributive fiscal policy was most clearly demonstrated by the Anglo-German 'Third Way' initiative which became emblematic of the new 'supply-side agenda for the left'. In their joint paper 'The Way Forward for Europe's Social Democrats', Tony Blair and Gerhard Schröder made an explicit distinction between the old politics of redistribution and the new politics of 'enablement'. In old-style social democracy, they declare: *the promotion of social justice was sometimes confused with the imposition of equality of outcome. The result was neglect of the importance of rewarding effort and responsibility, and the association of social democracy with conformity and mediocrity* (Blair and Schröder 1999). The years of opposition for both the Labour Party and the SPD (1979-97 and 1982-98 respectively) witnessed both the waves of deregulation, liberalisation and privatisation and the media-driven propaganda campaign against 'fiscal irresponsibility', public sector 'inefficiency' and welfare 'parasitism'. While 'New Labour' inherited and maintained the radical tax reforms of the Thatcher and Major administrations – which saw top marginal rates for income tax fall from 83 to 40 per cent and the top rate of corporation tax fall from 52 to 33 per cent – it was the Schröder administration which made the first incisive moves to reform German income tax law, to flatten the progressivity curve and to shift the burden of taxation further towards indirect (regressive) taxes; between 1999 and 2005, top rates of income tax were lowered by the Red-Green coalition from 53 to 42 per cent, the entry rate from 25.9 to 15 per cent. Corporation tax, which the Kohl administration had lowered significantly from 50 to 30 per cent, was reduced to a standard 25 per cent in 2001.

Meanwhile, the EU had implemented a series of directives in the areas of indirect taxation in conjunction with the inauguration of the Single Market in 1992; thus in October of that year, a minimum standard rate for VAT of 15 per cent was made mandatory for all member states, i.e. became part of the *acquis communautaire* which future applicant states in central and eastern Europe would be required to translate into national law as a pre-condition of EU-membership. The approximate harmonisation of indirect taxation was not matched at this or any future stage by corresponding directives in the area of the harmonisation of direct taxation. The only further significant harmonisation of fiscal policy involved the commitment within the Economic and Financial Affairs Council (ECOFIN) to maintain the strict budgetary rules of the Maastricht Convergence Criteria in the 1997 Stability and Growth Pact. The accession criteria – the Copenhagen Criteria of 1993 – and the subsequent 'Tax Package' agreed in 2003 in advance of the May 2004 enlargement (European Commission 2004: 4ff) contain no provisions relating either to tax minima in direct taxation or to the principle of progressivity. The 2003 Tax Package, like the 1997 Code of Conduct, contained nothing more than the requirement that member states should "refrain from introducing any new harmful tax measures ('standstill') and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code ('rollback')", with particular reference to the location of business (European Commission 2004: 5). The thrust of the Commission's efforts has rather been in the direction of removing tax obstacles to the optimal functioning of the Single Market, not on compensating for the subsequent contradictions of member states' tax regimes (Schratzenstaller 2007: 372). There have been extensive discussions within the Commission relating to the establishment of a 'Common Consolidated Corporate Tax Base' (European Commission 2007: 3f) and, most recently, considerable political pressure from several member states to combat the abuse of tax havens, but very little else. As subsequent developments within the EU-27 have demonstrated, the failure of the EU to establish either standard minimum rates of taxation for corporations and non-incorporated businesses or a common principle of tax progressivity (as well as minimum standards of what constitutes taxable income) has *opened the door to destructive tax competition between the 27 member states*, if not by design then clearly by default; Philipp Genschel, Thomas Rixen and Susanne Uhl have dubbed the approach "a common taxation policy lacking both consciousness and democratic control" (Genschel et al. 2008: 314). Frank Bönker (2003: 532) was correct in asserting that the tax competition between transition states in Central and Eastern Europe (CEE) would be fiercer than within the EU as a whole, but there seems to be little doubt that corporate tax regimes throughout Europe have been softened as incentives for attracting or retaining foreign direct investment (FDI) from transnational corporations and for protecting jobs, as Table 5.1 clearly indicates.

Table 5.1: Corporation Tax Rates in the EU15 1980-2009 in per cent

	1980	**1990**	**2000**	**2009***
Austria	55.0	30.0	34.0	25.0
Belgium	48.0	41.0	39.0	33.9
Denmark	40.0	40.0	32.0	25.0
Finland	43.0	25.0	29.0	26.0
France	50.0	37.0	33.3	33.3
Germany	56.0	50.0	45.0	15.0
Greece	43.4	46.0	40.0	25.0**
Ireland	45.0	43.0	24.0	12.5
Italy	25.0	36.0	37.0	31.4
Luxembourg	40.0	34.0	30.0	25.5
Netherlands	48.0	35.0	35.0	25.5**
Portugal	23.0	36.5	32.0	27.5**
Spain	33.0	35.0	35.0	30.0**
Sweden	40.0	40.0	28.0	26.3
UK	52.0	35.0	30.0	28.0**

Notes * Standard proportional rates, except for countries with differential rates
** Denotes top rates

Source World Tax Database

As Table 5.1 shows, 13 out of the 15 'old' member states have corporation tax rates that are considerably lower in 2009 than they were in 1980; all 15 have lower rates today than in 2000. The average rate of corporation tax for the EU15 was 42.7 per cent in 1980, 37.5 per cent in 1990, 33.5 per cent in 2000 and just 26 per cent in 2009. While German capital taxes also include local business taxes, its new, common 15 per cent corporation tax (CT) rate is almost as low as Ireland's much criticized 12.5 per cent rate and represents the most dramatic reduction in all EU-15 countries since 2000. Average CT rates for the 2004 central European accession states have fallen from 31 per cent in 1995 to just 19 per cent in 2009. Significantly, the CT rates in the two 2007 Balkan accession states (Bulgaria, Romania) and in the applicant states of the western Balkans are even lower on average. With several Balkan states (Albania, Bulgaria, Macedonia, Serbia and Srpska within Bosnia-Herzegovina) levying a standard 10 per cent, and Montenegro an even lower 9 per cent, the regional average for the Balkans is just 14 per cent.

Table 5.2: Corporation Tax Rates in the 2004 group of Central European States (EU8) 1995-2009

	1995	**2000**	**2009**
Czech Republic	41	35	21
Estonia	26	26	21
Hungary	18	18	16
Latvia	25	25	15
Lithuania	29	29	20
Poland	40	28	19
Slovakia	40	40	19
Slovenia	30	25	22

Sources World Tax Database; Bönker 2003; Vienna Institute of International Economic Studies (wiiw).

The effect of such rate reductions in CEECs will be examined below. It is important at this stage to examine the effects of rate reductions on revenue streams in general, as these have given rise to considerable controversy among analysts, since aggregate data for the EU-27 suggest that corporation tax revenue from European businesses has increased as a proportion of total tax revenue, namely from a weighted average of 6.5 per cent in 1999 to 7.5 per cent in 2007. This is interpreted by some as confirming the hypothesis of the Laffer-curve, which postulates that tax rate reductions generate an increase in tax revenue because of the diminishing returns of tax avoidance/evasion (McCain 2007). Closer examination points rather to growing contradictions within the tax systems of the EU-27 and to the effects of income inequality as causes of the CT 'revenue paradox' (Piotrowska and Vanborren 2008) as well as to the broadening of the tax base as a result of the elimination of *some* allowances. Sørensen (2006), Mooij and Nicodème (2008) and Piotrowska and Vanborren (2008) stress the effects of companies changing their registered legal form in order to enjoy the lower rates of taxation enjoyed by corporations, compared to the higher marginal rates imposed on non-incorporated businesses. *Incorporation*, according to Mooij and Nicodème, yields significant tax advantages to enterprises but not to revenue authorities, as the shift "comes at the expense of an even larger decline in personal tax revenue" (2008: 7).[4] As Figure 5.1 shows, the differential between (top) rates of corporation tax and income tax is very significant.

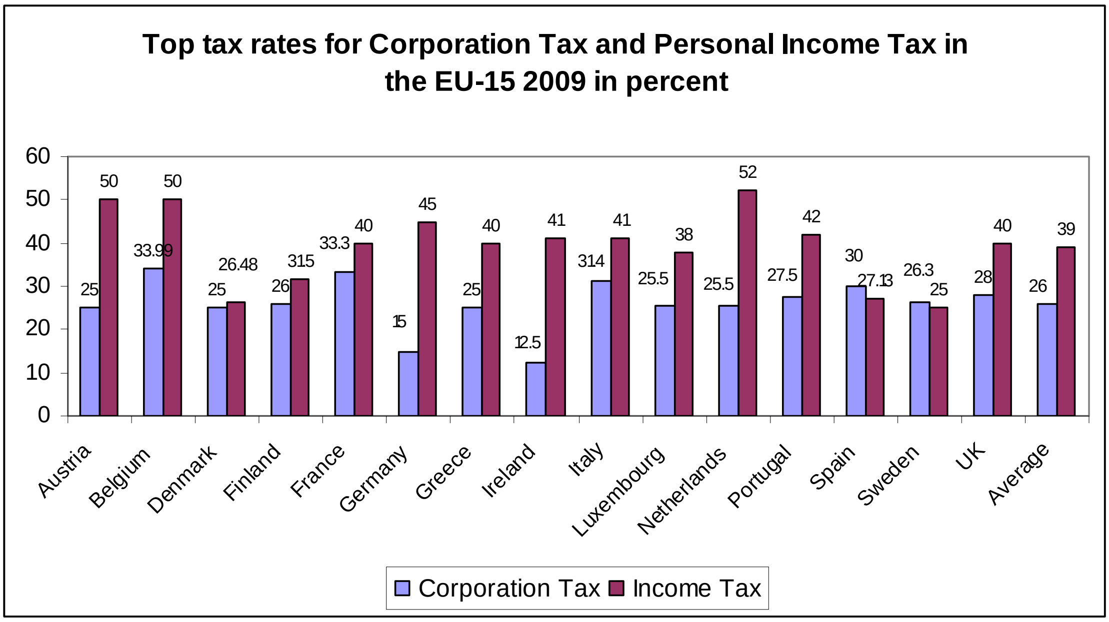

Figure 5.1: The Contradictions of the Direct Taxation of Businesses in the EU15.

Source World Tax Database; Eurostat.

With the exception of Spain and Sweden, all other EU-15 countries have higher top marginal rates of personal income tax (PIT); the (arithmetic) average differential is thirteen percentage points (39 to 26); the widest differential (41 to 12.5) applies to Ireland but Germany's 15 per cent CT is one third the level of the top marginal PIT rate, that of Austria and the Netherlands half as great. The evidence for *income shifting* is strong for Germany, even before the reduction of CT rates to 15 per cent in 2008: in 1980, when top CT and PIT rates were identical (at 56 per cent) the revenue share of corporation tax in Germany was 6.3 per cent, that of assessed income tax (i.e. on the income of non-incorporated businesses) was 10.3 per cent; the two taxes on capital income thus accounted for 16.6 per cent of total German taxation revenue; in 2007 receipts of assessed income

[4] According to Mooij and Nicodème (2008: 7), "in the absence of a tax differential between personal and corporate income taxes, the corporate tax base would be about 17% smaller than currently, lowering the average corporate tax-to-GDP ratio from 2.7 % to 2.25%".

tax had fallen to only 4.6 per cent of total tax revenue, not much higher than CT receipts at 4.3 per cent, suggesting significant effects of incorporation. The combined share of direct business taxes, however, had fallen to just 8.9 per cent.[5] In the meantime the share of indirect taxation in Germany had risen from 25.6 per cent to 31.5 per cent, mirroring developments in other OECD countries.

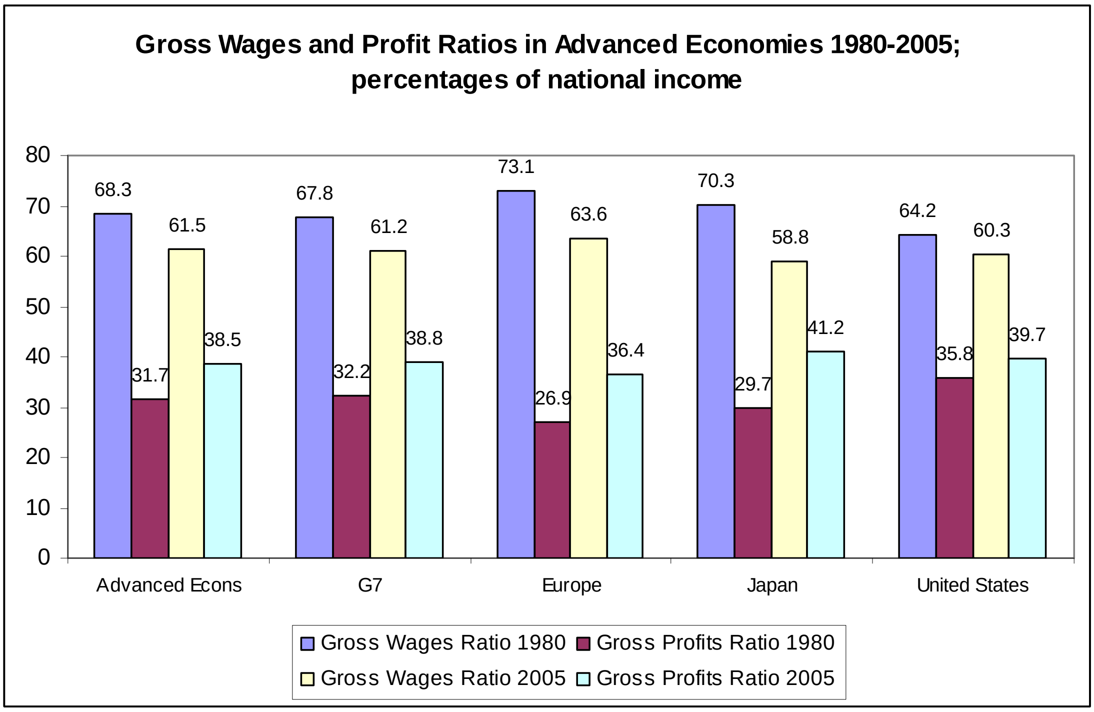

Figure 5.2: Redistribution of National Income in Advanced Industrial Countries

Notes Advanced Economies (30 countries): Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom, United States. Europe = EU27.

Source IMF, *World Economic Outlook*, April 2007; data for Figure 5.7.

The decisive factor for explaining the 'revenue paradox' is the extraordinary and much neglected increase in the profits ratio as a

[5] The figures for CT and assessed IT are derived from Bundesbank long series data and differ marginally from Eurostat revenue ratios; the latter are nevertheless used in this article for purposes of comparison; both sets of figures nevertheless confirm the trends in revenue streams; Eurostat thus records a rise in the CT share of overall revenues in Germany from 2.2 per cent in 1995 (Bundesbank: 2.2 per cent) to 3.5 per cent in 2007 (Bundesbank: 4.5 per cent)

proportion of national income in the last quarter of a century, i.e. the tax base of profit income was not simply broadened as a result of removing or reducing tax allowances but by the simple fact that business profits accounted for a much higher proportion of (taxable) national income in the vast majority of European countries.

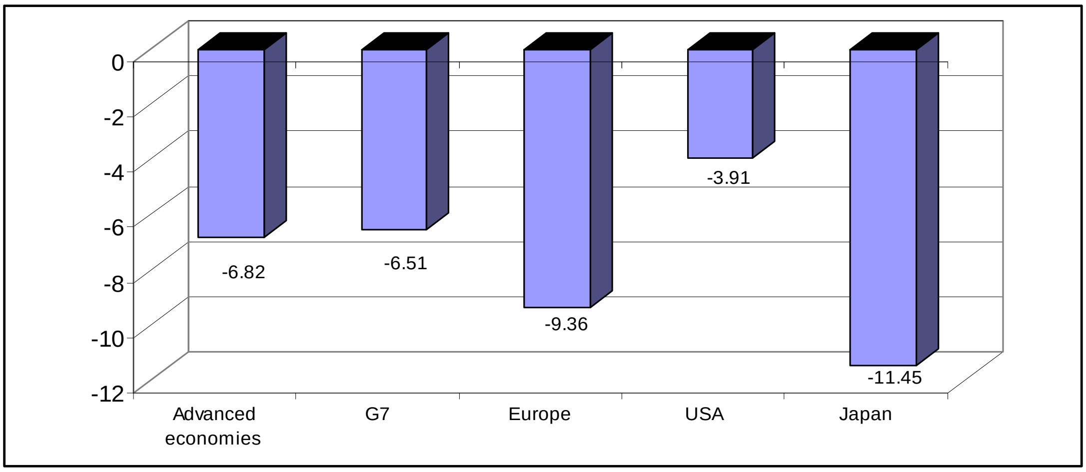

Figure 5.3: Decline in the wages ratio in advanced economies 1980-2005 in percentage points

Notes Advanced Economies (30 countries): Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom, United States. Europe = EU27.

Source IMF, World Economic Outlook, April 2007, data for Figure 5.7.

The distributional shifts represented in the two figures (Figures 5.2 and 5.3) are unprecedented in modern times; they help to illustrate the extent of the neo-liberal calamity that has befallen the global economy, notably the relative reduction in disposable household income which could ‘at best’ be compensated by the encouragement of private borrowing. It is sufficient here to point out that the revenue yield from 36.4 per cent of national income (the average European profit ratio in 2005) will *ceteris paribus* be higher than the revenue yield from 26.9 per cent (the 1980 level); it would have been around one third higher, assuming unchanged rates of taxation. The idea that the slight increase in corporation tax yields vindicates the Laffer-curve hypothesis is worryingly unsound; incorporation and income shifting would seem to have been just new vehicles of tax avoidance to protect the very considerable extra share of national income accruing to capital; the complicity of the EU and its member states in widening the disparity between top CT and PIT rates was and remains culpable. The revenue effects of increasing income inequality, touched on by Swiston et al. (2007) in relation to the United States, need seriously to be addressed by researchers in relation to Europe where the fall in the wages ratio/rise in the profits ratio has been considerably more dramatic (+9.36 percentage points compared to +3.91 in the US).[6]

The politics of fiscal irresponsibility: The pre-programmed calamity of flat taxes

The situation of the new central European members of the EU in regard to corporation tax differs significantly from its EU15 partners. While CT revenues grew as a result of strong GDP growth up to 2007, their proportion of GDP – at 2.96 per cent in 2007 – remained below the EU15 average of 3.46 per cent, where the EU15 had experienced much lower rates of GDP growth, reflecting the lower average CT rates in the EU8 of around 19 per cent (EU15: 26 per cent). Personal income taxes in CEECs mirror the development of corporate income taxation, with (top) rates declining to an average of 19.1 per cent in 2009, compared to the EU15 average of 39.3 per cent. Above all, there has been a *decisive shift towards flat tax regimes* in direct taxation, notably in income tax, in five of the EU8 countries: Estonia (1994), Lithuania (1994), Latvia (1995), Slovakia (2004) and the Czech Republic (2008)) and in Romania (2005) and Bulgaria (2008). This shift is the most striking example of the erosion of progressivity and is being reinforced by similar fiscal regimes adopted in other CEECs: Bosnia-Herzegovina, Georgia, Macedonia, Montenegro, Russia, Serbia and the Ukraine.

It is not my intention to rehearse the debate about flat taxes; the claims of flat tax proponents (Hall and Rabushka 1981b; Forbes 2005; Heath 2006) have been very adequately undermined in other studies (Murphy 2006; Keen et al. 2006). Rather, I wish to concentrate on the emergence of the flat tax movement, its effects hitherto and its potential effects in the medium term.

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[6] The comprehensive and robust analysis of the German *Wirtschafts- und sozialwissenschaftliches Institut* in Cologne on the functional distribution of income, in particular the work of Claus Schäfer would be a good example of best practice here.

Table 5.3: Flat tax rates among the new member states 2008

	Personal income tax rate	Corporation tax rate	VAT rate
Bulgaria	10	10	20
Czech Republic	15	21	19
Estonia	21	21	20
Latvia	15	23	21
Lithuania	20	21	19
Romania	16	16	19
Slovakia	19	19	19

The resurrection of John Stuart Mill's notion of a single proportional tax on income coincided with the second stagflationary crisis at the start of the 1980s and the capitulation of many mainstream economists to neo-liberal supply-sidism. Hall and Rabushka, economists at Stanford, floated the idea of a single rate tax in *The Flat Tax* (Hall and Rabushka 1981b); the idea was seized on by US members of Congress, generating several legislative proposals in the first Reagan administration, and it also attracted the support of market radical pressure groups like the Cato Institute, the Heritage Foundation and the American Enterprise Institute, the well-resourced exponents of what Susan George rightly describes as a new 'cultural hegemony' (2008). While the US flat tax debate remained theoretical, if very noisy, the real implementation fell to the newly independent states of eastern and central Europe. It is no coincidence that it was the three Baltic statelets of Estonia, Lithuania and Latvia[7] that first chose to adopt both low rates of corporation tax and single rate systems of income tax; their geo-strategic history and vulnerability, their sectoral economic deficiencies and extreme trade dependence and their weak capital markets made them arguably more fearful of continued dependence on the Soviet Union, later the Russian Federation, and even more urgently keen to attract capital imports through foreign direct investment and (western) credit than the Visegrad Group and Slovenia.[8] The vaunted bureaucratic simplicity of single rate systems also recommended itself to the states' limited administrative

[7] Estonia (population 1.34 million), Latvia (2.28 million) and Lithuania (3.39 million) with Cyprus, Malta and Luxembourg are the smallest states within the EU.

[8] It is also no coincidence that a large number of economics students were furnished with generous grants by US foundations to study neo-liberal economics at American universities.

authorities. The marked success of Ireland – as a peripheral EU15 state with a generous low-tax business environment – also encouraged the Baltic States to use capital imports as a key vehicle of growth. While the Visegrad states and Slovenia faced critical problems of infrastructural deficiencies, low productivity and mass unemployment, they all introduced progressive systems of personal income tax with relatively high marginal rates, ranging from 32 per cent in the Czech Republic to 50 per cent in Slovenia, rate levels that persisted until as late as 2002. It was a decade after the Estonian tax reform before progressivity was decisively breached in the more advanced of the transition economies. Slovakia's move to introduce a standard rate of 19 per cent on income tax in 2004, as well as on corporation tax and VAT must be seen against the background of persistently high unemployment in the republic (18.1 per cent in 2004; cf. Czech Republic 8.3 per cent, Hungary 6.2 per cent), EU-accession and a renewed wave of tax rate reductions within the EU15 and elsewhere on the continent. Additionally, the dependence of Slovakia – along with all other CEECs – on capital imports from foreign lenders and investors was chronic, with a current account deficit of 3.5 per cent of GDP even before accession. By 2004 the penetration of foreign banks in Slovakia – at 95 per cent of total balances - matched that of its Visegrad partners (Czech Republic: 95 per cent; Hungary: 82 per cent; Poland: 72 per cent) and betokened a clear potential vulnerability in any regional or indeed global banking crisis.

While Estonia's economic growth had generated significantly higher state revenues, the adoption of a single proportional rate of PIT did not produce a higher ratio of PIT revenues to either total taxation or to GDP. Slovakia's shift to a flat tax regime was thus predicated on the expectation of growth and inward investment rather than on any Laffer-curve calculation. Slovakia's experience with a single proportional rate of PIT and an identical rate of corporation tax mirrors that of the vast majority of new CEE member states, namely a markedly lower share of direct taxation to GDP than most of the old EU15 states:

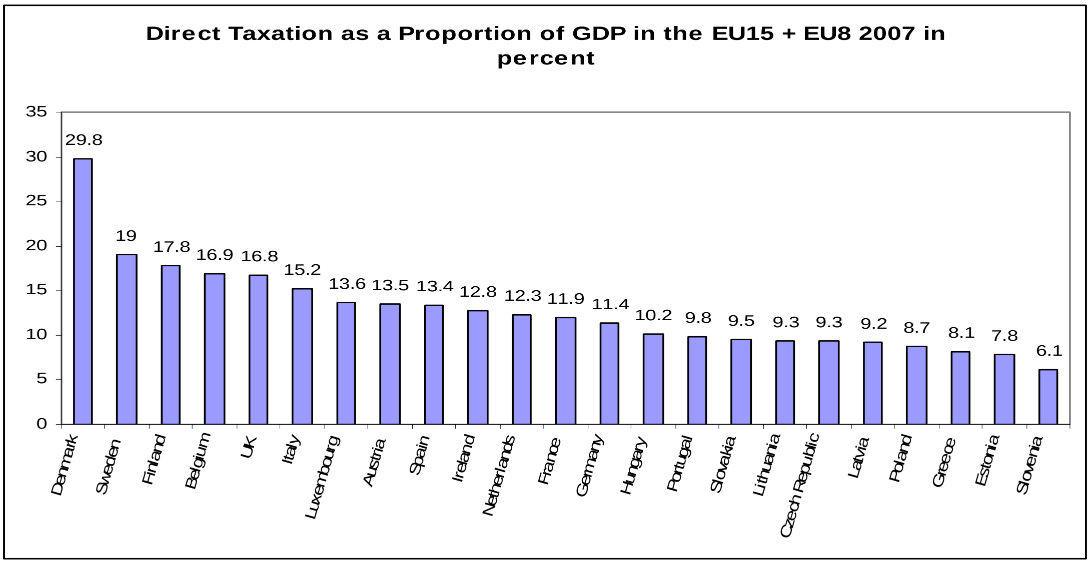

Figure 5.4: Contrasting taxation cultures in the EU.
Source European Commission (2009a)

Thus, within a general trend of flattening curves of progression, of lower proportions of direct taxation to GDP and total revenue, the new CEE member states show the strongest erosion of progressivity and an increasing dependence on regressive indirect taxation within the EU27 (see Table 5.4). No west European state has seriously considered introducing a flat-rate PIT, although the German Christian Democrats flirted with the idea briefly in the run-up to the 2005 federal elections.

The higher ratio of indirect taxation in the EU10 (41.4 per cent of total taxation revenue) does not however compensate for the weakness of direct tax revenues and has been insufficient to raise the overall state (taxation) ratio to the levels of the EU15, as Table 5.4 below indicates. The disparity between the average EU15 taxation ratio of 41.3 per cent of GDP and the much lower CEEC average of 31.7 per cent arguably represents a profound weakness in the capacity of the new and aspirant member states to address the general challenges of economic and social modernisation and the specific challenges of crisis management in the current global economic turmoil. Firstly, within the OECD group of most developed capitalist economies there is a general, if not consistent, correlation between higher state ratios (revenues on the one hand and expenditure on public goods and state transfers on the other) and a higher level of development, and worldwide there is a corresponding correlation between low state ratios and underdevelopment; technologically advanced political economies with refined divisions of labour and complex national, regional and global interdependencies overwhelmingly need extensive networks of publicly funded physical and social infrastructures to ensure that the comparative advantage of businesses and households in investment, production and consumption is maintained.

Table 5.4: Share of direct, indirect and wealth taxes in total tax revenue in the EU27 (2007).

	Direct Taxes	**Indirect Taxes**	**Taxes on Wealth**
Austria	32.2	34.2	2.4
Belgium	38.5	30.6	8.4
Bulgaria	20.9	55.1	2.9
Cyprus	33.6	47.9	8.3
Czech Republic	25.3	30.5	1.9
Denmark	61.2	37.1	5.6
Estonia	23.7	43.0	1.7
Finland	41.4	30.9	3.1
France	27.6	35.4	10.8
Germany	28.7	32.7	2.8
Greece	25.2	38.4	4.7
Hungary	25.7	40.2	3.2
Ireland	41.0	43.1	8.9
Italy	35.2	34.6	6.4
Latvia	30.2	41.2	3.4
Lithuania	31.0	40.3	2.0
Luxembourg	37.0	35.2	9.8
Poland	24.9	41.7	6.1
Portugal	26.5	41.7	6.1
Slovakia	20.8	39.4	2.1
Slovenia	24.9	39.2	2.4
Spain	36.1	32.4	9.3
Sweden	39.4	35.3	3.1
Average EU27	*32.3*	*38.4*	*5.2*
Average EU15	*36.5*	*35.4*	*6.6*
*Average EU10**	*25.0*	*41.4*	*2.6*

Notes * EU10: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia.

Source European Commission (2009a); own calculations.

Secondly, in joining the European Union within its unitary economic space, the countries of eastern and central Europe have aligned themselves politically and commercially with the most advanced group of industrialised states in the world[9] and have been obliged, as noted above, to accept the body of *acquis* designed (before 1990) to promote foremost the commercial and political interests of the western group. Thirdly, as transition states, i.e. quite unlike the western group, the dismantling of authoritarian socialist state systems and the piloting of enterprises, workers, scientists, households towards market economics required at the very least state apparatuses that had the resources and the administrative capacities to ensure the sectoral and spatial coherence of their political economies (i.e. structural economic policies) and to design and realise appropriate infrastructures for their modernisation.

A core hypothesis of this chapter is that the institutional and policy preferences of the EU15 were critically deficient (in general, but particularly in relation to transition states) and, above all, that the demonisation of the state in neo-liberal thinking and in the post-Soviet dismantling of state-socialist institutions pre-programmed the difficulties experienced by the overwhelming majority of CEE new member states in the global crisis. A more judicious approach to the role of the state would have justified both higher state ratios and greater progressivity in the administration of tax revenues.

This in turn could have provided a strategic cushion against the perils of a chronic structural dependency on capital imports. The juxtaposition of tax ratios with current account balances, as in Table 5.5, is one way of illustrating the structural dependency of the CEE transition states; while the current account balances of the EU15 contain one or two examples of long-term high external deficits (e.g. Portugal, Greece) and persistent if low deficits (Italy, UK), the average current account (CA) deficit for the EU15 has hovered around +/- zero since the early 90s.[10] All the CEE states in the table

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[9] Twelve of the EU15 are in the top 20 countries for per capita GDP in the World Development database of the World Bank.

[10] The current account disparities within the EU15 also represent a potentially explosive danger for the coherence and solidarity of the whole European project (Huffschmid 2007: 314f); the disparities between the EU15 states and the 10 CEE member states are potentially more politically divisive, not simply because of their scale but because, by their nature, they epitomise the unequal interdependence and the new hegemonic relationships within the enlarged EU.

have shown consistent CA deficits since the collapse of either the Council for Mutual Economic Aid (COMECON) or the Yugoslav Federation and manifested an average of -13.7 per cent overall in 2008; there were distinct differences between the Visegrad + Slovenia group (-4.5 per cent), the Baltic group (-13.6 per cent) and the Western Balkans (-18.1 per cent). Plugging current account deficits of 1.4 per cent (UK) to 3.4 per cent (Italy) via the capital account was, in the immediate aftermath of the global crisis, not particularly problematic, given the size and credit rating of these core EU-states. The same cannot be said of those CEECs (Baltic group and Western Balkans) that are currently living considerably beyond their means.

Table 5.5: Tax ratios and current account balances in Europe 2008.

CEEC	**Tax Ratio***	**Current Account Balance***	**EU15**	**Tax Ratio***	**Current Account Balance***
Albania	22.9	-11.3	Austria	43.4	3.8
Bosnia-Herz.	41.2	-15.8	Belgium	46.8	-2.6
Bulgaria	34.4	-24.4	Denmark	50.0	2.0
Cyprus	36.6	-9.7	Finland	43.6	1.7
Czech Rep	36.3	-3.0	France	46.1	-1.9
Estonia	31.1	-10.8	Germany	40.6	6.6
Hungary	37.3	-8.2	Greece	33.5	-14.4
Latvia	30.4	-15.1	Ireland	34.0	-4.5
Lithuania	20.9	-14.9	Italy	42.6	-3.4
Macedonia	29.3	-14.0	Luxembourg	36.4	5.5
Malta	35.2	-7.7	Netherlands	39.5	7.5
Montenegro	28.0	-39.6	Portugal	37.0	-12.1
Poland	33.8	-5.5	Spain	37.3	-9.5
Romania	28.1	-13.8	Sweden	49.7	8.3
Serbia	34.1	-18.6	UK	39.0	-1.7
Slovakia	29.5	-6.5			
Slovenia	39.3	-4.7			
CEEC Ave	**31.7**	**-13.7**	**EU15 Ave**	**41.3**	**-1.0**
Baltic Ave	**27.5**	**-13.6**			
Visegrad + 1	**35.2**	**-4.5**			
Western Balkans Ave	**30.3**	**-18.1**			

Note * As proportion of GDP; averages are mathematical not weighted.

Sources OECD, CIA, Eurostat, own calculations.

Current account deficits were, of course, to have been expected in the process of radical modernisation and in preparation for EU-accession, but their persistence and, more recently, their widening renders CEE economies vulnerable to currency devaluation and expensive rescheduling of debt. If, as has been the case in the Baltic states and Hungary, foreign loans were predominantly denominated in hard and appreciating currencies (euros or Swiss francs in the main) a large foreign debt-overhang can easily develop stagflationary dimensions and, consequently, political turmoil. In this context the essentially problematic ownership structure of CEE banking systems became a temporary blessing, as Italian, German, Austrian and Swedish parent banks were reluctant to write off the liabilities of their CEE subsidiaries. Nevertheless, the recourse of both Latvia and Hungary to emergency funding from the International Monetary Fund (IMF) in 2009 underscores the extreme vulnerability of economies that had, up until 2007, experienced record growth and investment lubricated by foreign credit, when suddenly confronted with the credit 'crunch'. Above all, fiscal poverty (*qua* tax ratio), together with the deficiencies of both the fiscal policy architecture and the EU's fiscal policy preferences, represent a critical disadvantage for a good many of the CEE economies. Strong evidence of this can be found in the bond spreads between nominally higher yielding CEE sovereign bonds and those of core EU-member states (Gabrisch and Orlowski 2009: 14); however, the marked disparities in bond yields within the group of euro-zone economies (Joebges and Grabau 2009: 505ff) began to take on critical proportions in late 2009 and early 2010, heralding the outbreak of the sovereign debt crisis which has subsequently plagued the Eurozone.

The contradictions of EU policy preferences in the early stages of the crisis were most tellingly exposed in the Commission's own pronouncements. All ten CEE member states are in recession in 2009, seven of them in a worse position than the two per cent fall in real GDP which, in the Stability and Growth Pact, allows a public sector borrowing requirement (PSBR) overshoot beyond the three per cent reference value (see column 3 in Table 5.6). And yet, in its 2009 *Spring Report*, the Commission consistently invokes the need for budgetary consolidation. Even in the case of Bulgaria which, as Table 5.6 shows, had a PSBR of only 0.5 per cent of GDP and an overall state debt ratio of 17.3 per cent of GDP, the Commission lamented the fact that "discipline has not been maintained" and urged "strict expenditure control" (European Commission 2009b: 62). In the case of Estonia, the Commission applauded the budget cuts by the Estonian state as means "to mitigate the risk of breaking the three per cent threshold in 2009", even though Estonia's accumulated state debt was only a paltry 4.8 per cent of GDP (Stability Pact Ceiling: 60 per cent), providing – one might have thought – sufficient latitude to 'mitigate' the extraordinarily severe effects of a double digit recession (2009 estimate: -10.3 per cent according to the Commission's own figures!).

Table 5.6: Real GDP growth, government deficit and state debt in Central and East European member states of the EU 2008-09.

	Growth rate of GDP 2008	**Growth rate of GDP 2009**	**Budget Deficit 2008***	**Budget Deficit 2009***	**State Debt 2008***	**State Debt 2009***
Bulgaria	6.0	-1.6	1.5	-0.5	14.1	17.3
Czech Republic	3.2	-2.7	-1.5	-4.3	29.8	33.7
Estonia	-3.6	-10.3	-3.0	-3.0	4.8	6.8
Hungary	0.6	-6.3	-3.4	-3.4	73.0	80.8
Latvia	-4.6	-13.1	-4.0	-11.1	19.5	34.1
Lithuania	3.0	-11.0	-3.2	-5.4	15.6	22.6
Poland	5.0	-1.4	-3.9	-6.6	13.6	22.7
Romania	7.1	-4.0	-5.4	-5.1	13.6	22.7
Slovakia	6.4	-2.6	-2.2	-4.7	27.6	32.2
Slovenia	3.5	-3.4	-0.9	-5.5	22.8	29.3

Note * As a percentage of GDP.

Source European Commission (2009b).

There are further examples of the Commission's economic contradictory pronouncements in the *Spring Report* in relation to Latvia (European Commission, 2009b: 85), Lithuania (ibid.: 81), Romania (ibid.: 99) as well as to the candidate states of Croatia (ibid.: 113) and Macedonia (ibid.: 115). There have been countless repetitions of the austerity dogma within the (woefully misnamed) Stability and Growth Pact throughout the course of the current crisis. The invocation of 18 'excessive deficit procedures' in 2009 alone was clearly futile in the one sense that the rhetoric is powerless to prevent the inevitable and predictable growth in public sector borrowing requirements, resulting from bank-bailouts, bankruptcies and unemployment. Less futile, from the perspective of neo-liberals, but arguably more dangerous is the persistence of a bankrupt doctrine of market radicalism which questions the allocative efficiency of state agencies at the end of a period where the theory of the allocative efficiency of markets has been demonstrably refuted[11]. The stubbornness of neo-liberal roll-back dogma was particularly evident in the adjustment programmes required of the CEECs, in conjunction with the World Bank (privatisation, deregulation and market opening) as elements of 'conditionality'. In relation to the core purpose of this chapter, it is also evident in the shambolic failure of the Commission and/or the member states to achieve anything approaching harmonised or coordinated programmes of counter-cyclical tax measures. The survey of *Taxation Trends in the European Union* (European Commission 2009a) illustrates on the one hand the worrying blindness of a political agency to the pro-cyclical policy which urges budgetary consolidation in an economic downturn; on the other, it cites examples of the disparate (and desperate) attempts of certain member states to fulfil the dubious logic of a Commission lacking a reliable policy compass (Estonia, Latvia, Lithuania and, to a degree, Hungary) and the overwhelmingly uncoordinated efforts of the other member states to undertake counter-cyclical policies which include dozens of changes to the administration of taxation (European Commission 2009a: 13ff). Reductions in rates of personal income tax (France, Germany, Hungary, Lithuania, Poland) stand opposite planned increases in top rates (UK) or new surtax levies on top incomes (Greece, Ireland) while such surtaxes are abolished elsewhere (Hungary) and planned rate cuts are deferred (Estonia); lower corporation tax rates for all (Lithuania, Sweden) or some businesses (Cyprus, Portugal) contrast with unchanged rates but increased allowances (most countries) or CT surcharges on hydrocarbon-based enterprises (Italy). The (albeit temporary) reduction in the standard rate of VAT in the United Kingdom or of special VAT rates for food (Finland) or restaurants (France, Hungary), hotels (Cyprus), labour-intensive local services (Czech Republic) or housing (Italy, Romania) contrast with the stronger trend towards higher standard rates of VAT (Hungary, Ireland, Latvia, Lithuania,) and higher excise duties (Finland, Latvia,

[11] Above all, the collapse of the neo-liberal promise of a virtuous circle of higher profits, higher real investments, higher growth and higher employment at an early stage in the 1980s, and the deployment of higher profits and corporate reserves in speculation and merger activity, should give even its staunchest supporters in the European Commission pause for thought, as they survey the wreckage in 2009.

Lithuania, Romania, Slovenia, UK). Some measures stand out, like Spain's 100 per cent rebate on wealth tax and its "free depreciation for companies maintaining employment" (European Commission, 2009a: 19) or Bulgaria's five-year tax holiday for investment projects. Contradictions in the area of environmental policy are also evident in the latest spate of tax measures: while Germany and the Netherlands have introduced incentives for promoting fuel-efficient cars, Romania has reduced its car pollution tax and several tourist-dependent countries have reduced or abolished airport fees (Cyprus, Greece, Malta), encouraging the most polluting form of transportation which already – and scandalously – enjoys fuel tax exemption where less polluting forms are obliged to pay high levels of fuel excise duty. Above all, the Commission's survey should be a source of embarrassment, reflecting not just the absence of any attempt actively to harmonise or coordinate tax policy changes but, above all, the re-emergence of intra-EU tax-driven location competition when member states should be seeking to achieve the opposite, that is an end to beggar-thy-neighbour macro-economic policies and the promotion of tax justice throughout Europe.

An end to tax havens?

There were grounds for hope in the autumn of 2008 that major changes would be made to the structure and thrust of global economic governance as a result of the sheer scale of economic calamity and the replacement of George W. Bush by Barack Obama. This hope was reinforced by the emergence within the WTO of a loosely aligned but determined group of BRIC-states (Brazil, Russia, India, China) that were subsequently included in the November, March and September summit meetings of the G20. This betokened not just an acknowledgement of the interdependence of the world's political economy but above all the recognition of an urgent joint responsibility for global crisis management. As a result of the widespread use/abuse of 'offshore' tax jurisdictions by most big finance corporations, and as conduit for some 70 per cent of global trade transactions, and the sudden reduction in the revenue flows of all major states, policy-makers also began focussing their attention on the long-ignored problems of tax-avoidance, tax-evasion and 'tax havens'. They were generally supported by public opinion, as major cases of financial fraud – the scandals involving Madoff and Stamford – revealed the programmatic concealment of financial assets in offshore accounts for the purposes of both tax avoidance and commercial malpractice. Estimates of the extent of offshore financial holdings vary considerably, for the obvious reasons of bank secrecy and deliberate concealment by individuals and corporations. While the OECD estimated that the world's 'high net worth individuals' held between 5-7 trillion US dollars offshore in 2008, the Tax Justice Network in 2005 had calculated the equivalent assets at 11.5 trillion US dollars (figures from Tax Justice Network 2009). Even though these and other figures do not include corporate assets, the fiscal losses of 'normal' tax jurisdictions can at least be guessed at. Alex Cobham (cited by Tax Justice Network 2009) has estimated that "poorer countries forego USD 385 billion in revenues annually, due to tax avoidance and tax evasion". Public pronouncements by Barack Obama, Nicolas Sarkozy, Angela Merkel and other European state leaders suggested a serious intention collectively to crack down on the tax-evasion-centres – wrongly dubbed 'tax havens'; they were supported in their pronouncements by the major report of the OECD (1998) into 'harmful tax competition' and by the long-standing, persistent and consistent work of the Tax Justice Network (2006; 2008). What has emerged has been a series of *accommodations* with jurisdictions like Switzerland, Liechtenstein and Jersey which have been bilateral and unilateral rather than multilateral in nature[12] and, predictably, spectacularly unradical in their likely outcomes. Above all, these bilateral deals involving primarily Britain and Germany look set to undermine the most promising, if limited, tax initiative in the EU's recent history, namely the 2003 Directive on the taxation of savings income, which came into force in 2005. The Savings Tax Directive (STD) applies solely to natural persons that are resident in an EU country, not to companies. The original scheme envisaged a uniform exchange of information between all member states and including the UK's Crown Dependencies (Jersey, Guernsey, Isle of Man), the UK's overseas territories (the British Virgin Islands, Caymans, Turks and Caicos, Anguilla), the Netherlands Antilles, Aruba and some small European territories (Andorra, Monaco, Liechtenstein and San Marino). The primary objectives were to neutralise one significant source of tax evasion and to expand EU state tax revenues through widening the tax base. Because of opposition from Austria, Luxembourg and Belgium, as well as

[12] The OECD (1998: 8) rightly identifies unfair tax competition as a multilateral problem.

Switzerland and the Channel Islands, to the abandonment of bank secrecy implicit in the exchange of information plan, a compromise was struck allowing some states to levy a 'withholding tax' on accounts held by EU nationals, while the majority introduced the full disclosure of both savings accounts and the identity of the account holders. While the Caymans and Anguilla have opted for the information exchange option, the three EU secrecy jurisdictions, together with Switzerland and the other non-EU jurisdictions have chosen the withholding tax option.

Even with the concession of secrecy and the limitation of the arrangement to interest income (dividends are not included), the Directive was highly significant in achieving a degree of unanimity in the sphere of direct taxation, and committing key secrecy jurisdictions to address long-standing grievances on tax evasion by EU citizens, either directly or indirectly. This significance was recognized by major campaigners for tax justice, but more tellingly, by the secrecy merchants in major global financial centres. One 'wealth management' outfit dubbed the Savings Tax Directive "the single biggest threat to offshore revenues" such that "[o]ver half of the [financial services] industry harbors serious concerns that it will drive assets onshore".[13] Veronique de Rugy of the Cato Institute saw the STD as "an enormous threat to America's long-term prosperity", if the then Bush administration were to sign up to it on the grounds that the US, as "the best tax haven in the world", could lose some of the 9 trillion US dollars of foreign capital that was attracted to the US annually (de Rugy 2002).

The 'threat-rhetoric' by proponents of offshoring and tax-havenry represented a negative endorsement of the potential of this multilateral initiative. Conversely, the reactions to the two recent bi-lateral deals between Switzerland and both Germany and Britain suggest that a serious blow has been dealt to the STD in favour of further beggar-thy-neighbour politics. The deals, struck on 10 and 24 August 2011 respectively, both envisage Swiss banks levying a one-off retrospective tax of between 19 and 34 per cent on the

[13] The Global Information Inc., *EU Savings Tax Directive: the market's response,* Report. Available at: <http://www.giiresearch.com/report/dc24138_eu_saving_tax.html>; cf. also de Rugy (2002).

accumulated interest income of German and UK tax evaders with accounts in Switzerland and a future annual withholding tax. The withholding tax rate differs significantly: the rate applied to German account holders of 26.4 per cent corresponds to Germany's own *Abgeltungssteuer* on savings accounts, that applied to UK account holders is 48 per cent, which is close to the new 50 per cent top marginal rate for high earners. The details of the bilateral deals are less relevant than the damage inflicted on the multilateral STD initiative and on the principles of transparency, legality and honesty which the EU, together with the IMF, World Bank and UN, is seeking to encourage in the tax governance of developing countries. It is not surprising that the assessment of the agreements by Patrick Didier, president of the Swiss Banking Association, was 'positive' (quoted in *EurActiv*, 26 August 2011), and that the *Neue Zürcher Zeitung* noted that Switzerland had "succeeded in protecting the interests of the clients to an unexpectedly high degree" (25 August 2011). Nor was it a surprise that Swiss bank share values rose on hearing the news. There has been vociferous opposition from both prominent tax justice campaigners and the political opposition parties in both countries.[14] A telling critique appeared in the Financial Times Lex Column, which suspects a "lingering tolerance for dubious practices":

> Swiss banks will pay taxes anonymously and in bulk. As long as specific names and account details remain secret, determined tax evaders will have an edge over governments. So why have Germany and the UK been willing to settle for less than the standard set in this area in the European Savings Tax Directive, and for fewer concessions than the US received in 2009?
>
> (*Financial Times,* 25 August 2011)

With further bilateral negotiations between Switzerland and other EU states underway, it is difficult to assess the overall damage these deals do to European harmonisation efforts, but they will significantly disrupt the work of the Tax Directorate under Semeta and above all, send the completely wrong message to the political elites and the civil society groups in LDCs, to other offshore financial

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[14] One of the most detailed critiques of the UK deal was the immediate response of the UK Tax Justice Network. Available at: <http://taxjustice.blogspot.com/2011/08/tjn-on-disgraceful-uk-swiss-deal.html>.

centres and to the tribe of accountants and tax lawyers running their money-laundries.[15]

Conclusion

The EU has thus, by design and by default, manoeuvred itself into a severe structural impasse which will critically hinder attempts to address the more immediate structural crisis of global financial markets and the cyclical crises of trade and growth. There are major *structural economic asymmetries* of demand within the old EU15: increased disparities of income distribution, associated weaknesses of domestic demand and household debt, weak growth, structural unemployment and large external imbalances. The 2004 and 2007 enlargements have boosted overall demand within the EU27 but have exacerbated the external imbalances and hence the vulnerability of individual member states to imported crises of investment, trade and overcapacity.

The *structural political asymmetries* are more intractable and can be traced back to the paradigm shift to neo-liberalism in the early 1980s, the constitutive reforms of the Single European Act and European Monetary Union and the fatal logic of supply-sidism and monetarism. The triumph of the deflationary imperative and the hegemonic role of the Bundesbank produced a policy architecture which still subordinates democratically accountable institutions of fiscal policy to the naïve dogmatism of deflationary austerity dictated by an unanswerable supra-national central bank. This policy architecture – which favoured (German) export-led growth strategies but which compounded domestic demand weaknesses – was ill-suited to the social and economic challenges facing mature capitalist economies, but even less well suited to the medium- and long-term development of the ten new CEE member states.

Whichever theory of economic development one deploys to examine the policy failure of the EU in the last thirty years, the case against neo-liberal market radicalism would appear to be overwhelming. Above all, the case for differentiated national strategies of economic

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[15] For further details of the weakening of EU approaches to tax avoidance and tax evasion, with particular reference to the effects on developing countries, see Leaman (2011).

modernisation and transformation which shield states from the imperatives of 'arrived' mature political economies and associated hegemonic interests is very strong. Ha-Joon Chang uses two metaphors to illustrate the hypocrisy of neo-liberal development policy: the 'Bad Samaritan' state (Chang 2007) devises schemes of 'development aid' which are driven by the self-interest of comparative advantage, and which by 'kicking away the ladder' (Chang 2002) deny to emerging economies the mercantilist means which promoted its own development. These metaphors apply as much to arguments illustrating the need for substantial state ratios and transparent and just tax regimes, as they do to illustrate the needs of infant industries and economic infrastructures. The tragedy of Europe's failure to achieve minimum standards in progressive direct taxation in the process of post-communist transformation is that it will not only hobble the development of the transition states but will rebound to weaken the fiscal integrity of all member states, old and new.

A central challenge of the 21st century remains the achievement of a just distribution of national and global resources, realising a fair and sustainable access to employment, income, education, health, food, water and other materials. The evidence supporting the view that "more equal societies almost always do better" (Wilkinson and Pickett, 2009) is persuasive. Tax justice is just one element of the distributional challenges facing us, our children and our grandchildren. We have an opportunity with the current calamity of finance capitalism of recasting national and international relations in a more progressive and hopeful direction. We need to grasp it.

Recommendations

- Restoration of higher marginal rates and steeper curves of progression in personal income tax across the whole of the EU; abolition of flat-rate systems of PIT
- Convergence of top PIT rates and CT rates to avoid income shifting
- EU-wide harmonisation of wealth taxation
- EU-wide harmonisation of tax base for corporations and non-incorporated enterprises
- EU-wide introduction of aircraft fuel tax; extension of existing carbon taxes
- Harmonisation of the ambition to raise national tax ratios

- Elimination of offshore low-tax jurisdictions
- Multilateral agreements on fair tax governance and progressivity as principles attaching to political conditionality
- Repeal/reform of the Stability and Growth Pact
- Recasting of the policy architecture of European macro-economic management, rendering the European Central Bank both committed to a broader range of macro-economic objectives, including employment, and to global and regional coordination, and the restoration of democratic answerability to central banking.

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Appendix 5.1: Major tax changes in the EU27 2008-09.

	Changes to Direct Taxation	Changes to Indirect Taxation
Austria	Raising of basic personal income tax (PIT) allowance to 11 000 euros, lowering marginal rates for second and third tax bands; increase in top tax band (50%) to 60 000 euros; increased child-related allowances; enhanced depreciation for investment in 2009-10.	
Belgium	Reductions in wage withholding tax (WWT); increase in hours of overtime allowed at lower rate of tax; prolonging of payment delay for WWT.	VAT reduction from 21% to 6% for housing construction.
Bulgaria	5-year tax free holiday for investment; PIT: mortgage interest deduction for young couples.	
Cyprus	Reduction in corporation tax (CT) for para-public organisations from 25% to 10%.	Decrease in airport landing fees; VAT reduction of 3 percentage points for hotel accommodation to 5%.
Czech Republic	Reductions in social security rates (SSCs); acceleration of depreciation of certain assets.	Lower VAT rate for certain local services; VAT deduction on cars for businessmen.
Denmark	Increase in PIT allowances; postponement of payment for assessed PIT; initiation of major PIT tax reform to 2019 with reduction of top marginal rate.	Postponement of VAT payments.
Estonia	Deferral of PIT rate cut and increase in personal allowance.	Increase in reduced VAT rate from 5% to 9%.
Finland	Adjustment of PIT scale by 4% re: inflation; reduction in all four PIT bands; increased PIT allowances; reduced employer contributions for social security.	10% increase in excise duties for tobacco and alcohol; VAT rate reduction for food from 17% to 12%.
France	PIT reductions for poorer households; tax credit reimbursements for firms; local tax exemptions for equipment investmentss to December 2009; change in tax base for local income tax from 2010.	VAT reimbursements, lower VAT rate of 5.5% for restaurant services.
Germany	Bottom PIT rate reduction to 14%; retroactive increase PIT thresholds and basic allowance. Increase in PIT credit for household repairs to 1 200 euros; incentives to buy environmentally friendly cars. Increase in thresholds for	

	equipment purchases for SMEs; introduction of declining-balance depreciation at 25% rate for movable fixed assets 2009-2010 inclusive.	
Greece	Extra PIT on high income earners; 1 000 euros for incomes between 60 000 and 80 000 euros up to 25 000 euros for income above 900 000 euros.	Reduction of local authority duty on short-term accommodation from 2% to 0.5%. Reduction of single property tax; 50% reduction in car registration tax; suspension of airport landing and parking fees April-September 2009.
Hungary	Plan for PIT reductions; solidarity tax on corporations and high earners to be abolished as of 2010; rise in lowest PIT band; decrease in employers' SSCs of 5 percentage points.	General VAT increase from 20% to 25%; temporary reduced rate for dairy products.
Ireland	Increase of 1 000 euros for standard tax band; income levy of 1% on incomes above 100 100 euros and 2% for incomes above 250 120 euros. Introduction of pensions levy on public sector wages; increased SSC ceiling to 75 036 euros. Increase rates of capital gains tax (CGT), capital acquisitions tax and Deposit Interest Retention Tax; Payment dates for CT and CGT brought forward.	Increase in standard rate of VAT to 21.5% and some excise duties. Reduction in stamp duty top rate from 9% to 6%.
Italy	CT surcharge for hydrocarbon companies; Reductions in advance tax payments by corporations; Capping of interest rates for variable rate mortgages.	Cut in excise duties on industrial gas; tax incentives for purchases of household appliances; removal of municipal property tax from first property owned.
Latvia	Reduction in PIT rate from 25% to 23%, increase in PIT allowances.	VAT standard rate from 18% to 21% and of reduced rate from 5% to 10%. Increased excise duties on tobacco, fuel, coffee, alcohol and non-alcoholic beverages.
Lithuania	Reduction of PIT rate to a flat 15%; introduction of separate SSC of 6%. Increase of CT rate from 15% to 20%; investment incentives up to 2013.	VAT standard rate rise to 19%; abolition of reduced VAT rates. Increase in excise duties on fuel, alcohol and tobacco.
Luxembourg	Linear indexation by 9% of PIT bands; reduction of CT rate from 22% to 21%; abolition of Capital Duty; extension of	Extension of reduced 3% rate of VAT for construction or renovation of owner-occupied housing.

	the 80% exemption for income and gains from intellectual property rights; increase in deduction ceiling for mortgage endowment premiums.	
Malta	Increase in PIT thresholds.	Extension of VAT exemptions for cultural services and to registration tax on trucks; travellers' departure tax abolished.
Netherlands	Increase in tax credit for working parents. Employee contributions to unemployment social security abolished; tax incentives for annuities and pensions; Easing of depreciation rules for investments Tax cuts for SMEs.	Abolition of tax on flight tickets. VAT payments allowed quarterly instead of monthly.
Poland	Lower PIT rates of 18% and 32% replace three rates of 19%, 30% and 40%; Increased investment incentives within PIT and CT.	Decrease in period for VAT refund from 180 to 60 days; refund of VAT on bad debts lasting more than 180 days
Portugal	New CT rate of 12.5% for taxable profits up to 12 500 euros; new investment incentives; increase in deductions from taxable income related to education, health, housing and nursing homes; exclusion of commuting expenses from taxable income; increase in personal allowance for disabled taxpayers.	Reduced real estate tax; reduction of VAT exemption threshold; anticipation of VAT reimbursements.
Romania	2% gross income tax for agricultural enterprises (?); increase in employee's and employers' SSC rates; reduction in employers' contributions for work accidents and personal disease; increase in level of deductibility of voluntary health insurance and pensions; Temporary tax exemptions on CGT from securities trading; reductions in dividend taxes on non-residents from 16% to 10%.	VAT reductions from 19% to 5% for certain categories of housing; reduction in car pollution tax; increase in excise duties on alcohol, cigarettes and fuel.
Slovakia	Increased PIT basic allowance; introduction of employee tax credit; decrease in SSC contribution rate for mandatorily insured self-employed from 4.75% to 2% CT and PIT allowances for property depreciation; CT	Reduction in refund period for VAT from 60 to 30 days.

	allowance for research activity.	
Slovenia	Increased investment allowances relating to CT and PIT; easing of CT pre-payment arrangements.	Increases in excise duty on petrol, diesel, alcohol and tobacco.
Spain	Temporary suspension of tax relating to property registration; 100% rebate on wealth tax. Free depreciation for companies maintaining employment. Cancellation of projected phase-out of R&D allowances for CT; Reductions of SSC for hiring unemployed workers with children; Additional tax credit of €400 for working and self-employed taxpayers.	Acceleration of VAT repayments.
Sweden	Cut in CT rate from 28% to 26.3%; reductions in SSC contributions for employees and the self-employed; increase in the in-work tax credit. Rise in lower tax band for central government PIT. Increased personal allowances for those over 65. New tax credit for renovations, conversions and building maintenance for households.	
United Kingdom	Increased personal PIT allowance for those under 65. Increase in capital allowance to 40% for one year; New top rate of PIT for incomes above £150 000 from 2010; limited PIT allowances for incomes over £100 000 from 2011; Increases in national insurance contributions of 0.5% for employees employers and self-employed from 2011; restricted tax relief on pension contributions for those with incomes above £150, 000 from 2011.	Temporary reduction of standard VAT from 17.5% to 15% until December 2009. Increase in alcohol and tobacco duty.

Chapter 6

A crisis of governance
Can comitology theory help legitimise ECB/ESCB operations?

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Governance versus the rule of law: Comitology under threat?

Although the Lisbon Treaty has dispensed with much of the reformist lawyerly zeal of the draft constitutional treaty, Article 290 of the new Consolidated Treaty (TFEU) may yet give some measure of comfort to those who had hoped for comprehensive overhaul of the Community's Byzantine scheme of legislation and implementation.[1] Above all, although the cumbersome historical distinction made between legislative instruments lives on in Article 288 TFEU (ex 249 EC), the new Article 290 may be argued to have at last established a nascent 'hierarchy of norms' within the European Union (EU), placing explicit Treaty limits, as well as operational conditions (to be determined by the Council and by the European Parliament), upon the exercise of delegated powers and

[*] This contribution is a slightly amended version of an earlier draft of a piece published by the Centre for European Legal Policy, University of Bremen: 'What Can the Law Do for the European System of Central Banks? Good Governance and Comitology "within" the System', *ZERP Diskussionspapier* 3/2010.

[1] Aided and abetted by Article 291 governing management of member state competences.

implementing competences by the European Commission. Thus, for example, a delegation of powers to the Commission 'to adopt non-legislative acts of general application' may now only occur where so stipulated within an originating legislative act, and only to the degree that such a delegated power 'supplement[s]' or 'amend[s] certain non-essential elements of that legislative act' (Article 290(1)). Equally, Article 290(2a) TFEU imposes a duty upon Parliament and Council 'explicitly' to detail the conditions upon which a power is exercised (e.g. by means of a sunset clause detailing the temporal limits of the delegation); and further stipulates that 'delegated acts' may only 'come into force' where the Parliament and Council have raised no objections within a pre-determined time limit (Article 290(2b)).

Talk of the establishment of a hierarchy of norms may appear obscure to non-lawyers. Equally, the complexities of treaty language also obscure the immediate significance for the 'governance' of the European Union of Article 290 TFEU. Nonetheless, the Commission's urgent response to the entry into force of the Lisbon Treaty – airing its views on the best means of implementing Article 290[2] – at once reveals the practical institutional and political importance of a new hierarchy of norms within the EU. Thus, for the Commission, the vital underlying issue is one of the impact of Article 290 upon the system of 'comitology' formally established by the Comitology Decision,[3] and operated enthusiastically by the Commission as a framework within which it might exercise powers delegated to it by the Council under the former Article 145 EC Treaty. In the view of the Commission, the stipulations of Article 290 TFEU are comparable, though not identical, with 'the regulatory procedure with scrutiny introduced by Decision 2006/512/EC',[4] and may thus – reading between the lines of the argument – herald a possible curtailment of the huge variety of comitology procedures they deploy. However, they are not necessarily a threat to the system of delegated powers and comitology *per se*, especially since comitology is seemingly encouraged by the new Article 291 TFEU governing implementation at national level. Others are not so sanguine. For the European Parliament,

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[2] 'Implementation of Article 290 of the Treaty on the Functioning of the European Union', COM(2009) 673 final.

[3] Decision 1999/468/EC, as amended by Decision 2006/517/EC, *Official Journal of the European Union,* C 2006/255.

[4] *Official Journal of the European Union,* L 200 2006/11.

a long standing enemy of comitology, which possesses an abiding suspicion that its arcane procedures have been deployed to subvert parliamentary competences,[5] the rationalising effects of Article 290 appear to be welcome as sounding the death-knell for the practice. In theory, the Parliament might thus establish such egregious limitations to delegated powers within legislative acts that all further manifestations of the comitology system are strangled at birth.

Abstracting to the level of constitutional design, a post-Lisbon context of potential conflict between Commission and Parliament on the appropriateness or otherwise of comitology procedures might accordingly also be argued to be a context of retrenchment: a period of the revenge of the rule of law, and of a reassertion of a fixed hierarchy of norms against the *ad hoc* system of 'governance' that has come to characterise the latter stages of European integration. In other words, where the evolution of comitology has answered *unforeseen* demands within the legal structures of the European Treaties – for administrative capacity, for national/supranational co-operation and for expert advice – it has joined a host of contingently constituted executive bodies and procedures that are intrinsically foreign to the treaties; bodies and procedures such as semi-autonomous European agencies and the Open Method of Co-ordination (OMC), whose legitimacy has generally been measured far less in formal normative categories of explicit treaty basis or clearly apportioned competence, and far more in terms of functional efficiency or an ability "to do the required job" (Everson 1995). Historically vulnerable to accusations of opaqueness or lack of transparency (Weiler 1999) and similarly viewed with suspicion by institutions of democratic representation, this *ad hoc* governance executive may now face a potentially fatal challenge in the guise of renewed assertion of traditional constitutional concepts, such as the hierarchy of norms, which demands a clear and limited mandate of delegation within foreseen and foreseeable institutional structures.

[5] A suspicion often aired before the Court of Justice of the European Union (CJEU); see, for example cases, Case C-302/87 *European Parliament* v *Council of the European Communities* [1988] ECR 05615, and Case C-70/88 *European Parliament* v *Council of the European Communities* [1991] ECR 1-04529 (Re: Radioactive Food), known as '*Chernobyl*'.

Such an assessment is nonetheless premature. Although prior to the euro crisis national governments may not have wished to revisit treaty structures for at least a decade, the EU clearly remains a work in progress, with its own operational demands for governance structures that lie outside the traditional rule of law. "The committee structure is a valuable contribution to the federal principle ensuring the involvement of all entities of the eurosystem in the preparation of the ECB decision" (de L'Honeux 2009: 473): far beyond the traditional reach of Commission comitology, various national central bankers have thus, for example, recently written in support of a new system of 'consultative' committees, established under the rules of procedure of the European Central Bank (ECB),[6] in order to aid the decision-making bodies of the European System of Central Banks (ESCB) and the ECB in the exercise of their decision-making competences.[7]

The vital underlying point of such developments for this chapter is both operational and normative in character. 'Governance', or the simple fact of the creation of unforeseen executive or administrative structures for the management of integration processes, appears to remain an unavoidable functional characteristic of the European Union. For all that national governments may yet – and against all current monetary reason – seek to imbue the Lisbon Treaty with an epoch defining finality, processes of European integration have not reached an end point or a *finalité* that might be easily captured by or reflected within finite institutional-constitutional structures. The operational demands of integration are still being met within *ad hoc* executive structures. At the same time, however, voices of normative suspicion have grown in volume and constitutional significance and point to Article 290 as a potent symbol of such reformist aspirations. In this contrasting analysis, governance is a simple analytical concept, deployed by political scientists, in order to categorise institutions of national, supranational and even global management and control,[8] but lacking in any deeper legitimating force of its own. Instead, as the provisions of the Lisbon Treaty forcefully remind us, executive or administrative legitimacy is still surely to be found within the

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[6] Article 9 of the Rules of Procedure of the European Central Bank (ECB/2004/2).
[7] See, for particular elucidation of this point, Everson and Rodrigues (2010).
[8] Pointing to the danger of this tendency, with specific reference to the OMC, see Joerges (2007).

historical notion of 'transmission-belt' control;[9] that is, the establishment of limited administrative mandates within a hierarchy of norms that are subject always to parliamentary and governmental recall, and that are policed by a rule of law that seeks to defend a polity, or its political competence, by strictly constraining and controlling the executive.

This clash between the normative and the practical, between a desire to establish more traditional means of legitimation for the *sui generis* EU and the contrasting demands of that unique body for the establishment of an executive that enables it to perform its allotted functions will undoubtedly outlive ratification of the 'epoch defining' Lisbon Treaty, and even any subsequent treaty reforms. Alternatively, for lawyers, the outstanding task unquestionably – if uncomfortably – remains one of adapting constitutional theory, constitutional practice, administrative law and the legal structures of executive design in order to ensure both the functionality and the legitimacy of the institutional structures of the European Union. The task is onerous and multidisciplinary, requiring both the forensic interrogation of traditional notions of constitutional theory, in order to identify the generic lines of constitutional legitimation that may yet transfer to a *sui generis* EU, and an understanding of patterns of social organisation that derive their own independent (non-normative) legitimacy by furnishing the EU with adequate institutional capacity to ensure that it can do its job. Certainly, in this regard, fact may not be allowed to lead norm: 'invented' institutions of European governance do not become legitimate simply by virtue of their 'invention'. Nonetheless, emerging practices of crisis control within the ESCB and ECB prove particularly instructive: as the ramifications of the recent financial crisis have amply demonstrated, nowhere is the demand for 'empirical' legitimation more potent than in the area of money management. Simply stated, and all traditional-historical notions of transmission belt executive control apart, the legitimacy of the ESCB and ECB resides firmly in its ability to 'do its job', or its ability to maintain the credibility of a youngish currency upon whose survival the interests of the continent as a whole rest.

[9] See, for details of the origins of the concept, Everson (1995).

A constitutional legitimacy for comitology: Between functionality, representation and deliberation

Transmission and the ban on delegation

'Comitology', or the interweaving of expert, interest driven and political interests within *ad hoc* governance structures is an affront to constitutional theory and above all to the notion of transmission and the ban on delegation. However, contemporary notions of transmission-belt administration, norm-hierarchy and non-delegation have their common antecedents within the 'Enlightenment' constitution and, above all, within the concept of the representative democratic primacy of the people. Accordingly, where once the ban on non-delegation was designed simply to preserve the absolute powers of the despotic sovereign, the Enlightenment constitution imbued this power-consolidating construct with a far deeper normative meaning. Consequently, the powers that were and are now to be protected are those of the people: that is, the sovereign powers of a constitution-creating polity personified within its own institutions of representative democracy. As a result, highly technical legal formulas demanding, on the one hand, that legislative mandates to the administration be strictly constraining – allowing little if any administrative autonomy – and, on the other, requiring the law to police any alienation of legislative competence by means of rigorous application of the rule of law to the administration, have their own inspirational underpinnings within the constitutive building blocks of constitutional and democratic theory (Everson 1995).

The fundamental inspirational consequences of constitutionally derived notions of non-delegation may be readily identified within the modern European Union. Above all, the *Maastricht* and *Lisbon* Judgments of the German Constitutional Court, in their forensic examination of the legitimacy or otherwise of the delegation of powers by the Federal Government to the EU under Article 25(3) of the German Constitution, are clear embodiment of a rule of law, which extends far beyond application of arcane procedural legal formats, such as *ultra vires*, to investigate instead highly existential questions of the preservation of the German polity in the face of the burgeoning competences of an external executive body (the EU).[10] Thus, German judicial emphasis upon Article 38 of the Federal Constitution – the stipulation that sovereign power derives from the people – similarly leads the Court into comprehensive and *empirical* analysis of German democratic process and the necessary conditions under which such democratic process might still properly be termed sovereign, even in the face of wide-scale transfer of executive competence to the European Union.[11]

As can be noted, the German Court's readiness to engage in empirical analysis, or the 'reality' of the vital sovereign giving qualities of representative democratic process, are an immediate indication that strict norm-fact divides are also elusive within traditional constitutional theory, such that the workings of the notion of transmission belt administration may be modified within the conventional confines of a constitutional court *"in the light of circumstances"*.[12] Nonetheless, and not to pre-empt such fact-norm complexities, simple legal extrapolations of the ban on delegation and the rule of law may yet prove to be an immutable barrier to delegation of powers, even where persuasive functional reasons for such a delegation exist; a potential problem that can immediately be highlighted by virtue of an initial, though basic, legal analysis of potential 'non-delegation' hurdles to the use of comitology rationales to legitimise the workings of the ECB and ESCB system within the context of the whole of the EU (its relationship to political power).

Accordingly, the Lisbon Treaty, and above all Articles 282-4 TFEU concretising the status of the ECB *as an institution of the European Union*, might now be argued to have ended all possible controversy on the autonomous character of the ECB and ESCB, and thus to have determined that the general ban on delegation applying within the EU will also apply squarely to executive conduct of its monetary policy. Alternatively, where once the ECB attempted to argue that its lack of institutional status and heightened independence under Article 108 EC (now Article 130 TFEU) precluded application to it of

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[10] *Brunner* v *European Union Treaty* CMLR [1994] 57 and '*Maastricht*,' German Constitutional Court decision from 12 October 1993, BVerfGE 89.
[11] See, *Brunner, supra* note 10.
[12] Ibid.

the general scheme of Community law,[13] the inclusion of the ECB and ESCB within the Treaty Title enumerating the European institutions seems to confirm that the Bank is indeed subject to general Community law provisions. As a result, the conduct of monetary policy as laid down in the Treaty (Articles 127-133 TFEU) must now surely be considered to be subject to the general Community prohibition on non-delegation established by the infamous *Meroni* doctrine of the European Court of Justice,[14] giving constitutional force to a principle of the balance of powers – or the 'institutional balance' – which includes a dual injunction that all institutions of the EU must work within the competences allotted to them and may never delegate those competences to institutions not named within the Treaty. The question posed by this contribution – on of whether the ECB might ever be legitimated with reference to theories of comitology – must surely be answered in the negative: comitology would seem to entail a dilution of the competences of the bank, a 'delegation' proscribed by the *Meroni* doctrine and the principle of institutional balance, now reformulated as a 'conferral of powers principle' within the Lisbon Treaty.

Transmission revised and the normative power of 'functionality'

All such projected legal pedantry law aside, the reality of historical processes of European integration is nonetheless one of the dominance – at least within the sphere of the Commission's legislative initiative – of committee proceedings taking place *outside* the named institutions of the Treaty. As painstaking analysis has shown, approximately 50 000 decisions were taken by agricultural and regulatory committees between 1971 and 1995 (Falke 1996). The years since passage of the Comitology Decision have similarly seen little if any abatement in committee activity, with the latest annual Commission Report on Comitology detailing the fact that 2 185 opinions were delivered by 270 comitology committees in the year 2008 (European Commission 2008). Is then the whole of the European system – or at least to the degree that its operations are founded upon the opinions and decisions of committees – an affront to the rule of

[13] Case C-11/00, *'OLAF'*, *Commission of the European Communities* v *European Central Bank* [2003] ECR I-7147.
[14] *Meroni* v *High Authority*, [1962] ECR 73.

law, to the ban on non-delegation now implied within the principle of the conferral of powers?

The answer to this question is 'no', but a 'no' that nonetheless exists within multiple tensions; tensions between intergovernmentalism and supranationalism, between 'good' and technical decision-making, between the tendency for intergovernmentalist bargaining and the need for political consensus-building, between a functional requirement for 'appropriate' and a normative demand for 'legitimate' decision-making, and between the realm of governance and that of the rule of law. In other words, although the Court of Justice of the European Union (CJEU) has consistently confirmed the legality of comitology proceedings in the face of firm parliamentary opposition to them,[15] their exact normative or constitutional foundations remain highly elusive both within the literature and before the Court, with comitology appearing contrastingly as prosaic child of regulatory necessity, as reflection of political compromise and as creature of constitutional renewal.

The history of the establishment of comitology as a procedure formalised by the Comitology Decision,[16] is instructive. The administrative and technical capacities of the European Community and Union have always been small, and its competences broad. Accordingly recourse to external expertise, gathered informally together in committees, always suggested itself as a mode of bridging this 'administrative gap'. With arrival of the Commission White Paper of 1985 for completion of the internal market (European Commission1985), however, the issue changed in both quantitative and qualitative dimensions. Historical modes of market integration, such as regulatory approximation, mutual recognition or even regulatory competition, were ill-suited to the wide-ranging 'deepening' of integration posited by the single market programme, especially in view of the member states' continued recourse to their residual competences under Article 36 TFEU (ex 30 EC) in order to regulate their markets in defence of the health and safety of their own consumers. Accordingly, in addition to overcoming an administrative

[15] Often in the face of parliamentary opposition, see, Case C-302/87 *European Parliament* v *Council of the European Communities* [1988] ECR 05615.
[16] Decision 1999/468/EC, as amended by Decision 2006/517/EC (*Official Journal of the European Union* C 2006/255).

gap, the Commission was now also required to overcome a 'regulatory gap', or a mismatch between the supranational interest in market regulation (Article 34 TFEU (ex 28 EC)) and residual national regulatory competences. It chose to tackle this with the 'New Approach', whereby framework directives would be augmented by technical standards established within committees of interest groups, technical experts and national representatives and subsequently approved by the Commission. Approximation of market regulation would be achieved by means of a general framework of regulation, supplemented by administrative/executive technical standard setting, designed to achieve a 'high level of protection' for European citizens (Article 108(s) Single European Act).

The complicating factor within this new arrangement, however, was not simply the fact that the Commission was now explicitly exercising powers delegated to it by the Council under the then Article 145 EC, but rather the reality that the Commission, together with its extended cohort of interest groups, experts and national representatives, was similarly exercising the regulatory competences of the member states. In particular, as the technical complexities of EU regulation have increased to the degree that the Commission is itself now often identified as a 'blind driver', directed rather than informed in its decision-making by the eyes of its expert and scientific committees (Everson and Vos 2008), a dual problem of legislative pre-emption by the EU executive has thus grown evermore acute: on the one hand, with regard to the pre-emption of the legislative competences of the institutions of the Community, and particularly those of the Parliament within co-decision procedures;[17] and, on the other hand, in relation to the supranational colonisation of the residual competences – and thus popular sovereignty – of the member states.[18]

The problem of potential legislative pre-emption both at EU and at member state level may go some way to explaining the extraordinarily complex series of procedures that are to be found in the Comitology Decision.

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[17] Case C-70/88 *European Parliament* v *Council of the European Communities* [1991] ECR 1-04529 (Re: Radioactive Food), known as '*Chernobyl*'.

[18] Specifically with regard to the governance of genetically modified organisms (GMOs), see Everson and Vos (2008).

Table 6.1: The effect of comitology opinions on the Commissions ability to adopt legislation

	Favourable opinion	No opinion	Negative opinion
Advisory procedure	Adopts	Can Adopt	Can Adopt
Management procedure	Adopts	Can Adopt	Referral to Council
Regulatory procedure	Adopts	Referral to Council	Referral to Council
Regulatory procedure with scrutiny	Adopts (but can still be opposed by the European Parliament)	Referral to Council and European Parliament	Referral to Council and European Parliament
Safeguard procedure[19]	N/A	N/A	N/A

Thus, in particular, the 'regulatory procedure with scrutiny' is designed to preserve the competences of the European Parliament in areas where Commission activity appears to impinge too greatly upon democratic processes at EU level, at least in the eyes of Parliament. Nonetheless, as continued parliamentary doubts about comitology indicate, procedural inventiveness is not sufficient to overcome legitimacy concerns. In short, comitology may very well be a necessary instrument of EU governance because it supplies the Commission with the necessary technical expertise for management of the internal market and likewise furnishes co-operative structures in an area of joint EU/member state competence. However, it still stands in a tense relationship with the deep-seated constitutional prerogatives of popular sovereignty.

In this latter respect then, the issue of an alternative form of normative legitimation for comitology becomes a pressing one. Certainly, 'governance', often dominated by soft law mechanisms such as 'naming and shaming', might, in its analytical character be argued to contain a normativity all of its own: governance arises as a form of management in circumstances that require problem-solving, yet defy intervention on the part of traditional governmental structures (De Búrca and Scott 2006: 4-10). Most visible within the supranational or international setting, structures or vehicles of

[19] Where the safeguard procedure is used, the Commission does not have to convene a committee. However, its proposal will not become law unless the Council agrees to it within a specified time limit.

governance act to ensure that problems may be solved and, more particularly, that 'patterns of co-operation' may also be established between 'sovereign' instances of decision-making which would otherwise stand in an inimical relationship to one another. Alternatively, given that vehicles of governance furnish solutions and provide for co-operation beyond any traditional conceptual limitation or ascription of competence and sovereignty, they surely derive a positive – that is, normative – legitimacy in that they ensure that a necessary 'job is done'.

Nonetheless, the normativity of functionality is likewise just as surely circumscribed: what price a job done, if it is not done well; what is the value of national/supranational co-operation if such co-operation produces arbitrary results with little or no cross-referencing – *Rückkopplung* – to the original normativity of the Enlightenment constitution, to the sovereignty of the people embodied in representative institutions? To this exact degree then, the dual affirmation by the CJEU of the normative significance of processes of national/supranational co-operation and of appropriate problem-solving,[20] is just as surely underpinned by legitimating considerations of a far deeper nature.

Thus, on the one hand, although the CJEU's 1994 *WTO* Judgment confirmed that where competences "fall partly into the competence of the Community and in part within that of the member states it is essential to ensure close co-operation between the member states and the Community institutions";[21] on the other hand, such co-operation must surely be of a quality that exceeds simple 'bargaining' between the member states and the Commission. By the same token, the Court's acceptance in the case of *Chernobyl* of the principle that parliamentary co-decision competences may temporarily be sidestepped by an executive (in this case, the Council) in the interests of expeditious decision-making and problem solving,[22] must equally reside in a confidence that decision-making and problem solving occurring in this emergency mode is not simply 'arbitrary', but is

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[20] See Opinion of the CJEU on the World Trade Organization (WTO), Opinion 1/94 [1994] ECR I–526 and Case C-70/88 *European Parliament* v *Council of the European Communities* [1991] ECR 1-045297.
[21] Opinion 1/94 [1994] ECR I–526.
[22] Case C-70/88 *European Parliament* v *Council of the European Communities* [1991] ECR 1-045297.

rather the 'best possible' problem-solving available under the circumstances.

As a consequence, the most potent of theories seeking to identify a deeper normative legitimacy for governance, and more particularly, for comitology as a vehicle of governance (Joerges 2002), does not overly dwell on the most immediately apparent of legal justifications for the presence of comitology within the internal market setting: that is, the notion that the re-integration of national representatives within the supranational regulatory process does not, in fact, undermine the institutional balance, but instead reinforces it, as the regulatory gap between Articles 34 and 36 TFEU is closed with due respect for the need for the member states to be properly represented within supranational decision-making which impinges upon national competences. Certainly, such a reading of the compatibility of comitology with the institutional balance of powers has much to recommend it, in particular as it might thus also – in a real world of practical decision-making – be seen as a compromise "between the need for more effective Community decision-making and the member states' desire to preserve national influence over Commission decisions" (Pedler and Bradley 2006: 240-41). Nonetheless, this supranational/national act of co-operation, giving rise to a fusion of administrative and political systems, where committees work in partnership to jointly manage 'situations of increasing independence', might equally be argued to be an affront to the separation of powers – confusing administrative and political functions – and thus to the rule of law should such co-operation not be disciplined by an overarching norm of polity-building that is not only as powerful as the 'we the people' of Enlightenment thought, but which also actively aims to give effect to the claim to universality of the traditional constitutional settlement. Accordingly, in this theory, comitology gains its normativity, or its constitutionality, to the exact degree that it represents an act of enforced and disciplined co-operation between (national) political and (supranational) executive bodies that aims to 'correct' the in-built exclusionary tendencies of the national constitution. Alternatively, comitology is an answer to the paradox of a 'universal' settlement that limits itself within territorial boundaries, disregarding the interests, of those people who find themselves outside the sovereign polity. Comitology thus achieves constitutionality to the exact degree that it forces sovereign polities to recognise that their representative democratic processes also have impacts far beyond their own territorial boundaries, and to ameliorate them accordingly with reference to a wider community of 'supranational interest'.[23]

In other words, consensus-building – or co-operation – within committees acquires its particular normative/constitutional character to the extent that interaction between a supranational administration, national political representatives, independent technical experts and social interests, not only provides formal cross-referencing to representative democratic process at national level, but also proceeds in line with a disciplining supranational 'conflicts norm'; or, a '*deliberative*' demand that the balancing of technical, executive and political interests – at the same time the balancing of national and supranational interests – occurs in an open and transparent manner, unmarred by the pursuit of hidden national self-interest and disciplined by commonly regarded and legally-recognised goals, such as market integration, rational decision-making, the maintenance of a 'high level' of protection for European consumers and continuing respect for the national peculiarities of regulation.[24]

In distinct rebuttal of common modes of intergovernmentalism, a normative form of governance thus proceeds apace in line with the legally assured dominance of 'arguing' over 'bargaining'. Consensus is not of itself an independent value, but only becomes such where the rule of law is removed from a realm of formal legal application – such as the mantra of the transmission belt model of administration – and is reborn in *proceduralised* form; where application of legal *principles* of transparency and rationality joins with pursuit of legally-assured goals of market integration, consumer protection and respect for national political process, in order to ensure that consensus is built around 'good' decision-making. Fact and norm are entwined and the essential characters, both of the rule of law and of an analytical category of governance are altered in order to ensure that it is possible to meet the functional demand for problem-solving and decision-making outside the traditional abstract demands of the Enlightenment constitution, but, at the same time, to reinforce the substance of the primary historical value (universalism) that has informed that constitution.

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[23] Denoted deliberative supranationalism (I) within the theory. See Joerges (2002).
[24] Denoted deliberative supranationalism (II).

Certainly, lying between functionality, representation and deliberation, comitology is inevitably vulnerable to empirical tensions between intergovernmentalism and supranationalism, between bargaining and arguing and between necessity and norm. Thus the countless studies – including those of the Commission[25] - which demonstrate a high level of consensus in comitology proceedings may always be countered by other studies highlighting a lack of deliberation in committee proceedings, especially in politically sensitive areas, such as the budget (Pedler and Bradley 2006: 241). Equally, and vitally so, the complexities of modern regulation, especially in the fields of emerging technologies (GMOs) will likewise always raise a spectre of the negating 'scientification' of deliberation, as supranational and national interests cede to expert advice which can no longer be understood, let alone challenged (Everson and Joerges 2007). Nonetheless and beyond these very important limitations, comitology – properly constructed and overseen by a proceduralised rule of law – can perhaps act to overcome the continuing tension between the need for effective decision-making within the EU and the demand for appropriate legitimation, and can further contribute to an amelioration of the antagonism between analytical categories of governance and the formal construction of the rule of law.

The challenge of ECB/ESCB governance within the treaties

There can be little or no doubt that the ECB, together with its partner ESCB, is not merely an immediate focus for the emergence of governance structures beyond the named institutions of the Treaty. Instead, taken together, the ECB and ESCB are just as surely a striking manifestation of the appearance of governance structures *within* the Treaty. In other words, it may be argued that, in addition to the high level of expertise that the operation of the eurosystem demands – a degree and level of expertise that defies the very limited resources of the ECB itself (Zilioli and Selmayr 2006) – governance beyond traditional modes of governmental operation is a simple

[25] Thus, for example, the 2008 Annual Report of the Commission on Comitology reports that of 2 185 opinions delivered in 2008, only one was negative. Similarly, in only 35 cases did committees fail to issue an opinion. See also Joerges and Neyer (1997), reporting on consensus-building and respect for rationality in foodstuffs committees.

given within the current provisions of the Treaty and the ECB Statute. Most strikingly in this regard, primary Community law assigns the pursuit and management of EU monetary policy, not to a single identifiable supranational institution, but rather to a 'system' of banks, comprising national central banks (NCBs) and the ECB (Article 127(2) TFEU and Article 3(1) Statute). Certainly, the Governing Council and the Executive Board of the ECB are recognised as 'decision-making bodies' and apportioned the 'responsibility' for 'performance of the tasks of the ESCB'; yet, this centralising supranational impulse within Community law immediately contrasts with the stark fact that the Governing Council of the ECB is made up of the governors of NCBs who maintain their own institutional personality (Article 14(1) Statute), are shareholders of the ECB, are the primary conduit for implementation of the monetary functions and operations of the ESCB (Articles 17-33 Statute) and retain competence to perform tasks outside the ESCB; or at the least, do so to the degree that such functions do not 'interfere with the objectives and tasks of the ESCB' (Article 14(4) Statute).

In an explicitly radical departure from the 'community method', the Treaty dictates that a 'system', made up of executive banking bodies at national and supranational level performs all of the tasks associated with the aim of pursuit of a Community monetary policy, from legislative initiative through to regulatory decision-making and technical implementation of policy; and further performs these tasks within a highly uncertain and fluid complex of national and supranational competences. To be sure, such an uncertain complex of competence also owes much to the fraught history of the establishment of monetary union and the eurosystem, and to a commonly exercised mode of European integration that continues to overcome fundamental political disagreement on the future nature of the Union itself by means of legal arrangements which appear, implicitly at least, to encourage 'stealthy' processes of institutional spill over.[26] However, this often seen functional imperative for ever closer national/supranational co-operation, as well as for pooling of technical/executive expertise, appears nonetheless to be much heightened in the particular case of monetary union and given

[26] In terms of an 'inevitability' of closer co-operation, and the dangers attached, see Majone (2005).

explicit, rather than implicit, recognition within the institutional provisions of the TFEU and ECB/ESCB Statute.

In other words, it may be argued that, in contrast to the stated aims of a community method founded in supranational legislative initiative (by the Commission), national/supranational policy-making (by the Council) and national implementation, the institutional architecture of monetary union itself entails an integral treaty commitment to an open-ended or evolutionary process of ever closer national /supranational policy-making and administrative co-operation, and thus to a form of European integration, which can no longer be conceived of with reference to a clear apportionment of competences between sovereign polities, and can instead only be captured within analytical categories of governance. At this one level of treaty structure, it may then likewise be asserted that an analytical category of governance inevitably wins in normative character within monetary policy as an imperative for its existence may be inferred directly, rather than indirectly, from the Treaty. However – and taking important note of the logical inconsistency or constitutional irony that arises when a political failure to establish a clear normative scheme of government becomes an argument in favour of ascription of normative value to an analytical category of governance – such a conclusion must also be immediately re-examined. More particularly, it must be carefully re-examined within the context of the Treaty's further framing of the architecture of monetary union within a dual and interconnected commitment to pursuit of price stability, or a *credible* monetary policy, in institutional isolation – or full *independence* – from political process.

The ECB as an incongruous 'fourth branch of government', or a credibility of independence

To recap: the vital lesson taught to us by comitology theorists is one that norm cannot be derived from fact, that a constitutional legitimacy for comitology cannot simply be established out of a functional need for co-operation and technical expertise. Instead, an analytical category of governance can only attain constitutional legitimacy where the rule of law, reborn in proceduralised form, establishes cross-referencing or *Rückkopplung* to the Enlightenment polity; where, within a supranational context of a universalised commitment to 'good' decision-making beyond the nation state, arguing replaces bargaining in a legally-disciplined supranational context of transparency, rationality and pursuit of commonly established goals. And yet, it is precisely this normative lesson which is seemingly most challenged by the peculiarities of the constitutional framing of EU monetary policy.

Mirroring the international political consensus established during the 1980s, the Treaty of European Union and its associated Growth and Stability Pact established an economic regime of fiscal discipline at national level to be partnered by a supranational monetary policy dedicated to the maintenance of price stability, and ultimately to the establishment and maintenance of a credible common European currency. Now concretised within Article 127(1) TFEU, the positive legal commitment to price stability still reflects the post-inflationary consensus that economic growth and stability is best served by removal of control of monetary policy from the short-sighted and inexpert realm of political gain and advantage, and its subsequent lodging within a realm of technical expertise and competence committed by a constitutional mandate to the long term goals of growth and stability (Majone 1996). The underlying challenge to the Enlightenment polity was and is clear and was founded, in Europe at least, within the happy coincidence between a pragmatic desire to correct the clear failures of the welfare and social state to furnish sustained economic growth and the renewed popularity of sections of a post-war economic philosophy, which argue that societal freedom is not only to be secured within the collective political community but must rather also be sought within an economic and monetary realm constituted, regulated and protected by positive law.[27] With further political machinations overshadowed by the various prices to be paid for German re-unification (Snyder 2006), economic and monetary union within the EU was thus also given a further 'ordo-liberal' flavour by means of the establishment of the ECB, whose independence was clearly guaranteed by the Treaty, and a further establishment or strengthening of the independence of the NCBs making up the ESCB from their own national authorities (now enshrined in Article 130 TFEU).

From political direction of economic affairs to independent management of a legally constituted market: the establishment of an independent ESCB/ECB in large part mirrors the general efficiency-

[27] Alternatively: the renewed interest in Hayek.

oriented management trend within modern government, whereby large sections of economic activity are now overseen by independent regulatory authorities. And yet, the de-politicisation of monetary policy, the apparent denial of the sovereign power of the Enlightenment polity – or at least the political power of its representtatives – can in this case be identified as posing a far more heightened challenge to traditional notions of government and the rule of law; or at least can be so to the exact degree that the leading theorists of independent economic management, or of the 'autonomous economy' are also distinguished by their refusal to engage with the 'system of money', or the institutional structures of independent central banks. At one level, as Niklas Luhmann (1988) concedes, this is a simple result of the 'complex' nature of money, a nature which defies rational analysis. At another level, however, Giandomenico Majone (2005) reveals to us the residual reliance of insti_tutional economic theory on traditional notions of government and transmission belt models of administration when he concedes that central banks – although a prime example and result of the logic which seeks to rid economic management of the disruptive risk of political short-sightedness – must nonetheless be starkly contrasted with independent regulatory authorities. In other words, they may not be inserted into his scheme of an 'independent fourth branch of government' since they are implicated in decision-making, which is not simply *Pareto* efficient, but is, instead, explicitly 'redistributive' in nature.

With this concession, the primary mantra of institutional legitimation for independent regulatory authorities – the notion that an agency is legitimate "when nobody controls the agency, yet the agency is under control" (Moe 1985) – is unmasked not as a legitimating tool of governance but rather as a cross-reference to the vital normative underpinnings of government. Independent technical or economic management is permissible *only* where a polity can commit itself on a long-term basis to regulatory action which will necessarily bring *equal* benefit for all. In this regard then, the dual institutional scheme of 'independence' and 'accountability' which seeks to legitimise regulatory agencies is predicated upon the effort to ensure that the narrow mandate afforded to such institutions by the polity is not alienated either by political actors or as a result of the poor technical decision-making of the experts gathered within an agency. Regulatory agencies are creatures of rather than an exception to the *ultra vires* rule: legal guarantees of independence shield the agency and its mandate from political interference; at the same time, accountability securing mechanisms, such as budgetary control by parliamentary bodies, the appointment of agency chiefs by the executive arm of government, judicial review and a very high level of transparency during agency operations, ensure constant review of the technical adherence of expertise to its mandate by political actors, expert epistemic communities and a wider public (Everson 1995).

By stark contrast, and despite the dedication of the ESCB to the principle of an 'efficient allocation of resources' (Article 126(1) TFEU) controversy must still rage over the *Pareto* efficient status of monetary policy. For all that it is embedded within a regime of fiscal discipline, monetary policy can and does have redistributive consequences, at the very least as a lack of European labour mobility continues to perpetuate economic imbalances between the core and periphery of monetary union. Equally, the inevitable object of attention from aggressive global finance markets, monetary policy can never be conducted within a regime dedicated to comprehensive transparency. The ESCB and ECB are thus far more to be regarded as bodies placed outside a constraining *ultra vires* rule, bodies with a substantive decision-making competence lying far beyond the narrow mandates of political process, whose institutional independence serves polity restraining goals of a far more fundamental nature. The link to governance, to the establishment of 'ruling' beyond government, is at once apparent as the framing of the ECB/ESCB defies and supersedes even the radical reframing of the transmission belt model of legitimation to be found within theories of the fourth branch of government. Such tensions, however, are similarly given concrete expression in the very visible and potent institutional tensions which characterise the system's current operations within the EU.

Given the structural similarities between the ECB/ESB and autonomous regulatory authorities, it is no surprise that the Treaty on European Union, and now the Lisbon Treaty deploy a legal framework of independence and accountability reminiscent of schemes applying generally to the fourth branch of government. As a consequence, the strong statement of ECB independence found in Article 130 TFEU is similarly balanced by provisions within the Treaty and ECB/ESCB Statute which lay down the concrete mandate of the ESCB (Article 127(1) TFEU), the role of the member states, Commission and Parliament in the appointment of the President and Vice-President of the ECB (Article 50 Statute), the possibility for judicial review of the operations of the ECB (Article 35 Statute), and likewise establish a reporting requirement from the ECB to the Council, Parliament, Commission and European Council (Article 284(3) TFEU). Nonetheless peculiarities and tensions remain that appear to confirm the *sui generis* nature of the ECB/ESCB system.

Such hidden tensions may initially be noted in the relationship between the ECB and the European Parliament. Accordingly, although individual commentators have noted that over the years of the operation of EU monetary policy a co-operative relationship has been established between Bank and Parliament, the Parliament has not effectively asserted its role of expert review of the ECB's pursuit of price stability and has instead tended to treat the Bank as a political actor with a potential influence upon the general economic policies of the EU (Amtenbrink and van Duin 2009). Alternatively, although 'co-operative' relations have clearly been established between Parliament and Bank, whereby the lack of any positive legal obligations notwithstanding, the President takes part in debates on the annual report and the ECB appears before parliamentary committees, expert monetary reports commissioned by the Parliament seem not to have had a quantifiable impact upon the ECB's pursuit of price stability. Meanwhile, in relation to general economic policy, or growth and employment in the euro area, it is also noted that the

> falling number of inquiries in this regard either suggests that over time the ECB has worn out MEPs in their efforts to have the ECB place more emphasis on its *secondary* objective, or that MEPs increasingly trust the ECB to make the right assessments and to take the right decisions.
>
> (Amtenbrink and van Duin 2009: 567–568, emphasis added)

The tension here is accordingly twofold. Firstly, and perhaps inevitably so given the fact that Parliament has no powers of sanction over the ECB – or, more particularly has no power of veto over the budget of the Bank or the ESCB, which is, instead subject only to 'independent external audit' (Article 27(1) Statute)[28]– the power of the Parliament to subject the bank's pursuit of price stability to forensic scrutiny is necessarily limited. With this, a primary technical plank within schemes of accountability – the holding of an independent body to its mandate by means of budgetary veto – is accordingly weakened. At the same time, however, the weakened position of the European Parliament in terms of technical oversight is likewise matched by parliamentary confusion over the role of the ECB within the general economic policy of the EU. Certainly, Article 127(1) TFEU also commits the ESCB to "support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty of European Union". In doing so, it appears also to commit the ECB to pursuit of Community policies such as employment and growth. Yet, such support is to be exercised "without prejudice to the objective of price stability". Meanwhile, the Treaty in any case offers few concrete institutional or normative indicators on how the ECB might offer such support. Alternatively, such support can only ever be considered a 'secondary' task of the ESCB; a task at best perhaps only ever to be viewed as a restraining element within discussions on anti-inflationary measures. By the same token, the Parliament's distracting concern with this secondary task is surely only to be categorised as a part of continuing and evolutionary efforts to establish effective elements of co-ordination, if not of direct economic influence, between pursuit of EU economic and EU monetary policy. In short: an evolving instrument of governance 'light'.

Commentators on the relationship between the ECB and the European Parliament have cautioned that their results cannot be regarded as conclusive and should not be overstated, being largely based on quantitative rather than qualitative review of the Bank-Parliament dialogue. Nonetheless, they are also confident enough to assert that the lack of effective monetary review plus parliamentary obsessions with secondary ECB tasks do not 'necessarily point towards an effective scrutiny by the EP of the ECB activities' (Amtenbrink and van Duin 2009: 568). At the same time, however,

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[28] Vitally, the system is self-financing. See, Advocate General Jacobs and his confirmation that the ECB posses a special status by virtue of this fact, Case C-11/00, *Commission of the European Communities* v *European Central Bank,* [2003] E.C.R. I -7147. Advocate General Jacobs on 3 October 2002.

the continuing lack of clarity on the ECB's role within general EU economic policy-making has also led to further tensions within the institutional framework of the EU as doubts have been raised as to the exact extent to which Community law applies to the operations of the ECB. "There is only one criterion on which the ECB [...] will be and should be judged, and that is whether it delivers what it is instituted for, namely price stability [...] That is the only judgment on which the ECB should be judged" (monetary dialogue of 9 November 1999, cited in Amtenbrink and van Duin 2009). Expressed within the context of Parliament's continuing efforts to interrogate the Bank on growth and employment, the ECB's implicit assertion that its independence from political process is legitimised since it serves and must *only* serve to ensure price stability, thus finds further expression within the *OLAF* Judgment of the CJEU and the efforts of the Bank to establish its own heightened independence within the institutional scheme of the European Treaty.[29]

The controversy highlighted within *OLAF*, decided prior to the recognition of the ECB as an institution of the EU, stems from the wording of Article 130 TFEU (ex 108 EC):

> When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank [...] shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body [...].

In establishing its own anti-fraud measures and thus failing to recognise Regulation 1073/1999 endowing the Community anti-fraud body, OLAF, with wide-ranging investigative powers, the ECB asserted a very wide measure of autonomy for itself in relation to the application of Community law. Challenged before the CJEU by the Commission, the Bank sought to justify this position, arguing that whilst "it does not exist in a legal world totally distinct from that of Community law", it was nonetheless to be regarded as distinct from the institutions of the EU. In support of this argument, the ECB pointed – amongst other things – to the failure of the Treaty to recognise the ECB as an institution of the EU, the ECB's legal perso-

[29] Case C-11/00, *Commission of the European Communities* v. *European Central Bank.*

nality, the measure of independence afforded to the institution by the then Article 108 EC, the ECB's independent competence to make regulations and take decisions, and, interestingly, the failure of the Treaty to subject ECB accounts to review by the Court of Auditors.[30]

With this non-exhaustive list of justifications, the ECB was seemingly arguing in favour of a wide interpretation of Article 108 EC (now 130 TFEU) and asserting a unique degree of autonomy for itself within the EU. Commentators have reacted with a degree of disdain towards the arguments of the Bank (Lavranos 2004: 118), citing isolated elements within articles written by employees of the institution that seem to suggest that the Bank was seeking to place itself fully beyond the reach of Community law. And certainly, statements arguing that the ECB constitutes a 'Community of its own', a 'Community within the Community' (Zilioli and Selmayr 1999: 284) do appear to suggest reluctance on the part of the ECB to accept conventional application of the Community's legal regime to it. Nonetheless, such critique and, indeed, the degree of *Schadenfreude* expressed at the CJEU's rejection of the Bank's case and its limitation of the institution's autonomy to a 'functional independence' in order to ensure price stability (Lavranos 2004: 118), perhaps fails fully to appreciate the normative conundrum facing the Bank, or indeed the wide range of independence in fact endowed upon the Bank by the Court.

> [T]he Treaty and the Statute confer upon the ECB a high level of independence [...] However, the principle of independence does not imply a total isolation from, or a complete absence of co-operation with, the institutions and bodies of the Community. The Treaty prohibits only influence which is liable to undermine the ability of the ECB to carry out its tasks effectively with a view to price stability, and which must therefore be regarded as undue.[31]

Advocate General Jacobs gives an accurate account of the CJEU's recognition of the 'limited functional independence' of the Bank. As such, the Court does speak directly to the primary concerns of the CJEU. Recalling the Parliament's efforts to assess the operation of the Bank predominantly on the basis of its 'secondary' contributions to

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[30] See, for comprehensive review of the arguments presented, Lavranos (2004).
[31] Case C-11/00 OLAF, Advocate General Jacobs, paragraph 60.

general EU economic policies, statements from Bank supporters asserting that the "independence in Article 108 EC does not provide for any exceptions or restraints" (Zilioli and Selmayr 2000: 591) are more readily understood. From the viewpoint of the Bank, where the *only* clear and unequivocal mandate afforded the ECB by the Treaty is pursuit of price stability, its enduring credibility as an institution of monetary management is surely *only* to be assured, if it may pursue this goal in full independence from the influence of *all* other institutions of the Union, including such influence that may be expressed within Community law. Certainly, degrees of co-ordination between monetary and economic policy may be necessary – think only of the potentially inflationary process of bond buying engaged in by the ECB during the sovereign debt crisis. Yet, such co-ordination must surely be a matter for the ECB alone: "the decision-making process inside the ECB is not even subject to a politician's suspensory right of veto" (Lavranos 2004: 118).

Between fact and positive law, the Bank is a potential victim of indeterminate political compromise, of the vagueness in the drafting of Article 127(1) TFEU, of the failure of the EU to establish clear institutional modes of co-ordination between economic and monetary policies, of increasing political pressures for co-ordination and its own credibility-securing demand for clarity within EU primary law. To this exact degree then, the ECB must retain credibility by forcefully asserting its unequivocal Treaty-based independence to pursue price stability. Equally, this strategic/factual quest for credibility is one that is supported by an CJEU, who, by virtue of their formula of 'limited functional independence' also create room for case by case analysis of the legality or otherwise of application of Community law to the ESCB and ECB.[32]

Between fact and norm, this preliminary conclusion nonetheless also leaves vital questions open. In the aftermath of *OLAF*, Bank supporters were keen to reiterate that "[t]o view the ECB as an independent specialised organisation of Community law therefore expresses it subordination not to the political process, but to the *rule*

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[32] Zilioli and Selmayr (2006), detailing the careful empirical analysis the OLAF regulation is subjected to by the CJEU. The Court is serious in its stated intentions to ensure that application of Community laws will not impact upon the ability of the Bank independently to pursue monetary policy.

of Community law" (Zilioli and Selmayr 2006: 63-4). At the one level, such a statement might be read as a strategic effort to assert the Treaty-based independence of the Bank with regard to pursuit of price stability. At another, however, the statement can also be read as a plea: placed outside the modern reformulation of transmission belt administration, challenged by the equivocal nature of an evolving economic and monetary policy, the ECB and ESCB are creatures of governance seeking to evolve their own normative framework in order to overcome the inconsistencies and impossibilities posed by the process of European integration. Which form of rule of law can then aid them in this process?

A credibility of expertise

Throughout the global system, a primary justification for the establishment of independent central banks has been the recognition that the complexities of monetary management are such that politicians and the political system can no longer master the vast body of technical detail required to establish a credible monetary policy. As a consequence, and once again highlighting the complex interplay between norm and fact within schemes of modern governance, it can thus be argued that establishment of an independent central bank and system of central banks is also commensurate with a normative commitment of the EU to the establishment of a high level of expertise in order to ensure the credibility of EU monetary policy in general and the operation of the eurosystem in particular. Fact appears to dictate norm: the TEU committed the EU to price stability; the unstated yet vital element within this construction is the integral commitment of the system to the establishment of a high level of expertise which might ensure credible pursuit of this aim.

By the same token, however, this underlying factual-normative commitment to the maintenance of a high level of expertise both increases the need for and creates its own tensions within the evolving scheme of governance that focuses upon the ECB and ESCB. On the one hand, the minimal technical resources of the ECB create a pressure for 'decentralisation' within the system, with the ECB being heavily reliant upon the expert resources of the NCBs in order to ensure that the ESCB might fulfil its tasks (de L'Honeux 2009). At the same time, this reliance on national expertise raises doubts at both a practical and political level. Does such national expertise act as a

'Trojan horse' for the member states (Zilioli and Selmayr 2006: 63-4): does it detract from the ability of the system to furnish one coherent system of establishment of undisputed technical expertise; does it furnish national interest with a conduit of influence over supranational decision-making?

On the other hand, however, the dedication of the ECB and ESCB to the establishment of a high level of expertise also raises far wider issues of governance within the context of the general co-ordination of EU economic and monetary policy. As both the private credit crisis and sovereign debt crisis have amply demonstrated, the monetary system within which the ECB and ESCB operate is subject to systemic shock and governed by systemic *risk*. Complex risk, as both a vast risk literature and even Community policy teaches us (Everson and Vos 2008), entails elements both of technical assessment and of *political* management; particularly with regard to the question of which level of risk are we prepared to tolerate. To what degree then, must the ECB/ESCB be receptive to societal impulses or 'messages' from a political realm, which reflect concerns far beyond the structure of price stability?

Eurosystem governance within the rule of law

This final point perhaps provides the key to the conundrum: in contrast to schemes of European governance commonly associated with the Commission's exercise of national/supranational competences (comitology), governance within the ECB/ESCB – and more pressingly, within the eurosystem – exists not within the multiple tensions of intergovernmentalism versus supranationalism, arguing versus bargaining, and good versus technical decision-making, but rather within a more streamlined, but arguably far more immanent tension between the constitutional aspiration for expert conduct of autonomous monetary policy and continuing, if more diffusely stated, concerns that the actions of the ECB/ESCB should be 'controllable', both in terms of application to it of the regime of community law, and with regard to 'political influence' in the matter of the co-ordination of the economic and monetary policy of the Union. At the time of writing, banking and sovereign debt crises have hogged the headlines and have determined that the question of the 'political' place of the ECB/ESCB within the governance of the European Union has morphed from a topic of purely academic concern into an issue of popular consternation. Nonetheless, this belated public spotlight on Bank activities should not detract from the simple fact that the ECB/ESCB has been navigating this tension for over a decade and has similarly done so within the further complicating context of a fluid division of competences between the NCBs and the ECB.

As a result, the vital question is not one of the identification of a mode of governance, which might aid the eurosystem to overcome the current crisis. Rather, the core issue is one of the pinpointing of a suitable manner of legitimating the day-to-day governance structures of the ECB/ESCB, and eurosystem, *as well as* the Bank's capacity to manage a crisis; and, more particularly, doing so within a proceduralised rule of law, which establishes, if not a mode of reference to, at least a degree of congruence with the Enlightenment polity – i.e. to its universal and 'rationalist' aspirations. The initial answer to this question, however, may appear disturbing, both in fact and in law.

The primacy of ECB accountability for the eurosystem

As noted, the treaty structure established to govern monetary union remains indistinct in two particular regards:

a) Article 127(1) TFEU, although committing the ECB/ESCB to price stability, appears also to suggest that the Central Bank should play a supporting role within general Union economic policy;

b) Equally, however, the supranational impulse which deems the Governing Council to be the architect of monetary policy is – to a degree at least – open to question, as NCBs are not apportioned distinct subordinate competences, but instead play an integral part within and beyond the eurosystem.

This leaves the analysis with two particular questions: is the ECB a general or economic actor; and, further, is the ECB/ESCB a decentralised, federal or unitary system? At the normative level, the answers to these questions must initially appear to be unsatisfactory.

a) Notwithstanding Treaty referencing to 'general economic policies', the ECB/ESCB can only be regarded as a specific economic actor, dedicated by means of its heightened independence to pursuit of price stability.

b) The ECB/ESCB must be considered a unitary system, dominated by the decision-making of the Governing Council and Executive Board, and dedicated, at decentralised level, simply to the best possible integration of necessary national expertise within such decision-making.

Thus, not only is the bank placed beyond the modern reformulation of the transmission-belt model by virtue of heightened independence, it is also seemingly wholly alienated from the Enlightenment polity with regard to the purely technocratic definition of its mandate. Equally, the relegation of nation influence within the system to a status of a 'pure technical input' seemingly severs all possible links with representative process at member state level, and further appears to deny the paradoxical reality of an expert process of decision-making, which, confronted always with issues of systemic risk, must surely always be implicated within redistributive, rather than simply *Pareto* efficient allocation of resources.

However, and making renewed call to the German Constitutional Court's preparedness to evaluate its application of constitutional norms to a complex European reality 'in the light of circumstances', such a stark formulation may nonetheless be argued to be the best currently available to allow us to bridge the gap between facts and norms, to ease the integral tension between governance imperatives *within* the ESCB/ECB and assertion of the rule of law *over* the ECB/ESCB and likewise, and vitally so, in order to ensure the credibility of the young euro currency. At one level, such an assertion derives from the wholly positive lessons of traditional constitutional theory: certainly, independent central banks may lie outside the transmission-belt model of legitimation; yet, in Europe, at least, we may identify one highly successful historical model of an independent bank – the German *Bundesbank* – whose autonomous status was 'constitutionalised' by the German Constitutional Court,[33] the selfsame Court which recognised the transfer of competences to the ECB within an ordo-liberal reading of the Maastricht Treaty.[34] Although the particular conditions for the success of this model will be treated in more detail in a concluding section, it may nonetheless be asserted here that the primary legal commitments of the TFEU

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[33] Rather than by the Constitution itself. See, for details, Everson (1999).

[34] *Brunner* v *European Union Treaty* CMLR [1994] 57.

represents the extension beyond the national constitutional settlement of a polity-restraining goal of depoliticised monetary stability. As such, it similarly makes cross-reference to the goals of the Enlightenment constitution, to a 'universal' or cross-border commitment to a shared goal of fiscal restraint, governed by an equally universal commitment to the transparency of de-politicised technical expertise. To the extent that monetary union is governed by technical criteria, it may be measured and monitored, not only for its effectiveness, but also for its 'civility'; that is for its resilience towards disruptive political influence, at national or at supranational level.

Directly related to this point, however, more defensive considerations may be identified which require us to view the ECB/ESCB system – for the purposes of effective application of the rule of law – as a unitary, independent system for which and within which, the ECB must retain a primary accountability. Alternatively, although the facts of governance may yet require a certain degree of co-ordination between monetary and economic policy, the strictures of the rule of law nonetheless demand that such co-ordination must be visible and transparent. To this exact degree then, the 'Trojan horse' of political influence over and within the Bank must be firmly resisted. On the one hand, the universalism of the common European commitment to price stability would be undermined were the Bank to be subject to institutionalised political pressures at supranational level or within the eurosystem itself (national influences). On the other hand, public transparency over the day-to-day operations of monetary policy is self-defeating in terms of the credibility of the eurosystem. Money and money markets are complex and volatile, such that currency governance must be conducted behind closed doors in order to ensure the *fact* of a credible currency. Accordingly, the primary counterweight to the system's independence – at the same time its constitutionalised guarantor for a universal commitment to the rationality of technical decision-making – must reside in a dual of accountability, not of annual budgetary control, published agendas and immanent expert/public review of daily decision-making, but rather in an internal guarantee of technocratic excellence, and an external guarantee of accountability for the *results* of autonomous monetary decision-making. *Normatively*, only one institution and one institution alone can be held politically and legally accountable for the conduct of monetary policy, for its technical excellence and co-ordination with the general economic policy of the European Union – the highly visible ECB.

The final point is perhaps determinative: fluid competences between national and supranational instances notwithstanding, the ECB remains the one institution which can be held politically and legally to account for the results of the eurosystem. The ECB can never and must never be placed in a position whereby it is held to account for the actions of others. The system must remain a unitary system for the independent pursuit of monetary credibility through technical excellence.

Comitology's sting in the tail: The deliberative place of the ECB within the European Union

In a final analysis, however, there is still much about economic and monetary union within the EU that remains unsatisfactory, if not wholly suspect. At a time of extreme crisis within the eurosystem, European publics might be justified in expressing extreme dissatisfaction with a mode of European integration that has consistently masked lack of political agreement upon the goals of union (federal or supranational?) within structures that invite governance beyond a conventional understanding of the rule of law, but which are – at core – a reflection of the EU's continuing inability fully to integrate political with economic will, to step beyond a piecemeal integration *telos* and properly to integrate the infinite range of European social, cultural, political and economic interests within a coherent and co-ordinated constitutional structure. Traditional voices of normative suspicion have grown in intensity since the failure of the constitutional convention and have been correct to do so.

In the particular case of the eurosystem, European publics are similarly correct to vent their varying frustrations with a process of stealthy spill-over, which at a moment of extreme crisis has seen various national interests in fiscal sobriety, in democratically, rather than market driven deficit reduction and in statistical exactitude undone by a political lack of leadership and honesty, both at the time of the coming into force of the Maastricht Treaty and during subsequent enlargements of the eurosystem area. The political indecision that haunts the entire process of European integration has now been painfully unmasked as the euro – the cornerstone of future

European integration – has been attacked by world money markets unimpressed by the continents' continuing political timidity and normative indecision.

Nonetheless, it should equally be noted, that the ECB/ESCB are victims rather than a party to political failings within Europe. Seen from the perspective of the upholding of the rule of law, the ECB's unwavering historical commitment to its own independence and the pursuit of monetary stability cannot but be applauded as an act of constitutional courage. Equally, however, the Bank's relative success – at the time of writing at least – in maintaining the stability of the euro at a time of crisis, of ensuring the integrity of a system containing various by now competing national interests (individual NCBs have largely spoken with one voice[35]) and of co-ordinating its monetary policies with the economic policies of the Council, European Council and individual member state governments is also highly instructive for the analysis.

In this latter regard then, a final reference must be made to the historical conditions for the success of an ordo-liberal conduct of monetary policy within the Federal Republic of Germany. As the fathers of German constitutionalism and ordo-liberalism taught us, normative commitments to monetary stability drew their enduring force from the dual constitutional commitment to entwined social and economic ordering. Walter Eucken highlighted the interconnection between the German economic constitution and the Republic's *Sozialstaat*.[36] In its transference to the supranational realm, the positive legal commitment to price stability lost its cross-referencing to the social and the political formulation of the social within the Enlightenment polity: the social competence – even post Lisbon remains firmly anchored at national level. Nonetheless, even at this 'culturally denuded' supranational level, it would appear that the constitutional values of co-ordination and social/economic integration are possible, or at least are possible to the degree that the ECB and its President can manage and continue to manage tensions

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[35] One important exception is Axel Weber, president of the German Bundesbank. See 'Axel Weber Attacks ECB Decision to Buy Bonds', Vihar Georgiev, European Union Law blog post, 1 June 2010. Available at: <http://eulaw.wordpress.com/2010/06/01/axel-weber-attacks-ecb-decision-to-buy-bonds/>.

[36] See, for details of the tradition, Wegmann (2002).

between the political, economic and social aspirations of Europeans and their representatives.

In short then, the vital lesson to be learned from Commission comitology – or at least, the most refined of theories legitimating Commission comitology – may be one of the need to ensure and secure 'deliberative supranationalism' within European governance. Certainly, where the talk is of deliberative discussion and co-operation between the ECB and politicised nodes of European governance, the analysis has moved far beyond the sphere of application of the rule of law. Nonetheless, this might still be a realm within which the *values* inherent to a *proceduralised* rule of law have important application. Firstly, since the vital recognition of universalism within deliberative supranationalism would require national governments and the ECB to ameliorate the impacts of their sovereign decision-making upon other sovereign instances (i.e. upon individual member states, as well as on the pursuit of a supranational monetary policy). But secondly, since co-operation between autonomous instances of monetary decision-making and representative instances of political decision-making might thus also be elevated beyond 'bargaining' to a process of 'arguing', governed by values of rationality, transparency and the pursuit of common aims.

Certainly, we cannot hope for wholesale transference to the supranational level of the social ties, cultural mechanisms of review (national press scrutiny) or, indeed, concrete normative structures (dual constitutional ordering), which ensured that the President of a *Bundesbank* would – where appropriate – co-ordinate that Bank's actions with those of the *Bundesregierung*. Nonetheless, where all European and national organs commit themselves publicly to shared European values of deliberation, and such deliberation is constantly scrutinised within the fragmented and common European public realm, might we not hope that governance at European level will continue to give us sufficient cross-referencing to the government of the Enlightenment polity? Perhaps the simple fact that the existence of the ECB is now one known to all Europeans its actions subject to heightened public scrutiny, is a significant step in this direction.

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Chapter 7

The size that fits no-one
European monetarism reconsidered

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Introduction*

The European Union (EU) is full of paradoxes and the European Central Bank (ECB) is one of them. There are many others, deriving from the structural determinants of EU law-making and from the 'architecture' of EU decision-making as well as from an apparent institutional inability to concede or learn from mistakes. The German scholar, Martin Jänicke, in his book *State Failure* (1986) uses the metaphor of the 'tank/*Panzer*' to describe the 'privilege of not having to be intelligent' and of pressing on, regardless of immediate consequences. The metaphor is arguably applicable to the operations of the European Central Bank, to its attendant fiscal policy arm, the Stability and Growth Pact (SGP), and to its predecessor and model, the German Bundesbank:

> A tank driver can be stupid and blind. In contrast to the cyclist, he does not need to adapt to the annoying obstacles of the environment. Problems are 'externalised': It is not the tank driver that is damaged but the environment. In the case of the

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* This is a slightly expanded version of a paper given in León, Spain, in September 2011.

> cyclist, on the other hand, the problems of an adaptive method of driving are completely internalised.
>
> (Jänicke 1986: 158)

The metaphor applies almost entirely to the institution, to the structure, and not to the people/agents that work in it and its associated System of European Central Banks (ECBS).[1] In many respects, the people working in such institutions adapt to their immutability with the intelligence of the cyclist. There is plenty of evidence to indicate that ECB insiders, like their Commission counterparts, don't subscribe to the institutional orthodoxies that bind their policy-making but resign themselves to maintaining the appearance of doctrinal uniformity as a *faute de mieux*. The ECB is probably too young to have generated a myth of infallibility, such as attached to the *Bundesbank* in the eye of (too) many people, but for that it enjoys the dubious privilege of being even more difficult to reform than its model. The Bundesbank Law of 1957 could, theoretically, have been modified by a parliamentary majority; the ECB, as prescribed by the Treaty on European Union of 1992, requires the unanimity of all member states to alter its statutory powers and its statutory responsibilities. It is this effective immutability, together with the lack of effective democratic accountability that provides the framework for the following analysis. How do we cope with a tank which has 27 drivers and neither a clear map nor a reliable compass?

This analysis is not value-free. It proceeds from a set of philosophical, ethical and politico-economic assumptions that inform the interpretation of structures, processes, events and 'facts'. The first is that of the extensive interdependence of contemporary human existence, which renders local, regional, national and international cooperation and solidarity an inescapable requirement of the survival of humanity and its habitat. The second is the observation/conviction that 'more equal societies almost always work better' (Wilkinson and Pickett 2010) and that significant inequalities of wealth, income, power and access to resources are corrosive of human progress. The third is that economic theory is at best a heuristic fiction for simplifying the understanding of partial processes, at worst a dangerous obstacle to the understanding of interdependent systems

[1] The participants at the conference in León confirmed this view of the necessary separation of institutions from those that work within them

of human organisation. The fourth is that political economy as an interdisciplinary discipline provides a more adequate basis for the diagnosis of socio-economic problems and for halfway appropriate prescriptive solutions.

Multiple asymmetries

The Bundesbank – the unquestioned parent of the European Central Bank – was the dominant actor in a German post-war political economy that was characterised by a severe separation of powers between the various institutions of macro-economic governance. Its autonomous conduct of monetary policy set it apart from the (democratically answerable) agents of fiscal policy at federal, regional and local level. For almost four decades, its institutional design stood out from all other dependent European central banks (apart from Switzerland's), in particular in the degree to which it predefined the fiscal room for manoeuvre available to subordinate finance ministries and municipal treasuries (cf. Leaman 2001: 114ff.). It eschewed counter-cyclical fiscal and monetary policy as part of its primary task of ensuring 'price stability', invoking the quantity theory of money in its statements on changes in short-term refinancing rates (Discount and Lombard), setting targets for future money-supply growth and frequently defying the preferences of the federal government with interest rate rises in periods of cyclical contraction (ibid., 193ff.). Nevertheless, the relative success of the German political economy in maintaining lower-than-average rates of inflation in the Stagflation decade 1974-1986 was credited in large measure to the Bundesbank (e.g. Balkhausen 1992), rather than to Germany's overall strengths as an innovative industrial and trading economy. This encouraged the popular (but syllogistic) view that operational autonomy was the precondition for a successful monetary policy.

The corollary of Germany's relative success in maintaining a low-inflation economic culture was the emergence of significant asymmetries in both the current account balances of European and OECD (Organisation for Economic Co-operation and Development) economies and correspondingly wide disparities in the central bank rates of Germany's European partners, as they sought to defend exchange rate parities with the German Mark (DM) and finance government borrowing; arguably the European Monetary System (EMS 1979 *et seq.*) reinforced the 'exchange market mayhem' (Eichengreen et al. 1995) by committing the system's central banks to defend parities against speculative attacks, thereby facilitating significant arbitrage gains.[2]

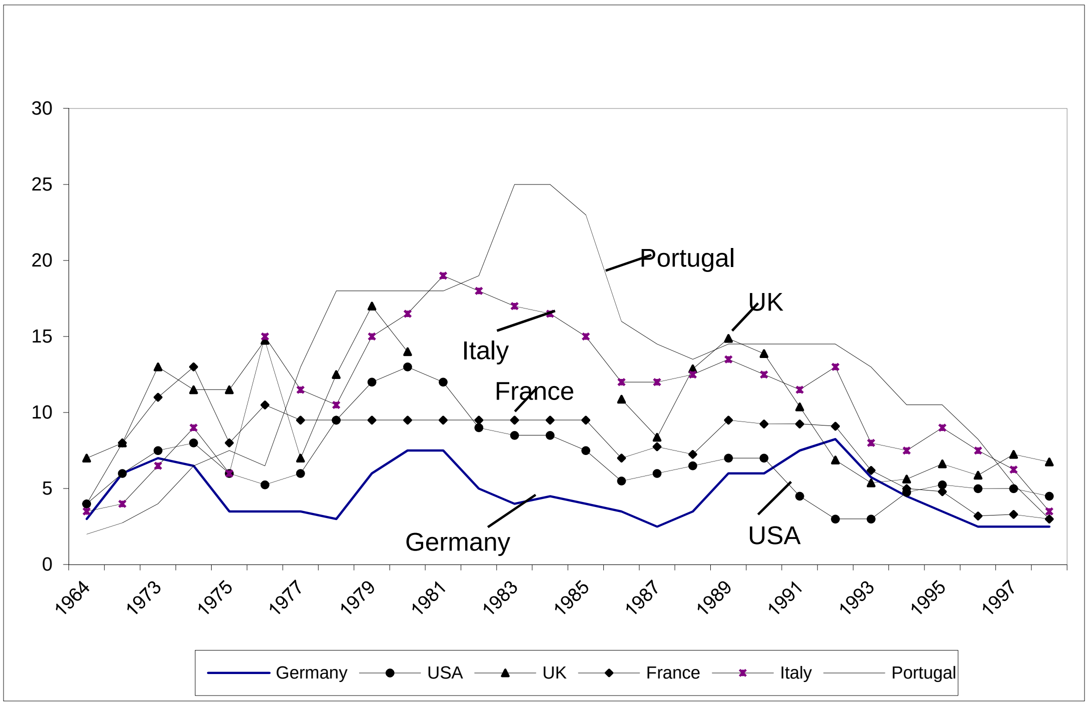

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Figure 7.1: Central bank discount rates 1964–1998 in selected OECD countries.

It was against the background of the chronic imbalances in the economies of the EMS member states *and* the unexpected collapse of the Soviet bloc *and* imminent German unification that the dormant plans for European Monetary Union (EMU) were revivified and accelerated. The need to contain any further strengthening of German economic hegemony – 'Bundesbank hegemony' according to Le Gloannec (2001) – informed the crisis diplomacy of 1990 and 1991. The fact that the primary vehicle of this policy of containment was the cloning of the Bundesbank in a supranational institution has been the subject of considerable debate (Marsh 1992; Kennedy 1991; Dyson and Featherstone 1999; Leaman 2001); the likening of the Maastricht Treaty and Germany's abandonment of the totemic D-Mark to the Versailles Treaty (*Le Figaro,* 18 September 1992) underscores the extreme ambiguity of the birth of the euro.

[2] It was only when the EMS' fluctuation bands were widened from +/- 2.5% to +/- 15% in August 1993 that the feeding frenzy at the expense of EMS member states subsided.

Suffice it to say that the qualification process for EMU, its policy architecture and its operational processes institutionalised the asymmetries embodied in Germany's lop-sided system of economic governance and pre-programmed further imbalances in European economic relations before and after 1999 and in particular in the current period of severe regional and global crises. The most obvious asymmetry is the decision to press ahead with a supranational monetary union and maintain national responsibility for fiscal policy, i.e. not to implement a parallel political union – a deficiency underscored by Bundesbank representatives among others (cf. discussion in Leaman 2001: 221f). Within this new nexus, however, the insistence (by the Bundesbank and the German Finance Ministry) on strict convergence criteria as conditions of membership and an on-going commitment to budgetary consolidation by all member states represented a much tighter replication of Germany's subordination of fiscal policy to monetary policy preferences (Heise 2002); the Stability and Growth Pact (1997) and the more recent the Economic and Financial Affairs Council (ECOFIN) commitments to aggregate balanced budgets over the economic cycle and even more recent German moves to install a 'debt brake' on state bodies,[3] reinforce this subordination, establishing what Abelshauser observed of German economic policy-making – that there was 'no place for Keynesianism' – as a general rule for Eurozone states (Abelshauser 1983: 106ff).

What is notable about the Maastricht Convergence Criteria is that they omit a number of measures that might be considered essential for the establishment of an Optimal Currency Area (cf. Arestis and Sawyer 2011). While the narrowing of disparities in rates of inflation and market interest rates is an important precondition for commercial activity to prosper in an open-market, single currency union, the limitation of fiscal convergence criteria to annual public sector borrowing and overall state debt was always questionable.

- Not only were the ceilings for PSBR (three per cent of GDP) and state debt (60 per cent) arbitrary and inflexible as guides to fiscal (un)sustainability (Eichengreen 1996), but there is a

[3] In 2009, both houses of the German parliament approved the introduction of a 'debt brake' (*Schuldenbremse*), which committed the federal government to respect a public sector borrowing requirement (PSBR) ceiling of 0.35% of GDP from 2016 and the 16 regional governments to incur no budget deficits at all after January 2020.

critical absence of any notion of the state's ability to maintain the provision of public goods and absorb exogenous shocks through a robust and well-resourced tax system. Convergence to a minimum tax ratio and an approximate harmonisation of tax bases, in particular for mobile factors like corporate capital, would have rendered EMU much less vulnerable to cyclical disturbances in its weaker periphery and much more capable of achieving the modernisation objectives of the Lisbon Agenda or Europe 2020 through properly targeted programmes of innovation and productivity enhancement.

- Also absent from the convergence criteria was any consideration of the disparities in current account balances which had grown significantly throughout the OECD since the 1970s and were indicative, in the case of countries with persistent and chronic deficits, of societies that were living beyond their means (producing less than they consume) and secondly of a constant need to rebalance their economies through the capital account. It is no coincidence that economies with low tax ratios (Greece, Ireland, Portugal) had significant current account deficits before 2008 (Table 7.1) and, after increasing problems raising money through sovereign bond auctions, were obliged to apply for assistance through the EFSF. The dependence on imported capital and low tax ratios are also evident across all of the newer member states, with serious implications for their ability to converge with the levels of economic performance of their EU15 partners.
- Rates of employment/unemployment were also not considered significant enough to demand a degree of convergence, even though unemployment is indicative of macro-economic performance weaknesses, for example in unit wage costs, systems of wage-setting, levels of productivity, poorer education and training infrastructure and, not least, domestic demand.
- The neglect of macro-economic demand as a factor in the determination of wealth-creation as well as in the setting of prices and wages – which frequently varies from one national economy to another – is typical of the mind-set of neo-liberal theorists with their emphasis on supply-side conditions. This problem includes, crucially, neglecting the strength of

demand as reflected in the changing distribution ratios of income and wealth. One of the greatest blind-spots of monetary policy, as exercised by both the Bundesbank and the ECB, was the neglect of a redistribution of national income resulting from the deflationary imperative and the deregulation of financial markets. In an early statement on its core operating principles, the ECB asserted confidently that: 'Maintaining price stability *avoids the large and arbitrary redistribution of wealth and incomes* that arises in inflationary as well as deflationary environments, and therefore helps to maintain social cohesion and stability' (ECB 1999: 40, emphasis in original).

Table 7.1: Tax ratios and current account balances in Europe 2008.

Central and East Europ. Countries	Tax Ratio*	Current Account Balance*	Countries of the EU15	Tax Ratio*	Current Account Balance*
Albania	22.9	-11.3	Austria	43.4	3.8
Bosnia-Herz	41.2	-15.8	Belgium	46.8	-2.6
Bulgaria	34.4	-24.4	Denmark	50.0	2.0
Cyprus	36.6	-9.7	Finland	43.6	1.7
Czech Rep	36.3	-3.0	France	46.1	-1.9
Estonia	31.1	-10.8	Germany	40.6	6.6
Hungary	37.3	-8.2	Greece	33.5	-14.4
Latvia	30.4	-15.1	Ireland	34.0	-4.5
Lithuania	20.9	-14.9	Italy	42.6	-3.4
Macedonia	29.3	-14.0	Luxembourg	36.4	5.5
Malta	35.2	-7.7	Netherlands	39.5	7.5
Montenegro	28.0	-39.6	Portugal	37.0	-12.1
Poland	33.8	-5.5	Spain	37.3	-9.5
Romania	28.1	-13.8	Sweden	49.7	8.3
Serbia	34.1	-18.6	UK	39.0	-1.7
Slovakia	29.5	-6.5			
Slovenia	39.3	-4.7			
CEEC Ave	**31.7**	**-13.7**	**EU15 Ave**	**41.3**	**-1.0**
Baltic Ave	**27.5**	**-13.6**			
Visegrad + 1	**35.2**	**-4.5**			
Western Balkans Ave	**30.3**	**-18.1**			

Note * As proportion of GDP. Averages are mathematical not weighted.

Sources OECD, CIA, Eurostat, own calculations.

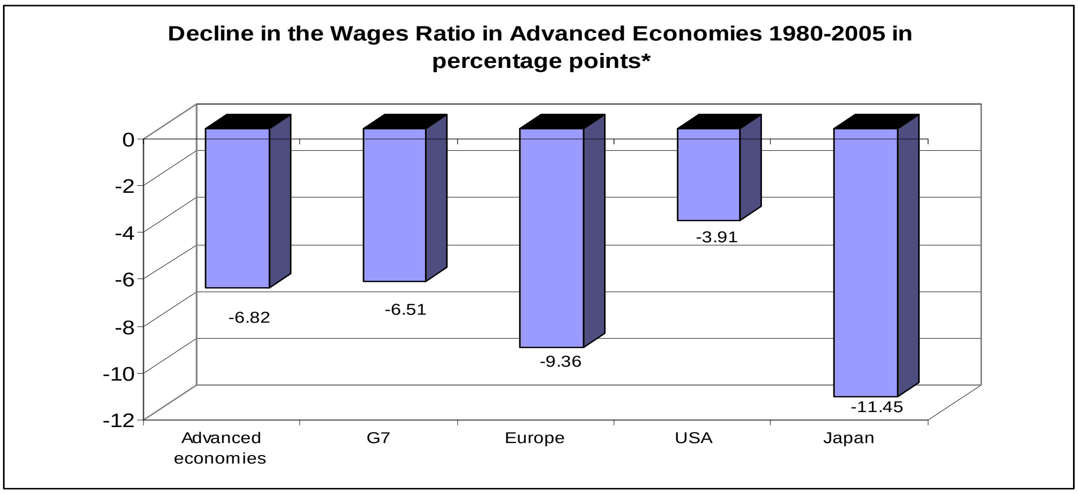

Figure 7.2: The redistribution of income in advanced economies 1980-2005.

Source IMF, *World Economic Outlook* April 2007, data for Figure 5.7.

Figure 7.2 indicates the dismal reality of the colossal redistribution of gross national income (market incomes before taxes and transfers), illustrated by the decline in the share of wages and salaries in the national income of advanced countries in the period of neo-liberal deregulation. Europe's record (a fall of 9.36 percentage points in 25 years) is significantly higher than the average for advanced economies. The fall in the wages ratio corresponds to a similar rise in the profits ratio. There is little doubt that the dominance of the deflationary imperative under the Bundesbank's hegemony of the EMS (Le Gloannec 2001: 123), and subsequently under the fiscal constraints of the Stability and Growth Pact, contributed to this process. Bibow describes the dominant deflationary imperative as 'lived German stability culture with one own goal after another' (Bibow 2011: 279). The redistribution, over which the ECB presided with apparent equanimity, had a critical effect on domestic demand structures in Europe, where typically private household demand makes up almost two thirds of aggregate demand. For those Eurozone economies, like Germany, Austria, the Netherlands and Belgium which are heavily dependent on net exports and which benefit from low stable real exchange rates and low unit labour costs, the German model has brought marginal gains. But, with high levels of intra-regional trade in the EU27 and the Eurozone in particular, the weakening of domestic demand through stagnating real wages ultimately becomes a negative sum game for all. Net disparities, after taxation, social insurance contributions and state transfers are factored in, show a similar trend (OECD 2011; Schäfer 2009).

Given that there had been persistent warnings about the reduced latitude in macro-economic policy for states that no longer had recourse to exchange rate devaluations to increase their trade competitiveness, the fixation on budgetary consolidation as a central fiscal condition of EMU membership indicates a dogmatic insistence on the sufficiency of market forces to rectify any residual national asymmetries in the political economy. This is confirmed in the ECB's first monthly report in January 1999 which asserts that:

> Maintaining price stability in itself [*sic*] contributes to the achievement of output or employment goals. The logic underlying both the Treaty and the Eurosystem's stability oriented monetary policy strategy is therefore that output and employment goals are best served by a monetary policy that focuses on price stability.
>
> (ECB 1999: 40)

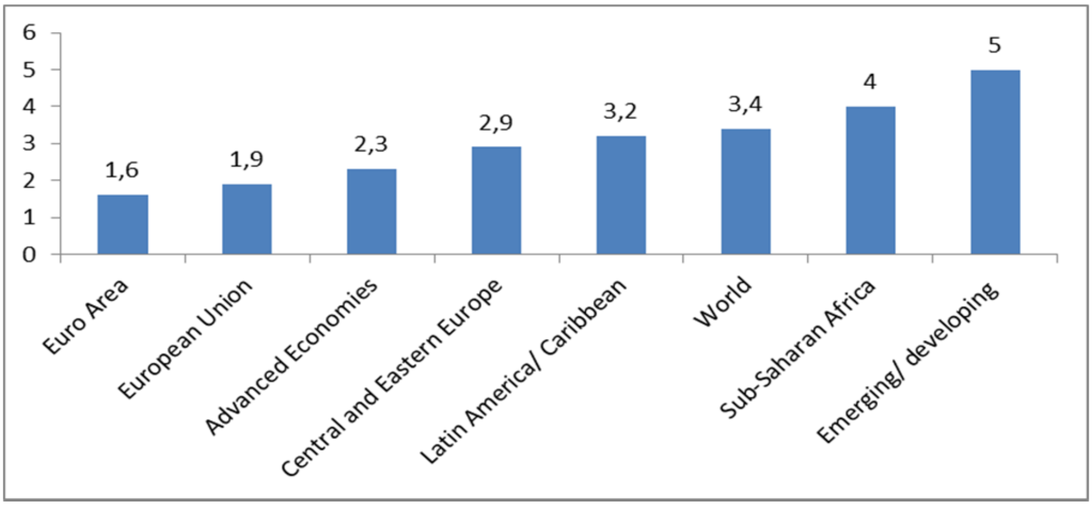

Figure 7.3: Average annual growth of real GDP in selected world regions 1990-2010.

Source IMF *World Economic Report* 2011, Database.

This faith in both the effective transmission mechanism of supranational monetary policy and the consequent benign effects on employment and growth was borne out neither in the preparatory phase for EMU (1992-98) nor in the subsequent growth cycles; in both periods the Eurozone remained the weakest region for real GDP growth (Figure 7.3) and a weak performer in reducing unemployment.

The causes lie arguably in both the flaws of monetary theory and the neo-liberal theory of efficient markets and in a seeming unwillingness/institutional inability to diagnose the critical changes that were affecting the global political economy, most notably in the financial sector.

The privatisation of money

One of the core articles of faith of monetarist theory is that a central bank, through the judicious deployment of its key instruments – short-term refinancing rates, open-market operations – can control the demand for credit, limit the growth of the money stock in its jurisdictional sphere of influence and thereby maintain price stability (actually mild inflation). Accordingly, the ECB established two central 'reference values' by which its performance could and should be measured: price inflation of approximately (but not exceeding) two per cent per annum and money stock (M3) growth of 4.5 per cent per annum. As Table 7.2 indicates, the Harmonised Index for Consumer Prices in the Eurozone showed inflation rates consistently above the reference value but not by much, suggesting the successful fulfilment of the ECB's core task.

Table 7.2: Consumer price inflation (HICP), unit wage costs (UWC) and oil prices (Oil) 1991-2010 in the Eurozone economies; annual increase in per cent.

	HICP	UWC	Oil
1991-1995	3,2	2,5	-6,4
1996-2000	1,6	0,8	19,0
2000	2,1	1,3	81,3
2001	2,3	2,7	-10,1
2002	2,3	2,2	-4,7
2003	2,1	1,8	-5,2
2004	2,1	0,9	21,3
2005	2,2	1,2	46,1
2006	2,2	1,0	18,5
2007	2,1	1,7	-0,2
2008	3,3	3,6	24,8
2009	0,3	3,9	32,3
2010	1,6	-0,6	36,0

The accompanying data, however, indicate that there is little evidence for wage-push inflation – a primary target of monetarist orthodoxy – and overwhelming evidence for imported inflation via oil prices, in part driven by increased demand for oil from emerging economies but also, as demonstrated by a recent United Nations Conference on Trade and Development (UNCTAD) report, by speculation and the 'financialisation of commodity markets' (UNCTAD 2011: 19). Unit wage costs grew by an annual average of 1.5 per cent between 1996 and 2007; (the surprising jump in UWCs during the global crisis – see Table 7.2 – derives in large part from a combination of lower capacity utilisation and labour-hoarding). The average annual rise in oil prices was 21.6 per cent. Consumer price inflation was also affected by increases in 'administrative prices', namely rises in rates of VAT and excise duties, in part to compensate for reductions in direct rates of taxation. There was also little evidence of the business cycle overheating, as reflected by the modest development of GDP and its component domestic demand factors (Figure 7.4). With GDP growth averaging 1.8 per cent between 2000 and 2008, private consumption in the Eurozone grew by an annual average of 1.4 per cent, state consumption by 1.9 per cent and gross investment by 1.8 per cent. Real net disposable income grew even less strongly in core EU countries like Belgium, Germany, Italy and the Netherlands.[4]

The modest growth of GDP was driven predominantly by exports (annual rate of growth of 5.7 per cent in the Eurozone between 1991 and 2007). ECB data for sectoral contributions to value-added within the Eurozone also demonstrate the relative sluggishness of the primary and secondary sectors compared to financial services,[5] but conceal the contribution that financial assets made to manufacturing profits in this period.[6]

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[4] OECD figures available at: <http://www.oecd-ilibrary.org/economics/real-household-net-disposable-income_hsinc-table-2011-3-en>.

[5] Financial services enjoyed average annual growth rates of value added of 3.9% between 1996 and 2000, 2.1% between 2001 and 2005, and 1.8% between 2006 and 2010; the figures for manufacturing are 2.8%, 1.2% and -0.7%; ECB Statistics Pocket Book (August 2011).

[6] Bundesbank data show marked increases in the ratio of financial assets to real assets in recent decades; cf. Leaman (2009).

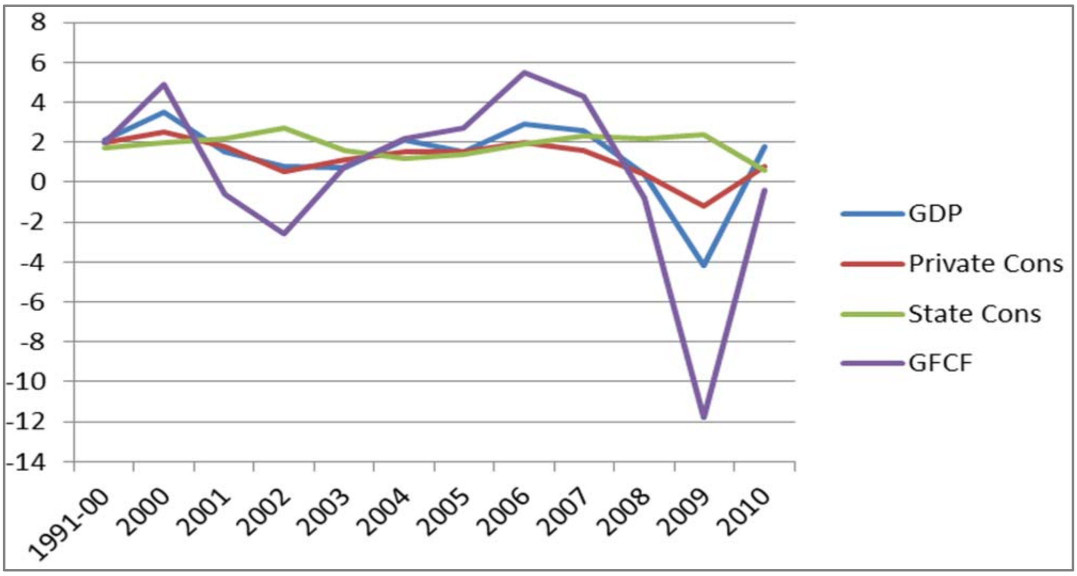

Figure 7.4: Annual growth of GDP and its domestic components in the Eurozone economies 1991-2010 in per cent.

Source European Central Bank (monthly statistics pocketbook, various).

What is more revealing is the development of the money supply within the Eurozone; Figure 7.5 reveals a consistent and significant overshoot in the expansion of M3 between 1999 and 2008 beyond the 'reference value' target of 4.5 per cent; by 2003, this overshoot was arguably embarrassing enough for the ECB to announce that it would 'no longer review the reference value for M3 on an annual basis because experience has shown that the underlying medium-term trend assumptions cannot be expected to change frequently' (ECB 2004: 64).

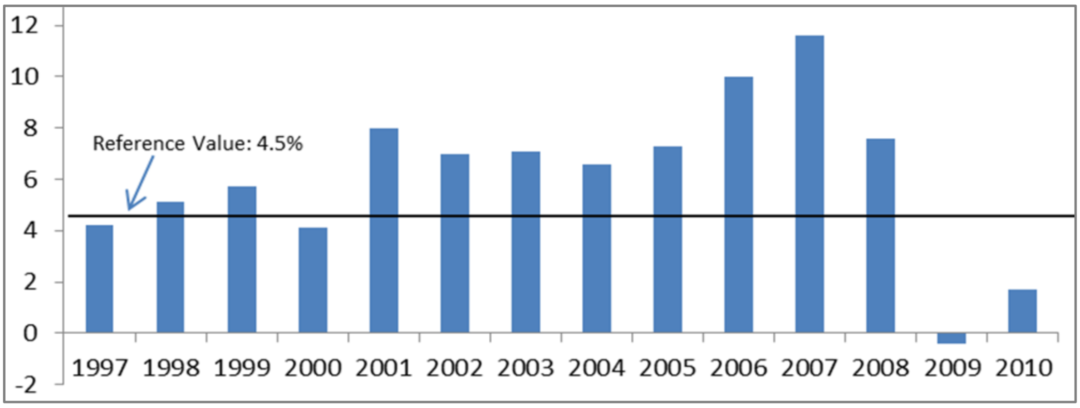

Figure 7.5: Growth of Money Stock M3 in the Eurozone.

Source European Central Bank.

This development and the extraordinary accompanying statement reflect, first and foremost, the relative powerlessness of the ECB – along with any central bank in the era of financialisation – to control directly the volume of base money: where banks and other financial institutions indulge in hyper-leveraging, through the multi-layered securitisation of loans and future income streams (where bond issues are given top credit ratings), 'the central bank, if requested, cannot refuse to back these loans, if the system is to maintain its viability' (Mellor 2010: 44). As Lapavitsas and Saad-Filho note: 'consequently, the central bank cannot control the quantity of base money [...] loans make deposits, deposits make reserves, and credit money determines base money' (2000: 311-12).

The limited demand for central bank refinancing of retail and investment bank loans before, but particularly after 2008 is fairly evident; it demonstrates in recent history at the very least that rates of return on certain classes of investment were high enough to make the refinancing costs less relevant in an environment where, overall, growth was anaemic and unevenly spread between sectors. The era of 'monetary accumulation' (Altvater 1991) was ensuring *pro tem* strong demand for financial 'products, which effectively diverted corporate reserves and 'normal' borrowing away from productive investments, with their higher rates of return. Additionally, however, the expansion of the interbank-market together with the facility of securitisation allowed banks to operate in part separately from systems under the notional control of central banks, reinforcing their ability to create money *ex nihilo*:

> Banks began to tap into the flow of money available by selling the debts they were issuing as an asset for investment, that is, as a security. Like the traders who once swapped the debts they held for ready bank money, banks started to swap the debts they held for ready money market finance. Investors would buy bank debt at a discount and receive a profit as the loans matured. This was a tremendous benefit for the banks' balance sheet because whereas in the past banks kept the loans they made on their books, now they were sold on and were therefore 'off balance sheet' and did not count against any lending ratios or against profits. More importantly, instead of loans that were slowly being paid off, the banks had more ready cash to expand

> their business. The more debts the banks sold on the more profit they made against capital.
>
> (Mellor 2010: 47)

The securitisation of credit card debt and later of mortgage debt was dominated by US investment banks, but their 'asset-backed' securities were bought by European and other finance houses on an increasingly large scale. Mortgage-backed securities multiplied from 55 billion to 2,117 billion US dollars between 1990 and 2006 (Mellor 2010: 48). A high proportion of these securities were channelled through 'structured investment vehicles', subsidiary entities of the major finance houses but increasingly held 'offshore' to avoid both tax liabilities and regulatory monitoring. This colossal 'shadow banking' system, which operated beyond the reach of even the weak influence of central banks, was regarded with benign indifference by the ECB, the Federal Reserve and the Bank of England; it has nevertheless been estimated to have totalled between USD 10 and 12 trillion by 2007, according to John McFall (2009), the chair of the UK Treasury Select Committee. It has also been estimated that, at the height of the derivatives boom, the total value of traded derivatives contracts stood at USD 2.29 quadrillion dollars (USD 2,290,000,000,000,000) (cf. Leaman 2011).

The relative immunity of transnational financial institutions and their non-bank counterparts to the ECB's main instruments of monetary control (interest rates and open market operations [OMOs]) is demonstrated by the extensive use of both interbank markets and the shadow banking system, but also by the limited number of financial institutions that actually required the ECB's open market operations; Frangakis (2011: 8) notes that in 2003 an average of only 252 out of a total of 6,776 financial institutions in the euro area were participating in short-term refinancing operations and just 136 in longer-term operations. The privatisation of money creation, beyond the control of central banks, was neither fully understood by central bankers nor properly identified as a systemic risk. The 'liquidity factories' (Phillips 2008: 185) were of benefit above all to territorially mobile corporations with their offshore Structured Investment vehicles (SIVs), whereas the credit conditions applying to nationally based SMEs were considerably less favourable (Carbo-Valverde et al. 2005). This of itself would strengthen the trend towards economic concentration.

As far as the ECB's conduct of monetary policy is concerned, Bibow identifies a record of 'asymmetrical interventions', in particular with its interest rate moves; up until 2008 these were characterised by poor timing, where the Bank was frequently too eager to raise rates but later reluctant to lower them despite signs of cyclical weakening (Bibow 2011: 280). This is analogous to the record of the Bundesbank, though arguably much less extreme both in terms of the intensity and length of deflationary rate rises (cf. Leaman 2001: 232ff). There is, to some extent admittedly, an element of the ECB seeking to underscore its credibility as an autonomous institution (Frangakis 2011: 7) and defying the preferences of democratic authorities, but again its actions and pronouncements have been less obviously political than its predecessor. In general, the ECB can be credited with a greater degree of pragmatism in its conduct of Europe's unique experiment in monetary union, albeit within an identifiably neo-liberal and monetarist set of preferences (Frangakis 2011; Arestis and Sawyer 2011).

While central bankers in Europe seemed to acknowledge that the boom in financial services entailed an increase in investment risk, there was – particularly in public statements – a general confidence that these risks could be cushioned by the new insurance vehicles deployed by the hedge fund sector. This confidence was best summarized by the IMF in its annual report for 2006, i.e. two years before the greater follies of the sector's risk management were revealed:

> [T]he dispersion of credit risk by banks to a broader and more diverse set of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient.
>
> (IMF 2006: 51)

This confidence was reinforced by the fact that the global financial system had absorbed the major shocks like the collapse of the hyper-leveraged hedge fund, Long Term Capital Management in 1998, the end of the 'dotcom-bubble' in 2000 and the bankruptcy of Enron in 2001. The apparent ability of the financial services sector to deliver low-inflation growth and high returns strengthened central bank views that the boom could be sustained without the danger of major 'deflations' of asset bubbles. This confidence persisted until 2007. It is clear in retrospect that leading central bankers (Greenspan, Bernanke, Duisenberg, Trichet, King) were more impressed by the achievement of relative price stability, and remained ignorant of the perilous levels of hyper-leveraging, the scale of shadow-banking and the abuse of secrecy jurisdictions underpinning the corporate world. Some worries were expressed by analysts within the Bank for International Settlements (cf. Tett 2009: 179ff.) at an earlier stage, but public expressions of concern remained limited; Trichet only raised doubts about 'elements in global financial markets which are not necessarily stable' at the World Economic Forum in Davos in January 2007. His statement is disarmingly honest:

> There is now such creativity of new and very sophisticated financial instruments, that we don't know fully where the risks are located. We are trying to understand what is going on but it is a big, big challenge.
>
> (Trichet, quoted in Tett 2009: 181)

A contributory factor to the previous indifference towards/ ignorance of systemic risks in the financial services sector on the part of the ECB was arguably the narrowness of its remit and the absence of any significant macro-prudential role, monitoring the diversification of financial institutions and the anatomy of the 'products' they sold to investors (Frangakis 2011: 16ff). However, this does not constitute an excuse.

In this context, a critical contradiction of the ECB's counter-inflationary stance is the deflationary zeal directed at consumer price inflation – the rise in the price of goods and services in the investment/production/consumption cycle – on the one hand, and the toleration or indeed applauding of the exaggerated appreciation in the value of specific asset classes, notably housing and share prices. The transformation of property finance and equity trading into dynamic vehicles for monetary accumulation had strong elements of the Emperor's New Clothes in the mind-set of economic and political elites in advanced economies. House-price inflation became the pre-condition for the expansion of the pernicious 'originate-to-distribute' system of covered bonds and their derivatives. Leveraged buy-outs and increasingly short-term shareholdings were the pre-condition for the artificial ramping-up of 'shareholder-value' at the same time as aggregate real investment ratios were declining. Hyper-leveraging above all created a dynamic which could only be sustained by serial increases in levels of borrowing and money-creation and, by definition, by increasing levels of exposure to extreme adjustments. The proximity of this process to Ponzi schemes was considerably closer than most people were prepared to admit.

Monetary crisis management

European monetarism has been played out both through the haphazard and uncertain pragmatism of the ECB and through its negative fiscal extension in the Stability and Growth Pact. In addition to the arbitrary thresholds for PSBR and state debt set in the Maastricht Treaty and the SGP (see above) the *excessive deficit guidelines* were similarly arbitrary and increasingly honoured more in the breach than in the observance. The fiscal latitude, allowed to each member state, was always extremely narrow and it compounded the limitation of macroeconomic policy choices available to governments that no longer had the devaluation option to compensate for trade and payments deficits. The disparities in the productivity levels of euro area states (GDP per capita), which were significant before EMU, have not been narrowed (Wilder 2011), with similar and critical problems of divergence applying to the newer member states (Halmai and Vásáry 2011). The ECB itself acknowledged the weakening of productivity growth across the whole of the euro area, particularly in comparison to the USA; its 2006 study draws attention to the associated deficiencies in realising the competitiveness objectives of the Lisbon Agenda and proposes that "further efforts are needed to increase the share of R&D spending in a number of euro area countries" (ECB 2006: 24). While it is possible to blame those individual peripheral states with lower productivity for neglecting the appropriate investments in productivity-enhancing new technologies and in human capital, it is also quite legitimate to point the finger at the incessant pressure from ECOFIN and the ECB to consolidate budgets as a real and ideological obstacle to the process of convergence within the common currency zone. It would also have been appropriate for the Commission, together with ECOFIN to have included *positive* fiscal objectives within the SGP – minimum tax ratios, the strengthening of progressivity and transparency in taxation, expenditure ratio targets for education, training and innovation, etc. – rather than imposing the negative fiscal constraints of a growth-reducing austerity and relying on markets to allocate investment resources efficiently and evenly across all member states.

The chickens of the 'stupidity pact' (*The Economist* 22 October 2002 quotes Romano Prodi's description of the SGP as 'stupid') and of the deflationary imperative in general began to come home to roost in 2009, as EU27 economies were affected by different levels of severe contraction. The contradictions in European monetary policy became even more crass, however. The ECB reduced its repurchasing rate significantly (from 4.25 per cent in July 2008 to one per cent in May 2009) in the early stages of the crisis, eased its refinancing conditions; it extended the list of assets accepted as collateral, providing unlimited liquidity to the market, and bought up some 60 billion euros worth of high risk covered bonds. However, at an early stage in 2009 it was already talking about the withdrawal of special measures and the need to return to strict budgetary consolidation as soon as possible. This betokened at the very least a dramatic underestimation of the severity and probable duration of the new crisis of finance capitalism.

The Commission's contribution to crisis management was even more confusing: on the one hand, it put itself at the head of the efforts of core-EU15 states to neutralise the financial meltdown and to counteract their unprecedented recessionary contractions in 2008 and 2009. On the other hand, in the same period it was enjoining several new member states – most notably the three Baltic states – to address their budget deficits, even though their overall debt levels were considerably lower than the EU15 average, and even though they were all suffering double-digit recessions (see European Commission, 2009: 62, 85, 81, etc.; see also Leaman 2009: 12). Despite the extraordinary circumstances of global financial crisis, a severe regional recession and the first contraction of global trade for decades, the Commission also continued to implement 'excessive deficit procedures' (EDPs) in 2009 and 2010 (Table 7.3). 26 out 27 EU member states were in the throes of deep recessions, exceeding the EDP 'exceptionality threshold' of a two per cent contraction of real GDP, all the major finance ministries were seeking to prevent financial mayhem, sterilising toxic assets and taking major equity stakes in bankrupt banks, and the Economic and Financial Affairs Directorate was indulging in the tragi-comedy of issuing parking tickets in a war-zone.

Table 7.3: EU excessive deficit procedures 2008-2009.

Country	**Date of the Commission report (Art.104.3/126.3)**	**Council Decision on existence of excessive deficit (Art.104.6/126.6)**	**Current deadline for correction**
Bulgaria	12 May 2010	13 July 2010	2011
Denmark	12 May 2010	13 July 2010	2013
Cyprus	12 May 2010	13 July 2010	2012
Austria	7 October 2009	2 December 2009	2013
Belgium	7 October 2009	2 December 2009	2012
Czech Republic	7 October 2009	2 December 2009	2013
Germany	7 October 2009	2 December 2009	2013
Italy	7 October 2009	2 December 2009	2012
The Netherlands	7 October 2009	2 December 2009	2013
Portugal	7 October 2009	2 December 2009	2013
Slovenia	7 October 2009	2 December 2009	2013
Slovakia	7 October 2009	2 December 2009	2013
Poland	13 May 2009	7 July 2009	2012
Romania	13 May 2009	7 July 2009	2012
Lithuania	13 May 2009	7 July 2009	2012
Malta	13 May 2009	7 July 2009	2011
France	18 February 2009	27 April 2009	2013
Latvia	18 February 2009	7 July 2009	2012
Ireland	18 February 2009	27 April 2009	2015
Greece	18 February 2009	27 April 2009	2014
Spain	18 February 2009	27 April 2009	2013
UK	11 June 2008	8 July 2008	financial year 2014/15
Hungary	12 May 2004	5 July 2004	2011

Source European Commission. Available at: <http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm>.

The ECB, true to its word, sought to phase out its temporary emergency measures in December 2009, even though financial markets were still extremely reluctant to revivify interbank trading and expand overdrafts and long-term credit to non-banks. In her recent paper on the ECB's crisis management, Marica Frangakis provides graphic evidence for the commercial banks' deployment of the extra liquidity intended (by the ECB) for relubricating commercial credit lines (Figure 7.6).

The removal of emergency measures was reversed by the ECB in the spring of 2010, as the spill-over effects of state bank-salvage operations and automatic stabilisers on state expenditure and borrowing generated the euro area's persistent and worsening sovereign debt crisis. A new 'Securities Market Programme' allowed interventions by the central banks of the Euro-system to be conducted in both public and private securities markets. With purchases of sovereign bonds only permitted via secondary markets, an unequivocal bias is evident, as Frangakis correctly observes:

> Thus in the face of the public debt crisis [...] the ECB aided the euro area banking system through the direct and indirect provision of funds – refinancing and buying bonds on the primary and secondary markets – whereas it aided the euro area governments through the indirect provision of funds only – buying bonds on the secondary bond markets. In monetarist terms, this is supply-side economics and in political terms, it is favouring the private sector over the public one.
>
> (Frangakis 2011: 14)

Figure 7.6: Deposits by monetary financial institutions with the Eurosystem (outstanding amounts in million euros), Sept. 1997 - Feb. 2011.

Source Frangakis 2011, p. 13.

Figure 7.6 demonstrates the fruitlessness of the ECB's efforts with the sudden upsurge in bank deposits back into the Eurosystem, rising by over 800 billion euros between the end of 2008 and early 2010. The more recent (October 2011) focus on the solvency of a wide set of European banks (Donahue 2011) indicates, at the very least, that the recapitalisation of banks through the blanket provision of central bank liquidity ('quantitative easing' in UK parlance) has failed both to generate new expansionary circuits of private credit and to prevent the serial down-grading of the credit ratings of both banks and European states.

The sovereign debt crisis has, above all, revealed the deficiencies of an asymmetrical EMU which has been subjected to a shock generated by a related asymmetrical global order, for which its overall guiding theory – monetarism and neo-liberal supply-sidism – is co-responsible. The neglect of demand factors in the construction of a union between countries of divergent levels of development, the neglect of fiscal harmonisation as a precondition for economic convergence and the minimisation of crisis-driven fiscal equalisation, the delusionary faith in the efficient allocation of resources among divergent economies via liberalised markets – these core deficiencies are as manifest in the shambolic management of the sovereign debt crisis as the failure of national and international regulatory regimes to diagnose the 'fool's gold' empire of global finance before September 2008.

Above all the sovereign debt crisis reveals the restored thraldom of fiscal states to the socially and ethically rootless army of financialised capitalism which they had just saved from self-destruction. In the absence of a correct appreciation of the scale of this crisis, the unresolved disparities of the asymmetrical union have rendered that union vulnerable to the same processes of rent-seeking speculation and ratings charlatanism (cf. Kettle 2010; Fricke 2011) that the neo-liberal disaster let loose on struggling democratic cultures.

The naivety of a one-size-fits-all monetarism has created an unsustainable European political economy, intractably rooted in an increasingly dysfunctional German model of export-led growth which cannot hope to resolve the dilemma of chronic current account surpluses and chronic current account deficits.

The widening of bond spreads, afflicting the Eurozone since the spring of 2010, was entirely predictable:

- The new risk-aversion of financial institutions was dramatically demonstrated by the sudden paralysis of the inter-bank market;
- Lower-than-average tax ratios in Greece, Ireland and Portugal, combined with rising external deficits, made these states both dependent on imported capital and less capable of generating future revenue streams to repay short-term loans (Table 7.1);
- The Irish state was overwhelmed by the scale of its commitments to salvaging its banking system, which involved sums of over 200 per cent of GDP and drove a modest state debt ratio (28.8 per cent of GDP in 2007) to over 100 per cent in three years.

Accordingly, the need for fiscal transfers from other euro area states was also predictable, given the level of exposure of German, French, Italian and other banks to the endangered bond issues of peripheral states. The absence of a refined system of fiscal equalisation within EMU, and in particular the absence of a common euro area bond, rendered the negotiations towards a stabilisation facility vulnerable to political/electoral pressures within individual member states, most notably within Germany with its brittle and unreflective new coalition. EMU heads of state were in consequence consistently behind the loop, reacting to rather than controlling events. The consequent cost of 'stabilisation' to all participant states is considerably higher than it needed to have been. More importantly, the conditionalities attached to the fiscal transfers are fatally informed by the simple logic of (German) austerity preferences and fail to address fundamental problems of divergence:

- Levels of productivity and unit wage costs – root causes of international competitiveness and hence current account deficits – can only be addressed by an intensified commitment of state resources to research, development and skill capacities within a country's economic culture;
- Low tax ratios, reinforced by beggar-thy-neighbour tax-rates (Ireland) or weak administration and compliance (Greece) are incompatible with an open and mutually supportive currency union; the 'free rider' option of poaching the tax bases of other member states, as pursued by Ireland, is corrosive of such support;

- Austerity, as demanded by Germany's export-led model, has demonstrably failed to encourage growth within the euro area, but has rather compounded the asymmetries of demand and the mal-distribution of income and wealth;
- In an integrated region of production and trade, the common pursuit of an export-led recovery is self-defeating; we cannot all trade our way out of recession and state debt.

The conclusions to be drawn from this brief survey of monetarist policies within Europe are sobering and challenging, but the real achievements of European integration can only be maintained by a decisive step-change in its institutional arrangements. There are clear doubts about the whether the leading figures of the EU and its member states have the ability or desire, collectively, to make that step change and to prevent the fragmentation that threatens the project. The conclusions would nevertheless seem to be:

1. The policy architecture of the euro area requires the formalisation of a fiscal union which allows both common sovereign bond-issuance and the flexible interpretation of deficit and debt levels to facilitate real convergence of productivity and unit labour costs; i.e. short-term sovereign debt expansion for weaker states must be acknowledged as a necessary pre-condition of economic modernisation, not as a structural obstacle to market-led growth *qua* 'crowding out'. Such flexibility must be conditional on the abandonment of free-rider fiscal strategies and the implementation of a common campaign to end tax evasion and tax avoidance.
2. There has to be a recalibration of demand within member states, which reverses the erosion of domestic demand through neo-liberal redistribution strategies in core states with chronic surpluses; this would have to involve wage-setting which matched wages to productivity gains and the restoration of effective tax progressivity throughout the EU27 (i.e. the abandonment of flat tax regimes) as a pre-condition for the improved provision of public goods.
3. The structural disparities between states with chronic external surpluses and states with chronic external deficits require a refined system of fiscal equalisation both within the euro area

but also within the EU27 as a whole; this would involve the enhancement of the admirable system of structural funds (Cohesion Funds) through measures targeted at the modernisation of weaker sectors in weaker regions. It would also mean bridging assistance to peripheral states to prevent any further erosion of welfare arrangements.

4. The interdependence of the secular economy of a highly integrated group of countries requires the harmonisation of key fiscal arrangements (a common corporate tax base, minimum rates of direct taxation and country-by-country reporting), the co-ordination of macro-economic policy institutions and a reduction in the 'democratic deficits' of current institutional systems. This has to mean an end to central bank autonomy, an increased role for the European Parliament and the acceptance of qualified majority voting in reform programmes relevant to macro-economic crisis-management.

The chances of these ideas being realised, not to mention of Europe adjusting to the inevitability of weaker growth patterns, cannot be high, judging by the current atmosphere of nationalist populism emerging within individual states. If Europe's deep crisis bore the physical signs of a destructive war, the chances of a collective enterprise aimed at restoring a sustainable economic and social order to the continent – as in the 1950s – would arguably be greater. The real nature of the crisis, however, looks like having economic consequences as critical as those of a continental war, without its severity being recognized soon enough by policy-makers. Weaning ourselves off an addictive dependence on hyper-leveraged finance capitalism will take decades of adjustment, to add to the challenges of demographic change and environmental sustainability.

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Chapter 8

Governance and the euro crisis

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The third phase of the global financial crisis (GFC) has been focused on the fears of sovereign default in Europe and the attempts that are being made to manage the problem in ways that will not have an unnecessarily severe impact on the real economy. The structure of Economic and Monetary Union (EMU) in the European Union (EU) has contributed both to the problem and to the difficulty in finding a lasting solution. This experience has revealed fundamental problems in the process of integration and the role of the state. This chapter focuses on the nature of the problem and the plausible ways out – not simply to end this phase of the GFC but to provide a sustainable future path for EMU and continuing integration in Europe and elsewhere round the world. The GFC has emphasised the extent of interconnection among economies through globalisation and the advantages of international cooperation and coordination in the avoidance and management of crises.[1]

The common response has been to suggest that either increased integration is required, particularly at the political level or that some countries should leave the euro area. This chapter suggests, however,

[1] For a helpful analysis of the issues and experience up to the end of 2010, see Hodson (2011).

that the original concept was workable, even in the face of shock as large as the GFC, had the agreed rules been applied. It is now much more difficult to follow this path, given the poor fiscal discipline of many of the participating countries, but a revised pact, involving not just a more plausible procedure for correcting potential excessive deficits but also a stronger procedure for improving the debt position of all members steadily – the so-called preventative arm – could still work. It is this route which was chosen in the 21 July 2011 agreement. By the time of the next agreement on 26 October 2011, it had become clear that the position of Greece, the most heavily indebted country, was only recoverable with a considerable write-down of privately held government debt, agreed at 50 per cent, and a recapitalisation of European banks. A package of six measures to try to ensure future stability had also been agreed (Council of the European Union 2011).

By late 2011, these measures and attempts to 'leverage' the European Financial Stability Facility (EFSF) by allowing it to take the first loss rather than underwrite all new debt from troubled countries had still not convinced markets and the outside world either that Greece or the other potential problem countries, Ireland, Italy, Spain and Portugal can be handled. It is difficult to decide whether the chosen recipe will work, not least because it is not clear whether Greece will accept it, as the political turmoil and public discontent have brought the government down, but also because the willingness of the other member states to contribute more is very limited – as evidenced by the difficulty in getting agreement to the previous 21 July measures. Italy is now also under great pressure and the prime minister resigned on 8 November 2011. The appointment of 'technocratic' governments in both Italy and Greece should mean that the measures required by the EU and the International Monetary Fund (IMF) are implemented in the short run but it does not entail either popular support or lasting governmental support.

These pressures from the GFC have affected the role of the state in the euro area in at least seven obvious ways:

- countries with difficulties in funding their debts have had to seek relief from their partners and the IMF, which has entailed conformity with strict conditions – in common with earlier IMF support;

- the other partners have had to offer funding despite a no bail out clause;
- countries have proved very susceptible to spill-over effects from others in financial markets and have not been able to address these fully on their own, thereby enhancing the degree of cooperation in financial markets;
- cross-border banking problems have revealed that cross country cooperation agreements are inadequate and that interests can conflict;
- previous means of trying to limit fiscal spill-overs in the euro area through the Stability and Growth Pact (SGP) have been inadequate;
- the expected problems posed by the single monetary policy for countries in difficulty have been fully borne out;
- the limits of the willingness to pay for other countries' actions has been exposed.

All of these concerns have an impact on economic sovereignty. Whether they represent a loss of sovereignty or whether in any sense the joining of the euro area represents an increase in sovereignty are complex questions to answer. Small countries did not have much sovereignty beforehand and were highly dependent upon the decisions of large countries, the views of financial markets and the shocks to the system that were beyond their control. The degree to which any one country with a specific problem has over the operation of common policies in the euro area is normally almost zero. Until that is they become a threat to the system. Some larger countries, such as France, Spain and Italy, now have more control over their destiny than was the case where in the earlier years of the European Monetary System (EMS) Germany effectively determined the general alignment of policy for its own domestic benefits. Consequently Germany must therefore have less sovereignty than before.

The system is not completely lopsided, otherwise small countries would not have joined. If they are not to subject to idiosyncratic shocks, they gain through the lower interest rates and greater stability of being part of the wider area – in part from being able to diversify their wealth in the larger euro area and hence provide a greater measure of self-insurance. All gain from lower transaction costs and reduced barriers but the small have a serious problem in the event of an idiosyncratic downward shock, as illustrated by Ireland (and the Baltic States) in the GFC. Here the trade-off between the years of gain and the years of harsh adjustment comes into play. No doubt electors are revisiting the judgements they made before deciding to join the euro area – if they were given a choice that is.

The main issue is that the process is highly asymmetric. Not only is it that the states with the fiscal problems have to make the adjustment themselves to return to prudence but that a downward adjustment is immensely more difficult than an upward one. It also represents a serious, many-faceted challenge to democracy in the EU. Not only does it illustrate the continuing democratic deficit in the EU in that the ordinary voter has little opportunity to express a view on what is happening either directly or through their elected representatives at the European or national level but many did not have the option of expressing an opinion on whether they wished to participate in the euro area in the first place. Furthermore, the institutions of the EU are having difficulty coping with the crisis as they are not designed for crisis management but for the administration and incremental development of European integration. As a result, much of the running has been made by France and Germany as it is very difficult to get agreement among 17 countries, especially if they have to be ratified by national parliaments. *Ad hoc* innovations such as the EFSF have been made, without as yet the need for Treaty revision. While some would regard this as a disturbing disregard for democratic rights others would view it as appropriate pragmatism and a welcome determination to try to get the job done.

The subsequent sections of this chapter deal in turn with the nature of the predicament the euro area faces; how the system was intended to work; how the fiscal and financial problems might be addressed before concluding. However, the primary concern here is not with solution to the crisis per se but with the implications that the crisis and its likely resolution have for the role of the state.

The current predicament

The problem that the euro area faces at present is that a number of countries, Greece, Ireland, Italy, Portugal and Spain (unkindly referred to as the PIIGS in the popular press) have accumulated levels of public sector debt that, in combination with present fiscal deficits, lead lenders to think that they may not be repaid in full. As a result the spreads that most of these countries are being asked to pay on new debt and rolling over the existing debt are such that the burden would be so high that the default that is feared would be triggered. Other than Greece, the countries themselves are convinced and have thus far succeeded in persuading both their EU colleagues and the IMF that they can manage to reorganise their budgets in such a way that they can service the debt in the short run and run down the excess so that it is sustainable in the long run.[2] Provided that is that the EU and the IMF offer rates of interest that reflect normal times and not the panic rates that have precipitated the crisis. Even the 21 July 2011 agreement over the handling of Greece did not involve writing down any of the debt but a rescheduling. Now the 26 October 2011 agreement goes further and writes down privately held debt by 50 per cent in a negotiated settlement with the banks holding the debt, in the hope that this will keep the country's debt ratio down to 120 per cent by 2020, which may be manageable. However, all this is predicated on a whole package of structural reform and increased competitiveness through lowering real wages and the net fiscal cost in Greece. For all countries concerned the problem is that they cannot simply make changes today that will solve the problem but that they have to continue to follow policies that keep debt sustainable over several decades.[3]

Offering a plausible commitment involves turning the current budgets from strong deficits into surpluses with a believable prospect that the position will be maintained over the future. Cutting expenditure and raising taxes at a time of difficulty will make the present recession deeper in the short run and it is not surprising that the Greek government for example has opted to meet as much as possible of the shortfall by asset sales. Being members of the euro

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[2] Although, in November 2011, Italy began to push the boundaries and the Prime Minister resigned.

[3] At the time of writing in December 2011, there has been a further agreement, on December 9, which seeks to embody the changes for greater fiscal prudence in future in the form of a new inter-governmental treaty, as the UK declined to participate unless the other countries were prepared to be more flexible over financial regulation. One of the innovations has been that the EU is now mandating maximum as well as minimum requirements for financial regulation, which the UK thinks may inhibit London's role as an international financial centre. It is not clear whether the agreement will be confirmed by the member states.

area, the troubled countries cannot undertake the usual stimulus to recovery by devaluing their exchange rate and their competitiveness can only be improved by deflation (or inflation clearly less than that of their competitors, which is clearly difficult when inflation levels are near zero).[4]

Making all these changes requires a substantial public and political commitment. Not only do the budgetary measures have to be agreed by parliaments but wage bargainers have to agree for wage levels to fall relative to competitors if the outcomes are to be sustainable. It is not surprising therefore that governments have fallen in countries faced with such pressure and that the public is reluctant to accept the austerity involved as they do not feel it is their fault but that of politicians and financial institutions that have allowed them to get into this mess in the first place. In any case such a route to adjustment, especially if applied slowly, runs the risk of progressive difficulty with rising taxes and falling expenditures leading to lower taxable incomes and greater demands on the welfare system. Rapid turnarounds are possible under fixed exchange rates without ramping up debt, as demonstrated by Estonia, but traditionally the exchange rate has formed an important pillar of the recovery from a severe fiscal and financial crisis, as demonstrated by the Nordic countries in the early 1990s and the Asian countries in 1997-98.

The idea behind the EU and the IMF stepping in in the interim is that it gives the countries time to implement the changes and start the recovery so that the longer term future looks feasible to private sector lenders who will then be prepared to lend to these countries at rates of interest that are not crippling. This has been the normal outcome of IMF intervention in the past, although countries quite naturally have not liked the harsh restructuring terms the IMF have imposed. Sometimes it has taken rather longer and subsequent programmes of IMF lending have been required. It has normally been a feature of such lending that it is offered at a rate of interest reasonably close to that which the lender itself raises the funds, hence providing a considerable improvement over what could be obtained in the market. In the present case, up until the 21 July agreement, Greece, Ireland and Portugal were paying penalty rates, thereby making their short run

[4] Devaluation of course increases the burden of foreign currency debt in domestic currency terms.

cash flow problems worse. (The reasoning behind this penalty was difficult to understand. If it reflected perceived risk then the other countries should not have been lending in the first place.) While temporary lending programmes are usually only of a size sufficient to finance new debt and debt that comes up for repayment, it is possible to use the facility to buy back debt in the market at a very substantial discount and hence reduce the nominal value of debt outstanding.

This approach of replacing market lending by EU/IMF lending 'temporarily' represents Plan A, although duration of the EU lending in the case of Greece can be as long as 30-40 years. If Plan A cannot be applied, because no convincing budgetary reorganization can be found or agreed, then the alternative is to reduce the amount that the governments have to spend on interest or the repayment of principal to lenders.[5] If this can be agreed with the lenders, as appears to be the case with Greece, then this can be arranged without triggering a technical default.[6] However, this is not normally possible because of the collective action problem. It would pay some lenders to opt out of the agreement as then they could get repaid under the previous schedule. Collective action clauses exist in some bond contracts in order to make just such reorganisations feasible.[7] It is planned for them to become normal practice in EU debt in 2013. The 21 July agreement included a degree of voluntary rollover by the private sector but the 26 October agreement included a voluntary write-down of 50 per cent. It is still being debated whether the reorganisation in the case of Greece would be treated as a selective default but collective action has been rather easier as most of the holders of the debt are euro area banks in other countries.

Defaults bring with them other unwelcome consequences as they bring all of the country's transactions into question at the same time,

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[5] Buchheit and Gulati (2011) provide a very clear exposition of the range of unattractive options that the other members of the euro area face.

[6] This technicality matters as it would trigger the credit default swaps that the bondholders have undertaken, thereby shifting the losses, quite possibly outside the banking system.

[7] Some sort of agreement is required, because there is no court that can compel a particular course of action by a sovereign borrower. Lenders are of course in a strong position as the defaulting country needs such a reorganisation if it is to re-enter financial markets. Drelichman and Voth (2011) show that the history of organised defaults and restarting borrowing is very long by considering the case of Philip II of Spain, who was a serial defaulter in the second half of the sixteenth century.

triggering close-out clauses and claims for early repayment, thus bringing the financing system to a halt. This would create a much worse recession and would make it very difficult to raise external finance for quite some while subsequently, until the position of all the debt holders has been worked out.

One of the difficulties that European governments railed against in the 21 July measures over Greece was that ratings agencies made the problems more difficult a complaint repeated when Standard & Poors put the major countries on credit shortly before the 9 December 2011 agreement.[8] This highlights that having a credible proposal is key to the solution.[9] The parties involved may have no problem persuading themselves but it is others they have to convince for market prices and ratings to change. The lack of success, in Greece in particular, of reining in the problem means that claims that such changes will happen in the future are not very persuasive, particularly given the lack of enthusiasm in the EU for a Plan B that involves avoiding default by other member states writing down Greek debt and thereby bearing some of the loss.[10]

The dilemma at present is that the governments of some of the lending countries feel that a default in the future may occur anyway and they are unwilling to step in and take over from private lenders, as their own taxpayers will then have to bear some of the loss. However, if there is a default in the short run they will also face losses, as some of the lenders to the troubled countries are their banks, which might fail as a consequence, either facing the governments with the need to organise a bailout or with disruption to their own financial systems. (At the time of the 9 December agreement it was suggested that a 115 billion euro recapitalisation would be required by euro area banks.) It is difficult to have much

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[8] Von Hagen (2010) argues that seeking more favourable ratings will not affect the views of those who might invest in the debt.

[9] Putting the other euro area countries on credit watch before the December 9 agreement could be construed as suggesting that Standard & Poors expected that the meeting would be successful and as a result that the other member states would become more exposed to losses in the troubled countries.

[10] Confidence in the 26 October agreement has also been weak because of the inability of the member states to agree how to 'leverage' the EFSF so that it effectively covers 1 trillion euro of debt despite having funding of only 440 billion euro by taking the first loss rather than issuing the security outright.

sympathy for these lenders, as the risks were well-known. Well before the crisis, surprise was expressed at the smallness of the risk premium in the market (Mayes and Viren 2007).

Furthermore, the European Central Bank (ECB) is holding many of the bonds and it would need recapitalising by the member governments according to its capital key if there were to be a default.[11] There is thus no easy way out. Indeed the ECB is now buying debt in the market in an effort to reduce interest rates on Spanish and Italian debt, thus expanding its balance sheet and increasing the potential exposure to loss. However, it is of the view that the market is exaggerating the default risk and that these bonds are still of high quality. Nevertheless it is constrained in its programme to provide liquidity for euro area banks and not to bail out insolvent euro area governments as set out in Article 125 of the Treaty.[12]

High in governments' minds are the consequences of the insolvency of Lehman Brothers, where world financial markets froze and asset prices fell dramatically as counterparties could not assess who was going to bear the losses, thereby constituting stage two of the GFC. The ECB has also fought very strongly to ensure that it only accepts unimpaired collateral in its operations. As a result, the July 21 agreement entailed that Greek debt would be effectively underwritten by the euro area and this position was maintained in the 26 October agreement.

In this instance, it appears to be rather easier to sort out who the bondholders are but the extent of the losses will be difficult to establish for a while.[13] Despite the existence of the Paris and London Clubs for sorting out bond write-downs, this process takes time if there is a default and meanwhile international financial markets

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[11] As it is, without a default, the ECB is likely to make a profit on its purchases as it is buying when prices are low and the haircuts large.

[12] Although Article 123 does provide for help in the event of exceptional circumstances. It is a bit difficult to describe the present problems as anything but exceptional as the last time strains in this scale were experienced in peace time was in the Great Depression in the early 1930s.

[13] 50 per cent was the view at the 26 October meeting but this would still only reduce Greek debt to 120 per cent of GDP by 2020 on current projections of Greek growth and restructuring. (Both of which have shown signs of over-optimism, thus far.)

would return to distress.[14] Thus the European problems would become problems for everybody. With collective action clauses the process would be smoother. Having such a plausible route to manageable sovereign default will be one the better incentives for more prudent fiscal policy (Von Hagen 2010).

To quite an extent the euro area countries have already been placing far more of the potential burden on themselves than was the case with the sovereign defaults in the 1980s (Buchheit and Gulati 2011). Then the problem was also the over-exposure of banks to the debt. The solution then used was first to roll over the debt and even increase it to enable interest payments without default, during the period of IMF lending and restructuring – the Baker Plan. Then, when this proved insufficient, the debt was written down and new longer term bonds issued – Brady bonds. Thus eventually it was the lenders who bore the loss rather than the taxpayers in the lenders' countries but the process was sufficiently drawn out and the loss recognition carefully timed so that it could be borne without a crisis. Some similar delay in recognition might help weaker banks survive in the present crisis but the authorities have taken the view that they should seek recapitalisation (estimated at 106 billion euro in the 26 October agreement) as soon as possible since a write-down of the debt has been agreed. However, in the interim, interest rates have to be low enough that default is not triggered.

It is important not to place all of the troubled countries in the same basket. Italy's debt, for example, is largely domestic. However, because of the size of the Italian economy the foreign holdings are more significant than the whole of Greek debt. It seems likely that Ireland has already put in place a recovery plan that will work unless there is another important downwards shock.[15] Similarly, while Spain faces substantial economic difficulty, it is not clear that it would be overwhelming. If the problem of possible default only really applies to Greece and perhaps Portugal, then these countries are sufficiently

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[14] Currently the position has been a little easier as the Institute of International Finance (IIF), the international association covering banks, has been able to negotiate on behalf of the industry.

[15] Although Ireland's primary problem was the exposure to bank losses through issuing a guarantee, the budget was also out of longer-term sustainability and thus restructuring was required even before adding in that needed to service the markedly increased debt (Whelan 2011).

small that the rest of the euro area could afford to bail them out – ignoring the moral hazard consequences of doing so – and hence could make a credible commitment that would calm markets.[16] In the same way, allowing the default would have very limited impact on the euro area as a whole, unless markets believed that this would push other larger countries into default as well. Whichever way the process plays out, people do not like the prospect of losses and in crises they become very risk averse and jittery. Solutions have to take this into account however irrational the behaviour might seem.

As Figures 8A.1 and 8A.2 and Table 8A.1 in the Appendix 8.1, drawn from Marimon (2011), show, in many respects the problem is most worrying for Portugal, as it has not managed to stop its debt from rising over the last decade, expects continuing slow growth rates and has relatively high tax rates. Greece had stabilised but not reduced its debt, while Ireland and Spain were on falling trajectories. The primary balance in Greece has been no worse than that in the euro area as a whole. The problem is the size of debt interest.

The key issues for the euro area countries are, first, that they need to be committed enough to overcome the fears of financial markets. Second, that they have to negotiate agreements with each other in order to find an equitable sharing of the burden, as just letting a default happen will be worse.

The intended rules

The primary issue for the euro area countries is that they should not have been having these problems at all in the first place. Under the terms of the Maastricht Treaty, which laid out the agreement on EMU, to qualify for membership countries the ratio of government debt should not exceed 60 per cent of GDP 'unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace'. Furthermore, under the terms of the Stability and Growth Pact debt positions should have been slowly improving, because not only were governments to avoid excessive deficits amounting to more than three per cent of GDP in any year except in

[16] The commitment would need to be very large – the Joint Shadow Financial Regulatory Committee (JSFRC) (2011) estimated this to be at least two trillion euro at the time of the 26 October agreement – because it has to cover all plausible eventualities and not just current known losses.

the event of a substantial recession but they should have been aiming for a budgetary position that was close to balance or in surplus (Breuss and Roeger 2007). Even with the slower than hoped for rates of growth attained over the period since the third stage of EMU started at the beginning of 1999, this would still have meant that debt ratios should have fallen in most years. As it was, in many countries they crept up (see Table 8.1).

Table 8.1: Euro area government debt/GDP (%).

Country	**1995**	**1999**	**2007**	**2010**
Austria	68.3	67.3	60.7	72.3
Belgium	130.4	113.7	84.2	96.8
Cyprus	51.4	58.9	58.3	60.8
Estonia	8.2	6.5	3.7	6.6
Euro area	72.1	71.6	66.3	85.3
Finland	56.6	45.7	35.2	48.4
France	55.5	58.9	63.9	81.7
Germany	55.6	60.9	64.9	83.2
Greece	97.0	94.0	105.4	142.8
Ireland	82.0	48.5	25.0	96.2
Italy	121.5	113.7	103.6	119.0
Luxembourg	7.4	6.4	6.7	18.4
Malta	35.3	57.1	62.0	68.0
Netherlands	76.1	61.1	45.3	62.7
Portugal	59.2	49.6	68.3	93.0
Slovakia	22.1	47.9	29.6	41.0
Slovenia	N/A	N/A	23.1	38.0
Spain	63.3	62.3	36.1	60.1

Source Eurostat.

The reasons have been widely debated (Heipertz and Verdun 2010), with some blame falling on the SGP itself, in that it did not attempt to try expressing the strategy in terms of cyclically adjusted budgets. However, in part that reflects the underlying problem of fiscal budgeting. The cyclically adjusted position is not known until after the event. There is an inherent tendency for forecasts to be optimistic, where some of any upturn in the growth rate is likely to be attributed to lasting changes – the IT revolution and the 'new economy' being an obvious case in point – and some of any downturn to be attributed to one off factors. This generates a fundamental asymmetry in the budgetary process, manifested in the euro area in a tendency to cut tax rates too far when the economy is doing well (Mayes and Viren

2011). The asymmetry is often referred to as 'deficit bias' for which there are many explanations.[17]

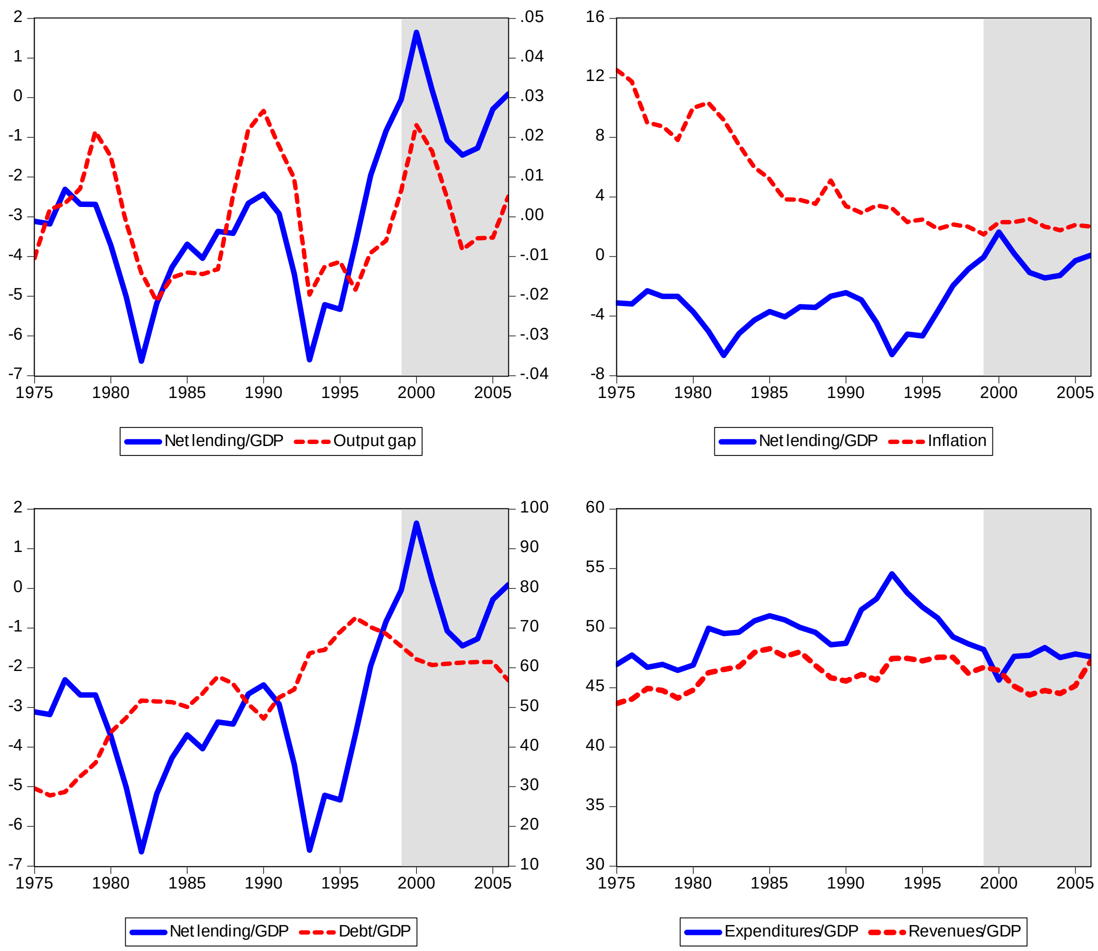

Figure 8.1: Debt and Fiscal Balance in the Euro Area (medians).

In Figure 8.1 (drawn from Mayes and Viren 2011) it is clear from the lower left quadrant that fiscal prudence increased substantially in the run up to EMU and has only weakened slightly since the euro area started. Thus while there was only one year in surplus deficits became much smaller for the same position in the economic cycle (shown in the upper left quadrant). Debt ratios had stopped their long rise and begun to turn down, a process that did not end after 1999. It is also clear from the lower right quadrant that the main contributor to the slight worsening in deficits was not expenditure but the decline in revenue. Thus the degree of adjustment required by the euro area as

[17] Calmfors and Wren-Lewis (2011) offer six: a lack of information, which permits governmental optimism; impatience to get things done; the ability to exploit future generations; electoral competition; the common pool problem – external consequences of budgetary decisions neglected; time inconsistency.

a whole was small and only a modest improvement in fiscal prudence would have led to clearer reduction of the debt ratio in each year. However, it is not just the overall behaviour which matters in this instance but that of the most vulnerable member states.

This experience means that the through the cycle setting of the budget should take this inherent bias into account. There are a number of ways this might be accomplished, for example by requiring that the target for improvement be somewhat harsher. However, any rules that are self-imposed are unlikely to get over the forecasting bias unless the computation is somehow above politics and open to ready verification. Sweden has offered an example of how to do this with its independent Fiscal Policy Council set up in 2007, establishing the budgetary position (Calmfors and Wren-Lewis 2011).

> The council assesses the extent to which the Government's fiscal-policy objectives are being achieved. These objectives include long-run sustainability, the budget surplus target, the ceiling on central government expenditure and that fiscal policy is consistent with the cyclical situation of the economy. The council also evaluates whether the development of the economy is in line with healthy long-run growth and sustainable high employment. Additional tasks are to examine the clarity of the Government's budget proposals and to review its economic forecasts and the economic models used to generate them. Finally, the Council should try to stimulate public debate on economic policy.[18]

In the same way the Office of Budgetary Responsibility in the UK should help reduce the asymmetry.[19] It is not that the government is compelled to adopt the independent body's views but that it needs to have a very well-articulated reason for disregarding them. Seven

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[18]Available at: <http://www.finanspolitiskaradet.se/english/swedishfiscalpolicycouncil/aboutthe swedishfpc.4.6f04e222115f0dd09ea8000950.html>.

[19] In New Zealand this should already be built into the system, as under the terms of the Fiscal Responsibility Act 1994 the New Zealand Treasury is required to provide impartial – and public – advice for ministers. Although it is of course up to them whether they choose to accept it and they could choose an optimistic stance, as was in fact the case in the run up to the GFC. In practice, however, opposition parties do not feel that they are told enough to make a full appraisal.

other EU countries have independent assessments of the budgetary outlook, the Central Plan Bureau being the longest serving, since 1947 (Calmfors and Wren-Lewis 2011). Von Hagen (2010) suggests that having such councils would be one of the few changes to the system that could have a marked effect on behaviour.

In any case the problem is that budgetary forecasts, like any other forecast, even if undertaken with excellent models and principles, will be subject to substantial error. While an independent body may avoid some of the errors of bias, the fact that its forecasts can turn out to be well off the mark may in fact damage its credibility. A body that merely comments on the official projections may retain greater credibility (Calmfors and Wren-Lewis 2011).

It is somewhat surprising that there is no fiscal equivalent of the fan charts used for monetary policy to show the likely distribution of forecast outcomes, nor a strategic approach to reacting to forecasting errors once they are made. In part this is because monetary policy can be altered at regular intervals during the year if necessary, without causing undue disturbance to the economy but short run management of tax rates, value-added tax (VAT) being the usually quoted candidate, has never been popular.[20] Trying to do much management of expenditure programmes during the year is also difficult. The European Semester, while the name might imply a six-monthly review, is an annual process that takes place in the first six months of the year. In any case it is normally argued that sharp changes in tax rates should be avoided and that smoothing is likely to be socially optimal (Leith and Wren-Lewis, 2000). In which case, the transition paths for debt ratios will tend to be slow – emphasising the importance of maintaining adequate cushions below any limiting ratios. On 4 October 2011, the EU agreed a package of six measures (five regulations and one directive)[21] to try to establish a new framework for better economic governance, including institutionalising the European Semester, and this is discussed in the next section.

The core problems were, however, twofold. The EU chose to make a very liberal interpretation of the Treaty when deciding on the initial

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[20] The setting of monetary policy can of course be altered at any time should the need arise.

[21] Labelled the 'six-pack' (Council of the European Union 2011).

membership of the euro area in 1998, admitting Belgium and Italy who had debt ratios substantially above 60 per cent. This was compounded in 2000 with the admission of Greece. Not only has it now been shown that the statistics were incorrect and that Greece did not qualify but even on the published statistics there has been no other period since the signing of the Maastricht Treaty in 1992 that Greece would have qualified. Despite the rhetoric relating to longer term stability in qualification it was clearly not applied in practice.

Furthermore the euro area abandoned the credibility of the SGP in 2003 when it decided to suspend its operation when France and Germany were found by the Commission to be running excessive deficits.[22] The weakened version of the Pact agreed in 2005 not only increased the chance of excessive deficits but made the suggestion that effective sanctions would be taken against errant members, whether in the form of a non-interest bearing deposit or ultimately a fine of up to 0.5 per cent of GDP, thoroughly unlikely. Had France and Germany been contrite and taken the necessary steps, then it would have been possible to take more credible measures against the debt pressures in other member states. The Commission's conclusions after the Economic and Financial Affairs Council (ECOFIN) decided to hold the excessive deficit procedure (EDP) in abeyance for France and Germany in November 2003. Council Document 14492/03 summarises the key point clearly: "Only a rule-based system can guarantee that commitments are enforced and that all Member States are treated equally".

According to Heipertz and Verdun (2010) most countries did not take the medium term objective (MTO) of getting budgets close to balance or in surplus (CTBOIS) seriously. Projections would show this occurring in the future but without a firm programme of how it would be achieved in the event that budgetary outcomes were insufficiently favourable. The argument during the review of the SGP in 2003-2005 emphasised the importance of getting countries facing deficits back to better growth paths. However, the deterrent value of the EDP stemmed from just the fact that having to tighten fiscal policy when the economy was doing badly would be politically unattractive. Hence it was thought that member states would want to

[22] Heipertz and Verdun (2010) provide a very rich description of the debate and the actions of the major players.

aim the trajectory of their fiscal policy through the cycle such that the chances of an excess deficit in a downturn were small. To take the example of monetary policy, central banks tighten when the threat of inflation breaching the target becomes unacceptably large – not that simply that inflation is expected to breach the target in the absence of a policy change. In the absence of major shocks central bank projections normally show inflation clearly within the target over the policy horizon.

It is the combination of admitting countries with high debt ratios and managing to do little to ensure their steady reduction which has proved the undoing of the euro area. Adherence to their own rules would have restricted the problems. Of the high deficit countries, Belgium made substantial progress despite political difficulties and has thus far managed to weather the GFC despite major problems with two of its largest banks, Dexia and Fortis.[23] The terms of EMU membership in no way prevented member states from improving their debt position if they chose to do so. Finland for example virtually halved its debt ratio from just below 60 per cent of GDP to close to 30 per cent over the period 1997 to 2008.

However, even if the Maastricht criteria had been applied rigorously, they were still open to wide criticism as they did not reflect the prevailing view in economics of the criteria for an Optimum Currency Area (OCA) (Mundell 1961; Edwards 2006). The Maastricht criteria were agreed following the work of the Delors Committee in 1989, which, while chaired by Jacques Delors as President of the European Commission, was composed of the central bank governors of the member states and two advisors. This Committee followed, instead, what has been labelled the 'monetary' approach to integration, requiring that the members converge to conditions for stability in financial markets both domestically through the long run rate of interest and internationally through the exchange rate and that they converge on an acceptably low inflation rate.

[23] Dexia and Fortis had to be bailed out in October 2008, following the Lehman's collapse but Dexia got into further difficulty as a result of holding impaired Greek debt and on 10 October 2011 was broken up, with its Belgian banking operations being bought by the government, some of its French operations being sold and its impaired assets being swept into an asset management company from which creditors will be repaid.

This approach has four main disadvantages. First, by concentrating on inflation it ignored the fact that the member states had very different price levels. Member states with low price levels would expect to see above average inflation as their price levels converged – countries with higher price levels would be likely to adjust far less, as lowering price levels is very difficult without a clear recession. Any such adjustment would tend to come from increasing competitiveness through productivity and reductions in real rather than nominal wages in a rather subdued economic environment.

Second, the monetary approach ignores the main concerns of the OCA criteria, namely that countries should not be subject unduly to idiosyncratic shocks that affect just them and not the rest of the area to which they belong and that they should have the necessary flexibility though labour markets, wages and fiscal policy to respond to any such shocks that did occur.[24] In the event of an idiosyncratic shock, the area-wide monetary will not respond, nor will the exchange rate move. Hence other policies will have to compensate for this rigidity.

This is not an impossibility as most large countries, such as the US, Canada or even Australia, do not meet the OCA criteria in terms of exposure of some parts of the country to idiosyncratic shocks but they do have adequate responses in place to absorb the shocks, whether by people moving away from adversely affected areas or trying to regenerate the local economy. The most important deficit in this need for other sources of flexibility is that there is no significant ability to make fiscal transfers to the adversely affected regions in the euro area. This means that a member state with a problem has to rely far more on its own resources, which makes adjustment much more difficult. However, this was all predictable and the chapter discusses

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[24] Edwards (2006) suggests there are 10 criteria that should be borne in mind: (1) factor mobility, and in particular labour mobility, across the members of the potential union; (2) high level of trade in goods across the members of the union; (3) different (or diversified) composition of output and trade across countries; (4) price and wage flexibility across members of the union; (5) similar inflation rates across countries; (6) financial markets should be integrated across countries; (7) absence of 'fiscal dominance' in the individual countries; (8) low, and similar, levels of public sector debt in the different countries; (9) similarity (or synchronisation) of external shocks to which the different countries are exposed to; (10) political coordination across countries.

in the next section the provisions that Finland, within the euro area, and Sweden, outside, have made to have the necessary resources to handle these shocks.[25]

The third issue that was set on one side was that many countries would be able to qualify only occasionally, mainly when they happened to be out of phase with the rest of the euro area. Estonia is a good example. It has become the most recent member of the area at the beginning of 2011. Since it has been a member of the EU it has shown real convergence, with trivial public debt and has normally run a surplus each year. Since it had a currency board based on the euro it has met the criterion of exchange rate convergence automatically. The problem was inflation. As a low income and low price level country it expected higher inflation than that in the lowest three inflating members of the EU much of the time. It only qualified because it was much worse hit by the GFC than most of the EU with a 20 per cent decline in GDP. The resulting collapse in price pressures meant inflation fell to 0.2 per cent and hence the country qualified.[26]

While Estonia will no doubt be an excellent member of the euro area with the most prudent fiscal policy in the whole area (possibly Finland excepted) and a highly flexible economy (Mayes 2010) some of the other newer members of the EU and the obvious case of Greece would not necessarily meet the longer term requirements for sustainable membership even though they can (fleetingly) meet the Maastricht criteria and be admitted.

Fourth, financial markets adjusted on the basis of the likelihood of membership of the euro area actually occurring and not on a judgement of suitability for joining EMU. Thus the convergence of long term interest rates to the German level only indicated that the countries were expected to join. Now this close relationship between all the members and the most stable countries, primarily Germany, has been broken and signals from the market about individual countries will be of more value.

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[25] One of the reasons that Ireland is managing to cope with the massive downturn and fiscal restructuring it is facing is that there has been a major exodus of the population since 2008, thus inter alia easing the potential demands on social benefits.
[26] With such low public debt it was quite difficult to come up with a reference ten-year bond rate to compare with the other countries to establish convergence under the interest rate criterion.

Interest rate convergence was itself a contributor to the disequilibrium within the euro area as countries that were previously an inflation risk and hence attracted high interest rates got a major gain on entry to Stage 3 through the interest rate reduction.[27] This helped stimulate faster growth. By the same token that the single monetary policy cannot respond to individual country adverse shocks so it is true for these positive shocks. As a result not only do countries grow faster but they experience greater inflation than they would if they had a domestic monetary policy that could respond to domestic pressures. Thus positive as well as negative shocks have disadvantages in EMU although in the former case it takes a lot longer for them to emerge. With a positive shock there is a very clear benefit at the outset with improvements in GDP per capita and reductions in unemployment but the downside is that the increasing real wages tend to overshoot, reducing competitiveness and meaning that regaining competitiveness has to be achieved by deflation, at least in relative terms, which is a painful process.

Ireland is perhaps the most important exception to the general picture as it did not start the crisis with a debt problem but encountered a debt problem as a result of the great cost of bailing out its failing banks. In part this was a self-imposed cost as Ireland issued a blanket guarantee in September 2008 thereby protecting all creditors and not just depositors (Honohan 2010; Lane 2010). This has proved hugely expensive and nearly brought the country down as well as the government. Nevertheless, the fact that it does appear possible for Ireland to survive shows that shocks can be absorbed under the euro area system and that it is prior fragility from high debt which brings countries down not the EMU rules *per se*.

Addressing the fiscal problem

There are two levels at which the fiscal issues can be addressed in the EU framework. The first is for the euro area countries to agree a revised preventative arm to the SGP, which members actually adhere to. This is the route chosen in the 21 July 2011 agreement and forms part of the 'six-pack' of measures. Building prudence into the consti-

[27] One might also argue that some of the interest rate premium was because of default risk, which also fell to near zero on the expectation of EMU membership, because lenders expected that the system would avoid defaults by one means or another.

tution or law and having independent fiscal councils also forms part of the measures. The worsening in the debt position in the euro area is general so a clear downward path in the medium term is required. At present, the members are required to get back inside the excessive deficit procedure by 2013, i.e. to have an actual and projected deficit of less than three per cent of GDP by then, although some will clearly not be able to make it by then. Thereafter they need to move at least to balance if they are to start repaying debt. The problem is that the faster they grow, the faster the debt ratio will fall for any given financial balance. On top of that for any given structure of the fiscal system, the faster the growth rate, the higher will be the surplus/lower the deficit. The proposal of introducing mandatory good budgeting principles into the law (constitution) of each member state would help prudence, somewhat along the lines of the balanced budget legislation in many US states (Poterba 1995; Hou and Smith 2010).

The second would be to move towards greater fiscal integration. If the EU were more politically integrated then there would probably be a significant EU-level budget that enabled fiscal transfers to be made to states troubled by high debts and adverse shocks. However, one of the reasons that the EU has developed the way it has, rather than following the precepts of the McDougall Report (1977) which set out how to organise a low cost redistributive system, is that this was thought to encourage fiscal laxity – at that stage relating only to Italy although Belgium was building up problems. Fiscal federalism can develop where richer regions accept that those that have lower revenue raising ability or higher costs are not in a position to do anything about it. In the case of the member states with debt problems at present, it is in the main not a question of fiscal capacity or higher burdens from commonly agreed expenditure programmes. Ireland has above average GDP/head and the debt problem has been caused largely by poor financial policy and a non-sustainable budgetary stance (Honohan 2010; Lane 2011). It is difficult to see why fiscal transfers would be thought appropriate in these circumstances. The current arrangement of only going as far as providing access to loans at near the finest rates and negotiating a plan for recovery is understandable in the circumstances (There are limits even to this process as at some point those raising the debt at the finest rates will find that their own credit rating falls because of the size of the commitments).

While there are many who would like to go down the road of closer economic integration, it is not on the political agenda and would contravene what is labelled as the 'no bailout clause' in the Lisbon Treaty. In circumstance where each part of the euro area follows good fiscal standards then it might be possible to consider a measure of fiscal transfers beyond those inherent in the use of structural and cohesion funds. At present inequalities across the EU are addressed by co-financed investment projects in both physical and human capital. This approach has proven extremely successful in advancing Ireland from the bottom of the EU GDP per capita rankings when it joined to well above the average before the GFC. Spain, Portugal, Greece, Italy and all the new member states have similarly benefitted extensively. It does not, however, address the problem of short-term asymmetric shocks which heavily affect one area compared to the others.

There is of course a further dimension to either approach, which is to ensure that the costs of a sovereign default for the rest of the euro area and to the country itself are manageable, hence bringing the position in line with defaults by non-federal government entities in the United States.

The conditionality being imposed on the states borrowing from the EFSF follows standard practice in trying to encourage all the facets of the economic system that would lead to greater flexibility, some of which is under the general label of structural reform. By bringing the IMF into the lending programmes, the euro area countries have not merely managed to increase the funds available but have added credibility to the restructuring imposed and the process of monitoring its implementation over the future.

What is required for a successful and sustainable fiscal stance is not simply that debt is low enough but that countries have a sufficient insurance against shocks. The simplest example is the development of a sovereign wealth fund so that should a country find that foreign markets are effectively closed to it, it can nevertheless continue to finance a counter-cyclical deficit through running down assets.[28] Such financial assets are likely to be much easier to sell than the real assets that are to be sold by Greece. It is only in the event of a broader

[28] The Irish sovereign wealth fund was readily swallowed up by the scale of the crisis but did reduce the need to borrow (Whelan 2011).

international crisis that such assets might fall substantially in price and hence make avoiding the need to raise new debt in the crisis impossible. The pension and unemployment buffer funds that exist in Finland and Sweden are a smaller scale example (Mayes 2009).

Pursuit of fiscal rules on their own is not enough. The UK applied two main rules over the period from 1997 up to the crisis. The first was to limit the debt ratio to 40 per cent of GDP, thereby building in a cushion for shocks, and the second to limit borrowing to investment.[29] Similar such attempts to avoid using debt finance for current expenditure over the course of the cycle have existed elsewhere before, Japan for example. However, the underlying rationale that the investment will bring in future revenues, whether through taxation of increased incomes and activity or user charges, does not always follow as some investment, while socially meritorious, does not generate much in the way of an income flow. Indeed it may well generate increased streams of expenditure. Vulnerability to a shock and to over-optimism about sustainable expenditures in the face of good growth was very clearly illustrated in the UK despite the existence of such rules, with debt approaching 70 per cent of GDP and likely to double over the course of the crisis.

The experience of some of the more distressed euro area countries in the GFC is likely to make some of the new member states who are yet to join the euro more cautious about doing so. The debate is reflected very clearly in that which went on in Finland and Sweden before the euro was introduced (Mayes and Suvanto 2002). Both countries launched an expert commission of enquiry into the likely outcomes (published as Calmfors et al. 1997, in the case of Sweden and Pekkarinen et al. 1997, for Finland). Both concluded that there was no conclusive evidence one way or the other but Sweden concluded that in the light of this the sensible route was to delay entry until the country had reduced unemployment to low levels and established sufficient fiscal buffers that they could withstand a severe economic shock. As a result Sweden is still outside as the performance of the

[29] Having rules with a fixed ratio of debt to GDP only make sense if the taxing capacity remains constant. Large demographic changes can alter the sustainable budget balance considerably. Indeed, Calmfors and Wren-Lewis (2011) argue that there are no good simple rules. However, having a limit well below the Maastricht Treaty criterion of 60 per cent of GDP is clearly necessary if shocks are to be survivable.

economy has been at least as good as that of the euro area and flexibility in the exchange rate has been valuable. Finland on the other hand, which was rather further away from meeting the OCA criteria, argued that membership would force a change in wage setting and other labour market behaviour and hence the country should enter at the outset and then adjust rapidly thereafter. Finland's performance has been even better than that of Sweden and it is clear that it has been the beneficiary of two facets of membership: lower interest rates and an initially low exchange rate, leading to good competitiveness. Finland has indeed adjusted, with, until the immediate run up to the crisis, moderation in wage growth and steadily falling unemployment, albeit from very high levels. Finland has also been a model of fiscal rectitude, bringing down its debt from close to 60 per cent of GDP to nearly 30 per cent so that it could withstand a severe shock – which indeed it received in the GFC with a nine per cent fall in GDP – and establishing buffer funds for both unemployment expenditures and pensions.

Finland thus shows that by following the spirit of the Maastricht rules it is possible to succeed in the euro area, while Sweden shows that fiscal prudence outside and inflation targeting can also lead to a satisfactory outcome, with smaller real losses in the downturn. The key question, therefore, is whether the EU can devise a set of incentives that will be sufficient for states to comply with the new SGP rules.

One problem with the current rules is that they are asymmetric. Countries face constraints on their fiscal actions with the threat of fines in the event of non-compliance but they receive no prizes for prudence. This asymmetry is continued in the 'six-pack' of measures to improve economic governance approved on 4 October 2011. Overall a country that decreases a surplus by €1bn has exactly the same impact on the area's total debt as one that increases its deficit by the same sum. Prudent countries will get some benefits in terms of lower interest rates but once they attain AAA status further gains are rather limited. Hence motivation to improve on not just the minimum required but the general target for longer term debt is limited. This was not addressed in the 'six-pack' measures. Indeed the only sorts of ways that this could be implemented would be to give prudent members states some benefit through the EU budget, perhaps in terms of some rebate. A straight piece of symmetry with the idea of interest free deposits in the case of an excessive deficit would be the ability to borrow from the other member states at below the market rate. This does not sound a very likely proposition either.

Secondly it is very difficult to get round the problem that fiscal projections are highly inaccurate as they depend on growth assumptions. Furthermore any attempt to estimate 'through the cycle' measures can only be verified after the event. Hence it will be difficult to get over the inherent bias that falls in the actual rate of growth are viewed as being temporary whereas increases are quickly rationalized as being more permanent. Having an independent assessment, as in Sweden and the UK, may help, whether these are at the national level or performed by the European Commission.

One suggestion which has some appeal[30] is to issue euro area bonds for the first x per cent of a country's debt. Such bonds would be guaranteed by all the member states. Beyond that all debt would be on national responsibility only. In current circumstances, the more indebted countries would pay a sharp premium on this national debt. This would cut the borrowing costs for states in difficulty without impacting on the interest rates of the most prudent borrowers. If one wanted a strong incentive for prudence, then choosing x to be a fairly low value, such as 30 per cent, would make sense. However, several of the existing member states with AAA ratings have more debt outstanding than that and hence might find that their own borrowing costs rose at the margin. Choosing too high a value would threaten the credit rating of the entire system and would be counterproductive.

Strong arguments have been advanced (Issing 2011, for example) that debtor countries have a sufficiently strong hold over the rest of the member states because of the strength of the wish to avoid defaults that they will effectively be able to impose costs on the others. This is not immediately clear from the nature of the bargaining that has gone on thus far, including the 21 July and 26 October Agreements. What has been imposed on the borrowers is at the limit of what is politically achievable, pushing them much further is likely simply to

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[30] Although not to the French and German governments according to their 18 August 2011 communiqué, available at: <http://www.reuters.com/article/2011/08/21/us-eurozone-germany-schaeuble-idUSTRE77K0SW20110821>.

trigger the default. It is not clear what more could be achieved by closer economic integration. Clearly such integration cannot involve harsher restraint on these countries. It would have to offer some attraction to the prudent countries that would actually reduce the pressure on the indebted countries. That is difficult to spell out.

The European Commission (2010) has argued that as well as tackling fiscal imbalances through an enhanced SGP, the EU should consider the emergence of both internal and external imbalances among countries and this is implemented through the 'six-pack' measures. Thus the Commission will consider the savings and investment and current account balances on an annual basis, as part of the European Semester, with a view to deciding if such imbalances were excessive. In line with the SGP there is a preventative arm drawing attention to imbalances and encouraging action and a corrective arm where such corrections became mandatory through the agreement of the Council. It is difficult to make such a scheme as transparent and rule bound as the SGP and the idea has been widely criticized (Giavazzi and Spaventa 2010, for example). Imbalances might be picked up rather better through the process of macro-prudential supervision that has begun with the European Systemic Risk Board. Although such measures are inherently financial and do not relate directly to the real economy, sources of imbalance such as declining competitiveness and rising real exchange rates would be clearly identified. Such a framework would this look more deeply at structural and other fundamental features of macroeconomic policy.

However, what has been decided through 'six-pack' of measures on 4 October is to reinstate the more compulsive side of the SGP, augmented by a similar requirement for adhering to a stable medium-term outlook and a requirement to avoid excessive macroeconomic imbalances as described in European Commission (2010). This is an extension of the Euro Plus Pact agreed at the European Council in March 2011, which seeks to improve the competitiveness of the EU, to which the euro area members and most of the rest of the EU have been prepared to subscribe.[31] There are

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[31] Only Czech Republic, Hungary, Sweden and the United Kingdom declined to participate, mainly because it implied constraints on their behaviour beyond those agreed in the Treaty. The outline of the agreement is in the European Council Communiqué published on 20 April.

other requirements for greater transparency and statistical standards to ensure that the other member states are not so easily misled as they were in the case of Greece. The medium-term requirement is essentially a balanced budget requirement for countries that comply with the maximum 60 per cent ratio of government debt to GDP ratio and a declining ratio requirement for those whose debt is higher.[32] Failure to comply with any of these requirements, including the statistical standards, can result in a fine, in the form of a non-interest bearing deposit initially, which can be forfeited in the event of a continuing lack of compliance. In the case of excessive deficits and statistical infringements the deposit/fine can be up to 0.2 per cent of GDP and in the case of the macro-imbalances up to one per cent. An Excessive Imbalance Procedure (EIB) is thus added to the Excessive Deficit Procedure. The balance of effort is thus firmly on trying to stop problems emerging. Imposing penalties on those in difficulty simply makes the problem of correcting the difficulty worse.

One feature of the 'six-pack' that should help credibility is that to prevent recommendations for action and the imposition of sanctions, a qualified majority of states, excluding the one involved, must vote for this. Under the previous arrangements, member states had to vote in favour for such measures to be introduced. Reversing the nature of the majority required makes it much less likely that a weakening of the system can occur as in 2003 with the SGP.

It is obvious from the lack of response by financial markets and the widening spreads, particularly for Italy, that this set of changes is not yet convincing for the countries at risk. Unfortunately, while troubled countries look for immediate reductions in interest rate spreads so they can reduce the interest burden on their budgets while they struggle to restructure and return to a sustainable long-run trajectory, convincing evidence on how the revised measures are likely to operate will only be generated over a sustained period of time. That evidence would involve either compliance with all of the requirements despite difficult budgetary consolidation on the part of those who appear otherwise likely to breach the rules or the actual imposition of sanctions leading to change. Given the experience of

[32] These take the form of medium-term budgetary objectives and are linked to an annual growth assessment by the European Commission.

2003, seeing France and Germany actually pay sanctions or make unpleasant adjustments would help restore confidence.

Macroprudential supervision at an EU-level is now being addressed through the European Systemic Risk Board but it is not planned to give the ESRB operational tools to alter the behaviour of the member states. Actions will be limited to advice and moral suasion.

It is likely therefore that the EU will continue to operate with what can perhaps be described as a 'fair weather' system. Provided the pressures are not too great, countries will move towards a lower debt burden when the area is growing satisfactorily. But when problems arise they will tend to run deficits through the automatic stabilisers at least, in a way which is not symmetric with periods higher than average growth.

As it is inherent in the asymmetry facing the system that debt is run up much more rapidly than it is run down, this implies an optimistic view of the economic cycle if position is to continue to improve over the longer run. Countries will accept hardship in a crisis but it becomes rapidly difficult to apply this in normal times or for long periods. With the implicit adjustment period for Greece being 30-40 years from the framing of the 21 July agreement this implies considerable strength of will. Even with the reductions in the burden implied by the 26 October agreement similar requirements apply, as the restructuring requirements for Greece have increased not diminished. (What has changed is that the other member states, the IMF and bondholders have become much more pessimistic over the expected stream of debt servicing payments that following these requirements will generate.)[33]

Efforts for such long periods are not impossible. Germany did not complete the reparations for the First World War until long after the end of the second and the UK's repayment programme of debt to the US accumulated during the Second World War took half a century to pay back. Deciding at the outset whether this will happen is a combination of an act of faith and an assessment of whether the adverse consequences from failure to comply are likely to ensure

[33] Even after a 50 per cent write-down in privately held debt the debt ratio is still expected to stabilise at as much as 120 per cent of GDP in 2020.

compliance. History is clearly important and countries that get into difficulty tend to have an unfortunate history, so the process is reinforcing – in the negative direction.

Concluding remarks

The various proposals that are being put forward by the EU jointly, such as the 21 July and 26 October Agreements, and by individual member states, such as the Franco-German proposals of 18 August, are not as yet convincing markets.[34] One of the main reasons is that they are being drip fed and reflect obvious reluctance on the part of the participants. Convincing measures are usually sweeping in character and reflect an observable willingness to do whatever is necessary to address the problem.[35] The initial May 2010 measures with respect to Greece fell in that category. It was by no means clear at that date that over half a trillion euros would be required to address the problem.

In many respects therefore it is not that the agreed measures or likely developments in trying to enforce structural change and fiscal prudence and recovery will not work. It is that outsiders are not convinced that they will be fully implemented and be sustained. Insiders are also not convinced, with Finland demanding collateral from Greece for its own contribution to the bail out fund. The history of the SGP suggests that unless there is a fundamental change in attitudes towards fiscal prudence, most of the changes envisaged in its structure will have only a limited effect (Von Hagen 2010). Although it is currently the southern European countries that are most at risk, it is the large countries' actions in the past, particularly those of France and Germany, which have weakened the pressure for correcting and preventing problems and indeed have contributed most to the increasing total of euro area government debt.

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[34] Indeed some remarks, such as the Franco-German statement in Deauville on 18 October 2010 actually made matters worse by making bond holders fear that a compulsory bail in would be imposed at some date in the future, see: <http://www.elysee.fr/president/root/bank_objects/Franco-german_declaration.pdf>.

[35] Von Hagen (2010) argues, for example, that most of the proposed changes to the SGP are limited in character and while moving in the right direction will not achieve a lot. Establishing fiscal councils might however change the nature of the political discussion towards debt and the adoption of a framework for managing defaults smoothly would act as a major incentive.

In some respects the euro area countries have made the problem worse for themselves by in effect taking so much of the troubled countries' debt onto their own books, either through the official EFSF and European Financial Stabilisation Mechanism (EFSM) lending or through the purchases of the ECB. Even the IMF debt is potentially a burden for the euro area (either through the ESM or a write-down of the outstanding privately held debt) as the IMF is preferred creditor and hence will get paid out first.

It is thus likely that if current proposals are seen through, the debt position in the euro area countries can return to sustainable levels. Although the intention is to try to rein in deficits by 2013 or more likely by 2015 if growth does not pick up, the downward path for debt ratios could easily take 20 years to achieve. Some form of relatively crude fiscal rules that are easy to monitor and difficult to evade will no doubt help, as would independent fiscal councils to ensure that there is a good public debate and that some of the causes of deficit bias are restrained. The 'six-pack' of measures agreed on 4 October are a step in that direction. The concern is with the extreme cases. However, even if the process should fail at some point for Greece or another heavily stressed country, this will be more a comment on over-enthusiasm for euro area membership in the past than the indication of a fundamentally flawed mechanism for countries starting with a compliant deficit. The fiscal shocks experienced in the global financial crisis are unusual but even so the well prepared countries look able to see themselves through without incurring downgrades from the rating agencies.

The nature of the bail out process over the crisis is, however, more open to question. It appears that there has been a considerable transfer of potential loss from the lenders, who knowingly took it on, to the taxpayer. This reflects a lack of preparedness. But the introduction of collective action clauses in sovereign bonds is likely to offset some of the moral hazard this has caused. The ironic consequence, however, is that raising debt will become more expensive at a time when budgets are already strained.

Perhaps the most telling aspect of the crisis and the steps being used in its resolution is that it has had utilise inter-governmental co-operation rather than Community methods. The EU does not have clear crisis resolution structures in place nor is the whole process of closer integration designed to handle the allocation of losses. It is founded on the presupposition that closer integration will provide gains for all and, as in the cohesion funds, the only extra step required would be that the greater gainers redistribute some of their gains so that all experience the social cohesion sufficient that they all feel they are gaining. Allocating losses is a much more unpleasant business and readily generates a process of mutual blame, whereby no country wishes to accept losses for events for which it does not feel responsible. Hence none of the other countries are enthused by the idea of accepting a portion of the losses incurred by the heavily indebted countries and non-euro area countries, such as the UK, which appreciated the dangers of being in the single currency yet subject to adverse idiosyncratic shocks, are very reluctant to assume any of the losses from those who did not appreciate the problem.

It is easy for democracy to lose out in the need to achieve rapid and convincing resolution of crises. Nevertheless, popular discontent has held the countries that have the resources for resolving the problem from committing them. It appears after the 9 December agreement that a Treaty change and, where felt necessary, referenda, will be required to cement the way forward. In fragile times, referenda will always prove difficult and hence the future will be anything but easy.

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Appendix 8.1: Tables and figures

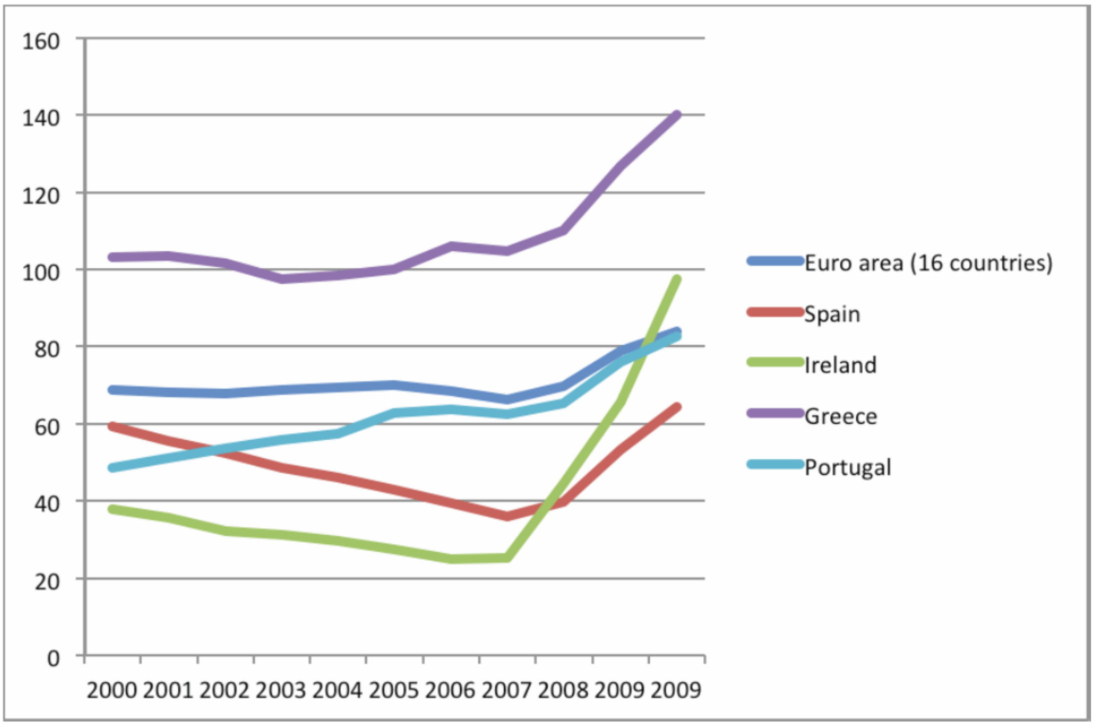

Figure 8A.1: Government Debt to GDP ratio.

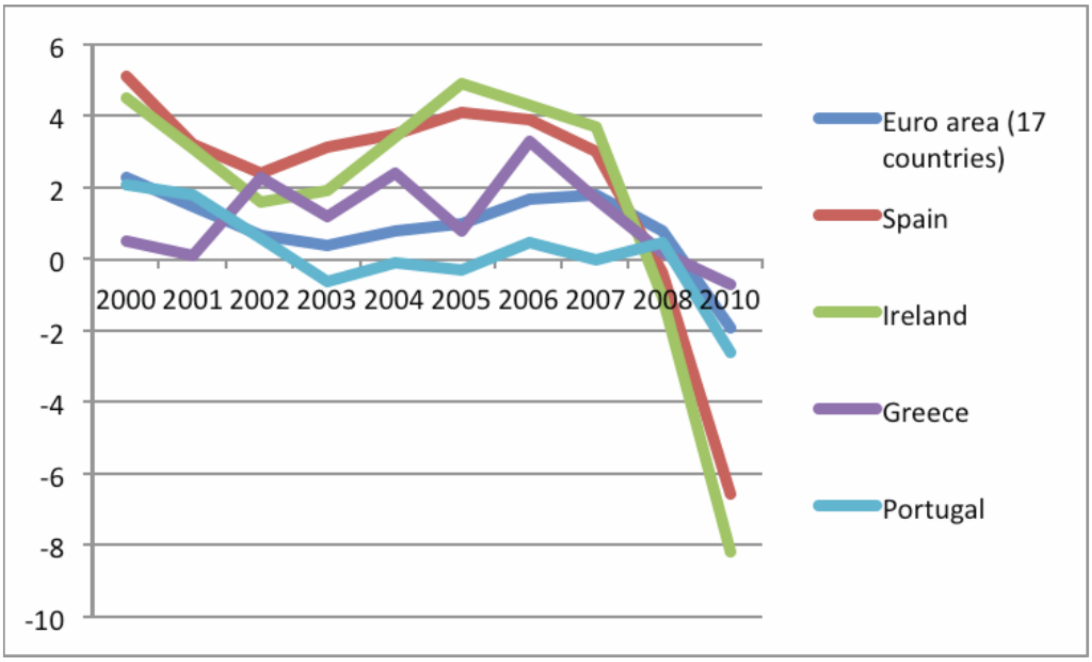

Figure 8A.2: Governments Primary Balances.

Source Eurostat, cited in Marimon (2011: 4-5).

Table 8A.1: Differences in growth rates in the euro area.

	Average									Projections		
Real GDP	**1993-2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2016**
Advanced Economies	**2,8**	**1,9**	**3,1**	**2,7**	**3,0**	**2,7**	**0,2**	**-3,4**	**3,0**	**2,4**	**2,6**	**2,4**
United States	3,4	2,5	3,6	3,1	2,7	1,9	0,0	-2,6	2,8	2,8	2,9	2,7
Euro Area	2,1	0,8	2,2	1,7	3,1	2,9	0,4	-4,1	1,7	1,6	1,8	1,7
Germany	1,5	-0,2	0,7	0,9	3,6	2,8	0,7	-4,7	3,5	2,5	2,1	1,3
France	2,0	1,1	2,3	2,0	2,4	2,3	0,1	-2,5	1,5	1,6	1,8	2,1
Italy	1,6	0,0	1,5	0,7	2,0	1,5	-1,3	-5,2	1,3	1,1	1,3	1,4
Spain	3,2	3,1	3,3	3,6	4,0	3,6	0,9	-3,7	-0,1	0,8	1,6	1,7
Netherlands	2,9	0,3	2,2	2,0	3,4	3,9	1,9	-3,9	1,7	1,5	1,5	1,8
Belgium	2,3	0,8	3,1	2,0	2,7	2,9	0,8	-2,7	2,0	1,7	1,9	1,9
Austria	2,2	0,8	2,5	2,5	3,6	3,7	2,2	-3,9	2,0	2,4	2,3	1,8
Greece	2,7	5,9	4,4	2,3	5,2	4,3	1,0	-2,0	-4,5	-3,0	1,1	2,9
Portugal	2,7	-0,9	1,6	0,8	1,4	2,4	0,0	-2,5	1,4	-1,5	-0,5	1,2
Finland	3,5	2,0	4,1	2,9	4,4	5,3	0,9	-8,2	3,1	3,1	2,5	2,0
Ireland	7,7	4,4	4,6	6,0	5,3	5,6	-3,5	-7,6	-1,0	0,5	1,9	3,4

Source IMF, *World Economic Outlook*, April 2011.

Appendix 8.2: The 21 July 2011 agreement

The agreement set out in the communiqué from the heads of state or government of the euro area[36] has seven main ingredients:

(1) a doubling of the size of the funding support programme for Greece from 109 billion euro to 218 billion.

(2) an extending of the term of the facility from 7.5 years to 30 years with 10 year further transition period.

(3) a reduction in interest rates (also applies to Portugal and Ireland) so that the premium over the EFSF's borrowing rates is not so large.

(4) a voluntary roll over programme by the private sector amounting to 36 billion euro after the cost of credit enhancement by the EFSF (a figure of 106 billion euro up to 2019 is also quoted).

(5) a task force to help Greece make maximum use of the structural funds for economic growth and recovery.

(6) widening of the terms of the EFSF (and ESM) ability to intervene by permitting purchases in the secondary market in exceptional times.

(7) a strengthened preventative arm for the SGP.

[36] Available at: <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf>

Appendix 8.3: The 26 October 2011 agreement

This agreement has seven main elements:[37]

(1) Additional financing for Greece up to 100 billion euro.

(2) An agreement to discount Greek government debt held by private investors by 50 per cent, in part financed by 30 billion euros from the other member states.

(3) A gearing of the EFSF to around one trillion euro (by methods to be announced later) involving credit enhancement and increased funding.

(4) Recapitalisation of the banking system by June 2012 to a 9 per cent Core Tier 1 ratio – financing to be provided by governments should banks need or wish it (without deleveraging).

(5) A new restructuring package in Italy following on the packages in Greece, Spain, Ireland and Portugal.

(6) Further enhancement to the 'six-pack' measures to ensure better economic governance, in particular a set of 10 measures to ensure the better functioning of the Eurogroup, including twice yearly summits at Heads of Government level and an enhanced secretariat.

(7) Further measures, perhaps including treaty changes, to be proposed by December 2011.

[37] A summary of this agreement is available at: <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf>.

Chapter 9

European sovereign bailouts, political risk and the economic consequences of Angela Merkel

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Introduction

The Greek debt crisis has caused the euro's first financial crisis and pushed the European Union (EU) to the brink of collapse. This crisis has raised important questions about the management of macroeconomic stabilisation policies in the euro area. Good crisis management reassures markets, avoids panics, and then concentrates on fixing fundamentals. By contrast, bad management signals uncertainty among policy makers, confuses observers and generates panics. Of course, there is also nothing new about confusions in a financial crisis. The 15th century Tuscan banker Alamanno Acciaiuoli wrote during the 1465 banking crisis in Florence: "the poor are without bread, the rich without brains, and learned men without good sense" (Goldthwaite 2009: 456). Little has changed since then.

Prior to the euro crisis, it was thought that markets would discipline member states with large or excessive deficits (Codogno et al. 2003). This turned out to be wrong. From the beginning of monetary union until the Lehman crisis, sovereign bond yields in the euro area moved together with minimal spreads. During this time some governments, like Greece, did not face hard budget constraints imposed by markets and they borrowed more than allowed under the Stability and Growth Pact. Others, like Ireland and Spain, enjoyed a property bubble fuelled by low interest rates that filled their treasuries. These happy days ended with Lehman Brothers. In many Southern European member states, sovereign bond spreads suddenly shot up to levels that, if they persisted, would make sovereign debt unsustainable. While markets first were negligent to default risk, they now panicked. Greece was the first to be cut off from market liquidity, Ireland and Portugal followed. Also Spain and Italy were repeatedly coming under pressure. When the European authorities started to bail out some of these countries, they encountered a lot of political resistance, especially in Germany. But in the end, governments intervened to stabilise markets and prevent the melt down of the euro.

All financial crises are in the end banking crises. They start with a bubble caused by exuberant optimism in the private sector, when investors speculate on sustained rises in asset prices. In Europe, major asset bubbles occurred in Ireland's and Spain's property markets. But even before European Monetary Union (EMU) began in 1999, so-called convergence trades caused sustained rises in prices for Southern European government bonds. Banks kept a large part of these securities in their portfolio. However, when shocks hit inflated asset prices, a crisis is unavoidable. Given that they are subject to asymmetric information, investors change their perception of risk and raise their liquidity preference. In the euro area, the initial shock was the Lehman bankruptcy, which generated fears about other banks defaulting. The resulting credit crunch caused a sudden and deep recession and public revenue collapsed. Governments found it increasingly difficult to finance the huge deficits by borrowing from risk averse and panicked investors. Hence the supply of securities increased, while demand fell; not surprisingly, bond prices of Southern governments collapsed and yields shot up. At this point, the crisis became systemic, because the falling asset prices deteriorated the balance sheets of banks, which had previously bought southern bonds during the convergence boom. With the decline in the value of assets and liabilities nominally fixed, banks' capital shrank and the capital adequacy ratio (the ratio of capital to assets) fell. Hence banks had to sell assets and the price rod accelerated. Liquidity in the interbank market dried up as banks were unable to judge which banks were safe and which were not. This is the European version of a bank run.[1] Now the European Central Bank (ECB) had to step in as a lender of last resort (Freixas et al. 2000). Thus, the link between a sovereign debt crisis and a banking crisis are bond prices.

Gary Gorton (1988) has made the analytic distinction between panics based on a 'failure hypothesis' when investors fear either the default of a large corporation, and others based on the 'recession hypothesis' when they fear a deep recession. But these two aspects interact. The bankruptcy of Lehman generated fears of further corporate failures, and this fear aggravated the recession because it caused a credit crunch. But the recession reduced government revenue, which in return generated the fear of sovereign defaults. The European economy was hit by a second shock in late 2009 when the newly elected Greek government of Papandreou discovered that the previous Karamanlis administration had knowingly deceived voters and lied to European authorities on the effective public deficit in Greece. The subsequent loss of trust in the governance of Europe's Stability Pact reduced the willingness of the financial markets to lend to highly indebted governments. It is possible that without this shock, the euro area could have muddled through the crisis, as Japan did in the 1990s or the USA after Lehman. However, this was only the beginning. The crisis deepened as a consequence of political uncertainty. Were national governments going to bail out distressed sovereign debtors or not? The German government said no and then did it anyhow. Some actors sought to involve the ECB, which could have weakened its credibility. Politicians, journalists and academics made sometimes outrageous claims, which gave them media spotlight – and confused everyone. National governments seemed to be 'without good sense', although in the end they always came at the euro's rescue in the last moment.

The German government had a particular role in this respect. Germany is seen as the *économie dominante* in the euro area. It had pulled out of the recession more quickly than others, and fiscal consolidation was more advanced than elsewhere. German current

[1] Most of the literature on banking crises models bank runs as loss of trust in their bank by depositors. But arguably, with deposit insurance the interbank market has become more important. Freixas et al. (2000) have shown that the freezing of the interbank money market is equivalent to a classical bank run.

accounts were in surplus and it seemed evident that Germany had the means to rescue Greece. Instead, Chancellor Merkel and the leading political establishment in Germany signalled that they would prefer to expel Greece from the European Monetary Union[2] rather than commit taxpayers' money to bail out lazy southerners.[3] Repeated conflicts between France and Germany also caused a sense of lack of leadership. Not surprisingly, these contradicting signals irritated markets. As the crisis got worse, the German and French governments finally pulled in the same direction, but a lot of damage was done.

The major vulnerability results from the impact of government bonds on the balance sheet of banks. When governments are no longer able to fund their public borrowing requirements from private markets, the excess supply of bonds will cause the price of debt to fall and yields to go up. If governments can no longer refund their debt service, they will have to default. Either way, the value of bank assets is negatively affected. If banks deleverage to restore their balance sheets, the credit crunch will cause a recession and make the debt problems worse. Thus, in the interest of maintaining the functioning of the euro banking system, illiquid governments have to be bailed out. We define a bailout as the discretionary provision of liquidity to a borrower, here governments but also banks, in reaction to an adverse shock that causes abnormal demands in liquidity that cannot be met from an alternative source. This definition implies that bailouts are effectively made by a lender of last resort (see Freixas et al. 2000). For foreign debt, this often requires the International Monetary Fund (IMF) to intervene; in nation states with national currencies, the bailout is usually done by the central bank for debt denominated in national currency, although this bears the risk of higher inflation. In the European Monetary Union, which has established price stability as the primary objective and financial stability as a necessary condition for it, the ECB may assume the role of lender of last resort in the very short term but in the long run it must maintain the hard budget constraint by keeping money scarce.

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[2] See her declaration in: Deutscher Bundestag, 17. Wahlperiode, 30. Sitzung. Berlin, 17 March 2010, p. 2,719.

[3] Chancellor Merkel declared on 17 May 2011: "We cannot have one currency and someone has a lot of holiday and the other very little. In the long run this does not go together". Available at: <http://www.tagesspiegel.de/politik/merkel-fordert-einheitliches-rentenalter-in-europa/4187960.html>.

In the last instance, the bailout would therefore have to come from other euro area member states.

Traditionally, the function of lender of last resort (LLR) is fulfilled by central banks with respect to banks that are hit by a run. In the euro area, the ECB has assumed this LLR-role impeccably by implementing unorthodox measures, such as the Securities Markets Programme (SMP), and the by open market purchases of excessively high-yielding sovereign debt (see ECB 2011). Since Henry Thornton and Walter Bagehot, it is generally accepted that central banks can and should provide all the necessary liquidity for solvent debtors against 'good' securities. In reality it is not always clear whether a debtor's difficulties are due to liquidity or solvency problems. However, if the function of banks is maturity transformation and the central bank issues liquidity to banks against sound long term debt, then the lender of last resort is in principle unproblematic, as long as the banks' assets are 'good'. But if the solvency of a debtor is in doubt, this is no longer true. The central bank could then refuse 'bad' paper issued by risky sovereigns in its refinancing operation to the banking sector, but that would push banks into a liquidity crisis. Alternatively, if the central bank buys government bonds in open market operations and the debt issued by the sovereign is unsustainable, the central bank liability (which is always a claim on an asset) becomes worthless and if this effect is large, the central bank could lose control over money supply. It is sometimes claimed that central banks need to be backed by strong governments, because these have infinite power to tax and print money. But governments' power is not absolute. Their taxing capacities are politically constrained and printing fiat money without real asset backing generates currency crises and high inflation.[4] It is therefore a myth that central banks have an unlimited capacity to supply money, even in traditional nation states (Goodhart 1999). The Greek crisis shows that the willingness-to-tax by the Papandreou government did not solve the debt crisis but made it worse by throwing the Greek economy into depression. The real constraint on central bank bailouts is therefore the commitment to monetary (i.e. in this case price) stability and not, as de Grauwe (2011) and others have claimed that governments issue debt in 'foreign' currency. However, contrary to

[4] Buiter (2008) has pointed out that the return on the inflation tax has a Laffer curve shape, meaning it becomes ever less efficient the higher inflation rises.

what some German economists seem to believe, the commitment to price stability is not a sufficient condition to solve the problem of financial instability and writing off sovereign debt and pushing the cost on banks will make a return to satisfactory economic growth even more difficult (see Lucke 2011).

In any country that issues its own currency, including Euroland, unsustainable public debt would cause a currency crisis. The euro exchange rate has remained reasonably stable, because aggregate euro debt is not excessive when compared to the United States or Japan. However, the problem is distributional: some member states have large debt ratios, others do not. In principle high-deficit countries could be funded by low-debt member states. *A priori* this does not impose undue burdens on lenders, for credit is a form of wealth, and taxpayers in lending states would build up assets, which they should be able to liquidate in the future. From this point of view, bailing out a member state in the euro area is, like banking: a form of maturity transformation. Illiquid claims on, say, future Greek tax payers are liquidified by other member states, say Germany, which dispose of greater liquidity margins. However, this story turns nasty if the borrowing state defaults, for then the foreign taxpayer loses the asset claim and her wealth is reduced. Given this possibility, each member state has a desire to minimise its own contribution to the collective bailout and the resulting collective action problem is likely to generate the under-provision of bailout funds. This collective action problem, which resembles a prisoner's dilemma, is likely to cause a further fall in bond prices and could (re)ignite a banking crisis.

The euro area's problem is therefore, first of all, a problem of governance. Because, by definition, member state governments have to serve their national constituencies first, they will limit the exposure of national tax payers to potential losses from defaults, and their communication in a crisis is dominated by discourses that say "no, we can't". Not by coincidence have the media named Mrs Merkel 'Madame No'. Nevertheless, assuming that the benefits from having the European Union, a single market and a stable currency are clearly recognised, the rationality of preserving the system should be high enough on the priority list that ultimately governments will provide the necessary bailout. Saying 'No' may then simply be a step in a drawn out bargaining process that aims at limiting national bailout contributions. But even if governments made *ultimately* optimal decisions, the noise around the decision-making process will raise the cost of a bailout more than it would be if the decision-making authority was centralised at the level of a European economic government. A centralised European economic government could minimise these costs by eliminating collective action problems and reducing the noise and uncertainty in the bailout process. By contrast, the cost of decentralised governance shows up in the high yield differentials on sovereign debt between deficit countries and the benchmark German *Bund*, in the need for larger bailouts and the higher risk of bank failure. It follows that a centralised macroeconomic government is in the interest of all European tax payers, as it reduces the cost of bailouts and risks of defaults and bank crises.

This chapter seeks to estimate the evidence for such cost. We will first present a model for optimal bailouts. The third section describes the political and economic setting and the independent variables. This will be followed by a discussion on the explanandum and presentation of the results of a GARCH model, by which we estimate the political noise. The last section concludes.

The model

We propose a model[5] for the euro area, where all public sector borrowing is financed by issuing bonds. Private markets hold a portfolio of two assets, risky and riskless government bonds. For linguistic convenience, we will call the risky bonds 'Greek' and the riskless 'German'. For risky bonds the return varies with different states of the world. To keep things simple, we look at the comparative statics of one period, where decisions are influenced by previous realisations and future expectations.

When deciding how much of these bonds they will keep in their optimal portfolios, private investors use all publicly available information. If the supply of risky Greek bonds exceeds what markets are willing to hold at given prices, the excess supply will push bond prices down and yields up, unless other governments or the European Union 'bail out' Greece. By *bailout* we mean a non-market intervention with the purpose of stabilising bond prices and yield spreads. In the context of the euro area, the intervening authorities are a syndicate of governments or a lender of last resort like the ECB

[5] The model was inspired by Calvo (1993) and Grossman and Stiglitz (1980).

or the European Financial Stability Facility (EFSF).[6] We will refer to these authorities alternatively as 'governments' or 'the Union'. While bond prices vary in private markets, bailouts are modelled as bond purchases at par.[7]

The purpose of the bailout is to prevent a fall in bond prices that could destabilise the banking system. Falling bond prices would not only damage banks' balance sheets, but generate yield spreads between risky and risk-free assets that may make Greek debt unsustainable. Thus, yield spreads depend on investment decisions made by private operators and on bailout decisions made by governments. Governments have privileged information about Greece's macroeconomic variables and policies, especially fiscal policies (i.e. the supply of bonds) and monetary policy (i.e. the supply of liquidity to banks). This assumption reflects the close cooperation within the European institutions (Council, Commission, ECB).

Because of asymmetric information, the private sector takes decisions after observing what governments reveal about their intended policies. In the European Union, policy decisions are the result of messy negotiations between member states and with European authorities. They often reflect compromises and/or the preferences of the most powerful member state government(s). These compromises are easily challenged by domestic opposition within member states, or by other member states, and as a consequence the communication about public policies is frequently disturbed by noise (signalling errors). The higher the noise, the larger is the uncertainty among investors about government's intended policies. Investors are risk

[6] Thus, our definition of bailout is compatible with TEU article 125.1, which says: "The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project." The reason is that if the Union buys bonds issued by member states, they are and remain a liability of the issuer, while they are an asset in the portfolio of the institution (member state) that buys them.

[7] This is equivalent to saying that the Union lends money directly to the Greek government.

averse, so that higher uncertainty lowers the willingness of the private sector to hold risky assets.

Let $\bar{B}_i$ and $\bar{X}_i$ denote the given total supply of safe German and risky Greek bonds respectively. The bonds are held by investors in the private sector *P* or by Union governments *G*. The total supply of riskless German assets is:

$$\overline{B} = \sum_{i}^{P,G} \overline{b}_i, \quad for \quad i = \{P, G\}$$

and of risky Greek assets it is:

$$\overline{X} = \sum_{i}^{P,G} \overline{x}_i \quad .$$

The individual investor's budget constraint satisfies:

$$(1) \qquad px_i + b_i = \overline{b}_i + p\overline{x}_i$$

The price of risky assets in terms of the safe asset is p. Hence, the price of German assets is always equal to 1. The return for safe German assets is ρ and for risky Greek assets $r_{t.}$ Thus, future wealth of actor *i* is:

$$(2) \qquad W_i = \rho b_i + rpx_i$$

The demand of assets is determined by the optimal portfolio allocation at given prices $p_{t.}$ The change of the relative bond price *p* is a negative function of the excess supply of bonds:

$$(3) \qquad \Delta p = p(\overline{X} - x_P(p_t) - x_G), \quad with \quad p' < 0.$$

Changes in bond prices determine the bond spread, which is $\frac{r}{p} - \rho$, and the extra return required for holding a risky bond in the private sector's portfolio at given prices is $r - \rho p$.

We will assume that the private market's asset allocation is dependent, *ceteris paribus*, on the relative bond price *p*, but the Union will bail out Greece's risky assets at face value. Following Stanford

Grossman and Joseph Stiglitz (1980) we assume an exponential utility function for wealth:

(4) $V(W_i) = -e^{-\beta W_i}$

Where β>0 is the coefficient for absolute risk aversion. Before we determine the optimal portfolio, we need to discuss the returns on assets. We take the return on riskless German assets as given and model the return on risky Greek assets as a stochastic process:

(5) $r_t = s_t + \varepsilon_t$

s_t is the function of a set of fundamental economic parameters, such as capital productivity, the debt ratio, deficits, growth, and competitiveness, all of which jointly determine the solvability of Greek bonds. Thus, s_t is the accurate signal for the return on Greek bonds given the state of economic fundamentals and ε_t is a white noise error. We assume that *s* and *ε* are normally distributed $s \sim \mathrm{N}(\bar{\mathrm{s}}, \sigma^2)$, $\varepsilon \sim \mathrm{N}(0, \nu^2)$. It follows that the extra return $s - \rho p$ required for holding Greek bonds, given full knowledge of the economic policies pursued by the Union.

Proposition 1. Uncertainty in the private sector is higher than for governments.

Proof (Enders 1995): Insiders in governments do not know ε_{t+1} , but s_t and the two respective distributions, while private operators do not know ε_{t+1} or s_t and only the distributions of *s* and ε. It follows that the expected return for governments from bailing out Greece is $E_t(r_{t+1} \mid G) = s_t$ and the expected return for the private market of holding Greek bonds is $E_t(r_{t-1} \mid P) = \bar{s}$. The forecast error variance *for governments* is:

(6) $E_t\left[(r_{t+1} - s_t)^2\right] = E_t\left(\varepsilon_{t+1}^2\right) = \sigma^2$.

If we assume[8] momentarily that $\{s_t\}$ is a stationary AR(1) process such as $s_t = a_0 + a_1 s_{t-1} + \varepsilon_t$, with mean $\bar{s} = \frac{a_0}{1-a_1}$ and 0< $a_1 < 1$, the error variance *for the private sector* will be:

$$(7) \qquad E_t[r_{t+1} - \bar{s}]^2 = \frac{\sigma^2}{1-a_1^2}$$

which is larger than the forecast error for governments because $(1-a_1^2) < 1$. *Q.e.d.*

The private sector could improve its investment performance if it knew the model s_t by which governments decide to bail out Greece. However, the $\{s_t\}$ process is based on confidential information available to governments, while private investors only know actual realisations of r_t. They could try to obtain information from past realisations which would improve on the unconditional error variance by calculating the conditional variance of the risky return as:

$$(8) \qquad Var(r_{t+1} \mid r_t) = E_t(r_{t+1} - a_0 - a_1 r_t)^2 = E_t(\varepsilon_{t+1}^2)$$

The question for private operators is then what drives the error process $\{\varepsilon_t\}$? Given the messy governance of the euro area, there will be lots of noise and uncertainty as to what governments will actually do. One may, therefore, model the conditional variance of the return on Greek bonds as a multiplicative conditionally heteroskedastic process first proposed by Engle (1982):

$$(9) \qquad \varepsilon_t = \kappa_t \sqrt{\alpha_0 + \alpha_1 \varepsilon_{t-1}^2}$$

Where $\{\kappa_t\}$ is a white noise process with $\sigma_t^2 = 1$ and κ_t and ε_t are independent from each other, and α_0 and α_1 are constants such that $\alpha_0 > 0$ and $0 < \alpha_1 < 1$. In this case, the error sequence $\{\varepsilon_t\}$ still has the

[8] The argument that follows does not depend on this assumption, but it simplifies the argument and exposition.

unconditional mean of zero, the constant variance v^2 and the errors are uncorrelated. However, the conditional variance of the error process is now dependent on the past history of ε_{t-1}.

(9a) $$E(\varepsilon_t^2 \mid \varepsilon_{t-1}) = \alpha_0 - \alpha_1 \varepsilon_{t-1}^2$$

If previous periods' errors were large, the conditional variance in *t* will also be large and the private sector has a noisy perception of risky returns. The conditional variance of the error term can be estimated by a GARCH (q, p) model from the observed data; it captures alternating periods of tranquillity and volatility.

It follows from equation (8) and (9a) that the conditional variance of the risky returns from Greek assets will go through periods of high volatility, depending on the nature and occurrence of shocks that hit the system. So far our system says nothing about how these shocks are generated. However, while the return s_t is known to policy makers (in fact their policies largely generate it), the forecast errors in the private sector must reflect political noise. When statements made by political leaders are clear and credible, markets will understand what governments will do and they will adjust their own strategies. By contrast, if the signals from governments are unclear, confused and contradictory, private investors will hesitate to take risky Greek bonds into their deposit for fear of making 'errors'. Thus, there is an additional risk factor for holding Greek bonds that is purely political and unrelated to the risk in economic fundamentals. We will refer to this as 'political risk'.

If the errors were normally distributed and investors were risk neutral, shocks should not affect the return on Greek assets. However, risk averse investors will ask for a premium that compensates them for holding risky assets. To assess that risk, they look at past errors, so that the conditional variance becomes the measure of noise. In this case, the rate of return that reflects fundamentals must be augmented by the political risk premium, which can be assumed to be an increasing function in the conditional variance of $\{\varepsilon_t\}$. For heteroskedastic political shocks, the return should be higher in periods of large noise and uncertainty. This political risk premium can then be estimated as an ARCH-M process (Engle et al. 1987):

(10) $$s_t = s_t^* + \delta h_t$$

where s_t^* is the risky return based on fundamentals (which may change over time, but, given our static framework, we take as exogenously set) and δh_t the political risk premium caused by noise in government communication. $h_t = \alpha_0 + \alpha_1 \varepsilon_{t-1}^2$ stands for the conditional variance of the error process (9) and $\delta > 0$ is a coefficient that measures the impact of noise on the rate of return.

Proposition 2. The larger the political noise, the larger is the need for bailouts.

Proof: We re-write equation (5) as:

(5a) $$r_t = s_t^* + \delta h_t + \varepsilon_t$$

and maximise public and private investors' utility function (4) for holding risky bonds (see Grossman and Stiglitz 1980). If the private portfolio is negatively related to the noise function for given bond prices, and Greek bond supply is fixed, then the Union has to absorb the excess supply of Greek bonds.

First, we determine the optimal portfolio for European authorities for bailing out Greece. Because the bailout price for the Greek bonds is always at par, the optimal portfolio for governments must satisfy:

(11) $$x_G = \frac{s_t^* - p\rho}{\beta v^2}$$

Because bailouts are at par, *p=1* in (11) and the optimal bailout portfolio is proportional to the extra return that would be required if bond holders had the insider knowledge of governments. If the two returns were identical, the extra return would be zero, which would imply that Greek assets are no riskier than German assets. Governments would not have to intervene in the bond market because private investors would buy up all the newly issued public debt at market determined prices.

However, private investors do not know s^*_t and they will therefore seek to infer its value from governments' will to bail out Greece. But the information about policies is subject to noise when policy makers make contradictory declarations. After a while the noise may subside and the effective actions by governments may become clearer to markets, but in the meantime private investors will either request a political risk premium or they reduce the share of risky Greek bonds in their portfolio.

One way to model this investment behaviour under uncertainty is to assume that private investors discount the value of government bailouts by the political risk premium that is generated by noisy governments. We can describe this discounted variable as:

$$\widetilde{x} = x_G - z \,, \tag{12}$$

Such that $z = x_G - \left(\frac{1}{1+\mu}\right)x_G = \left(\frac{\mu}{1+\mu}\right)x_G$, for $\mu = \frac{\delta h_t}{s^*_t}$.

Where z represents the noise variable. The higher δh_t, the louder the noise and the larger the risk premium.

Combining (11) and (12), we get:

$$x_P = \frac{s_t^*}{s_t^* + \delta h_t} \frac{s_t^* - p\rho}{\beta v^2} \tag{13}$$

The portfolio of private market operators will shrink when the political noise δh_t increases. Remember that δh_t is the conditional variance which exhibits heteroskedastic clusters of high and low uncertainty. Furthermore, if markets have a long memory, the negative effects of noisy political communication can be rather persistent.

If bond prices are to remain stable, bailout intervention is required to absorb the excess supply of Greek bonds. Hence, the excess supply, which is the difference between total Greek bond issuance and the optimal portfolio of private markets at a given price p_t and noise:

$$\hat{x}_G = \overline{X} - x_P(p_t, \delta h_t) \tag{14}$$

Because $x_P(p_t)$ falls, as the political noise δh_t increases, larger bailouts are necessary at given levels of Greek bond prices. *Q.e.d.*
Proposition 3. Bond prices will fall as public borrowing and political noise increase unless governments bail out Greece.

Proof: Inserting (13) into (14) and solving for p_t yields:

$$p_t = \frac{1}{\rho}\frac{s_t{*}^2 - (s_t^* + \delta h_t)(\overline{X} - x_G)\beta v^2}{s{*}_t} \tag{15}$$

Bond prices fall when the supply of risky Greek assets increases:

$$\frac{\partial p_t}{\partial \overline{X}} = \frac{-\beta v^2 (s{*}_t + \delta h_t)}{\rho s{*}_t} < 0 \tag{16}$$

They also fall with higher political noise:

$$\frac{\partial p_t}{\partial \delta h_t} = \frac{-(\overline{X} - x_G)\beta v^2}{\rho s{*}_t} \tag{17}$$

This expression is negative for $(\overline{X} - x_G) > 0$, meaning that the Union does not bail out the full excess supply. If the Union buys all Greek bond supply, bond prices are stable, even if the political noise increases.

The results in (16) and (17) are important when the private banking system is holding a substantial share of risky Greek bonds in its portfolio. For in that case, the losses in the bond market could destabilise banks' balance sheets and cause bank runs. Hence, governments may have to set a lower floor for bond prices in order to avoid financial crashes. Assuming this floor price is $\hat{p}$, the necessary bailout amount is $\hat{x}_G = \overline{X} - x_P(\hat{p}, \delta h_t)$ and only reducing the political noise or the Greek borrowing requirements can reduce the need for the Union to buy risky Greek bonds. A strategy to minimise government bailouts must therefore aim at reducing deficits and communicate clearly and coherently.

We will now estimate the impact of political miscommunication on Greek bond spreads. We take the communication of the German Chancellor Angela Merkel as a proxy for political noise. The reason is that Germany is the dominant player in the euro economy and Mrs Merkel's statements have frequently created uncertainty about Germany's commitment to support Greece or the euro.

The media-based variables: Data description

Our independent variables are based on a unique set of media data that contains information about political opinions and actions as well as about economic announcements of the Greek economy between January 2008 and September 2011. The data were published by Dow Jones International News, a real-time newswire focusing on business, financial and economic news from around the world. Its coverage involves foreign exchange, capital markets, and political news so that it is a crucial source of information for financial markets about the economic and political conditions in Greece.

We focus on Greece as it was the epicentre of the euro area debt crisis and the first to need financial assistance. As such Greece provides a suitable case to test the impact of media news on the interest spread between Greek and German government bonds. To assess the responsiveness of bond ratings to positive and negative news, we extracted news data from the Dow Jones International News through FACTIVA and coded the material with the software program MAXQDA. The coding of the variables is based on a codebook in line with the standards of a qualitative content analysis (Mayring 2008). It comprises all details regarding the search specifics and the coding guidelines for allocating text passages to the respective categories. It includes key words for finding important media articles and coding details for determining the tone of the article. High levels of coding accuracy and robustness of the data was achieved by repetitive sampling and coding.

In the coding guidelines we distinguish between two political and one economic news category. The following provides an overview of the independent variables that we generated from the Dow Jones International News Bulletin:

1. *Political Variable:* captures news from European institutions.

- *POL*: a binary variable with 1 if European news are reported on a day and 0 otherwise.
- *POLB*: support/solution is rejected or opposed.
- *POLU*: support/solution is postponed or uncertain.
- *POLG*: support/solution is implemented or supported.

2. *Merkel Variable*: captures news from Angela Merkel.
   - *MERKEL*: a binary variable with 1 if MERKEL news with respect to Greece are reported on a day and 0 otherwise.
   - *FMerkel2W:* captures the average number of Merkel statements over the previous two weeks.
3. *Economic Variable*: captures news from the three main rating agencies (S&P, Moody's and Fitch)
   - *ECON*: a binary variable with 1 if news from the rating agencies are reported on a day and 0 otherwise.

We designed the Political and the Merkel variables to capture political aspects that influence investors' risk perceptions for holding Greek bonds. The POL variable includes statements from informed representatives of the European Commission, the Parliament, the European Central Bank as well as the heads of the member states about their support for cooperation and financial aid. For instance, the statement *"European Union officials insist there won't be a bailout for Greece […]"* (DJ 17 March 2010) is coded as negative whereas the claim *that "European Central Bank President Jean-Claude Trichet sees no reason to doubt the solidity of other euro-zone countries after Greek's debt crisis* […]" (DJ 29 January 2010) is coded as positive due to their expected negative and positive effects on the interest spread. By contrast, Merkel is a binary variable controlling for when Angela Merkel participates in the discussion. We further constructed a variable indicating the frequency, with which Merkel news circulate as the effect of recurrent signals may be different than those of sporadic ones. The frequency is measured by the average numbers of Merkel statements over the previous two weeks.[9]

[9] We have experimented with several time lags but opted for the two weeks period due to its better performance in the estimates.

To test the effect of economic news on the interest spread, we designed the Economic variable, which documents the pronouncements of the three major rating agencies, Standard & Poor's (S&P), Moody's and Fitch. The rating agencies integrate past and present aspects of economic growth and unemployment of various actors and are therefore a powerful way to measure wide-ranging economic sentiments. Initially, we distinguished between a pessimistic and a positive outlook where we coded a downgrading of Greek bonds as negative whereas a stable or good outlook or a potential upgrading was coded as positive. However, in all but one case the data on the Economic variable belongs to negative the category so that it basically captures the effect of bad news.

Table 9.1: Distribution of the news variables.

from 01/1/2008 to 30/09/2011	MERKEL	ECON	POLG	POLU	POLB
0	900	934	919	936	926
1	79	45	60	43	53

The media-extracted categories were consequently transformed into categorical variables to allow for a better interpretation of their impact on bond ratings. More specifically, for each variable we build a dummy indicating whether the Dow Jones database releases corresponding news on a certain day. The distribution of these variables is summarised in Table 9.1. From the beginning of 2008 until the end of September 2011, we recorded statements from Merkel on 79 days, from rating agencies on 45 and from the European institutions on 156 days. As noted above the ECON variable mainly captures negative news effects whereas the MERKEL data are mostly classified as positive and as such reflect good news. The good-bad continuum is more evenly distributed for the EUS variable. Table 9.1 shows that although the category 'good' dominates, 'uncertain' and 'bad' news are also present on numerous days.

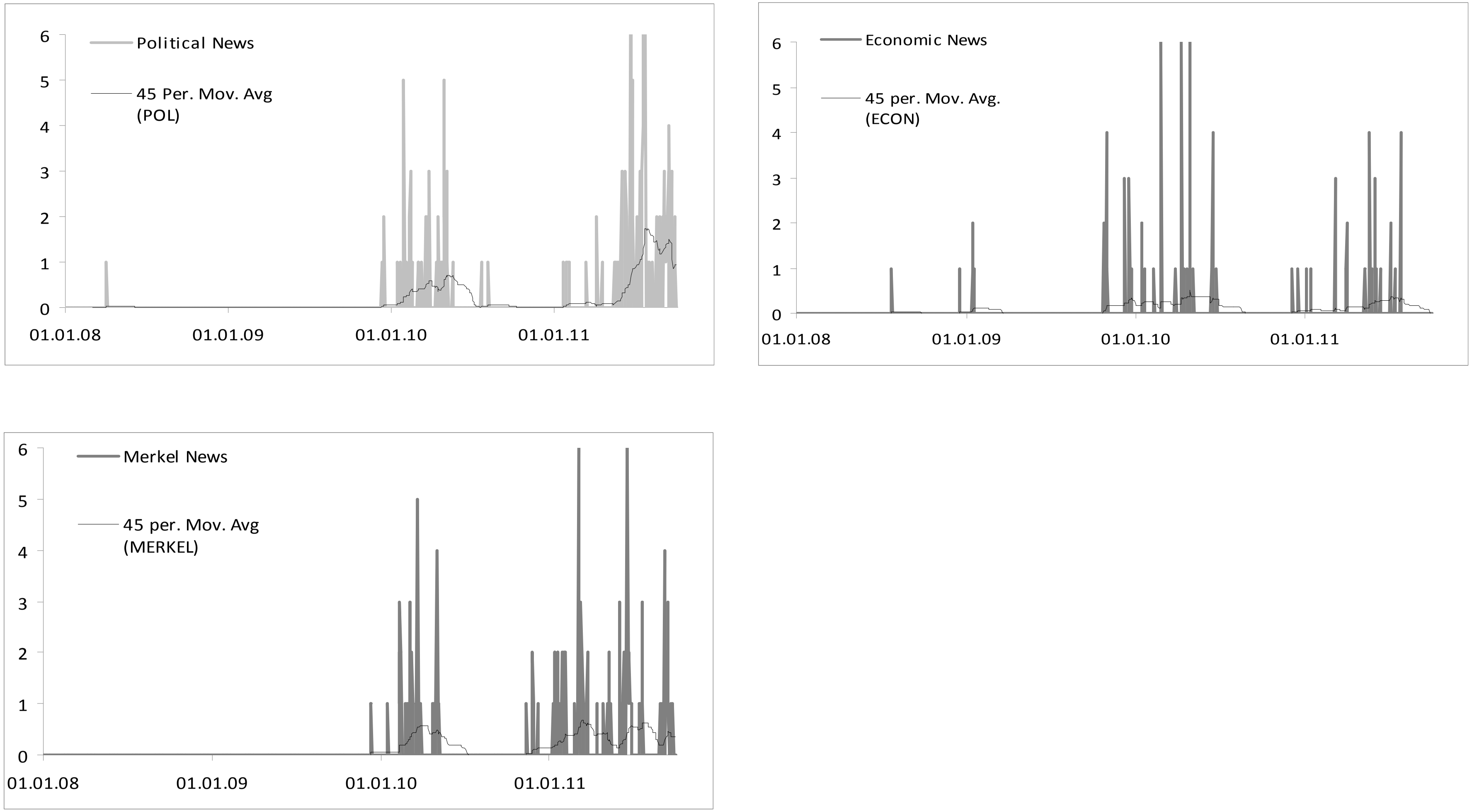

Figure 9.1: Timing and frequency of media statements.

In Figure 9.1 we plot the distribution of the three news categories, Political, Merkel and Economic, over time: the similarities of the timings are striking, above all between the political and the Merkel news as they exhibit similar strong concentrations in specific time periods. For all three categories the media coverage frequency picks up in December 2009. During this period, Greece's bonds were downgraded by Fitch to BBB+. Shortly thereafter Papandreou outlined the reforms with which his government planned to cut the public deficit. Among others, he proposed to cut social security spending by 10 per cent, to impose a 90 per cent tax on the bonuses of private bankers, to fight tax evasion and corruption and to drastically overhaul the pension system. The situation in Greece kept deteriorating: in February 2010 Papandreou announced further austerity measures and in April 2010 he started talks about financial support with the EU. The media coverage remained dense until mid-May 2010, when the European Union agreed on the first bailout package.

The first bailout package provided a short period of tranquility: the EFSF, which issues bonds and is backed by the member states' guarantees, aimed to safeguard financial stability in Europe by providing financial assistance to euro area member states. Among others, it provides loans to countries with financial difficulties; it can intervene in the debt markets and recapitalise financial institutions. Yet, the phase of tranquillity did not continue for long: in end of 2010 the news coverage picked up, once more and has not come to a halt since.

Since the beginning of 2011 the news has oscillated between negative and positive information. On the one hand, bad news have mainly emanated from or transmitted by the rating agencies. Greek sovereign bonds have continuously been lowered to junk status as the economic outlook has not recovered and default risk kept increasing. Yet, it is not only economic news that can be classified as bad. Also a substantial amount of political news can be grouped into that category (see Table 9.1). In fact, almost two thirds of the political news is classified as bad or uncertain. It means that financial support was either postponed, rejected or disapproved of by European political actors. On the other hand, these actors, including Merkel, provided a substantial amount of information and political action, which signalled their willingness to provide financial support to Greece and to keep it in the euro area. In sum, the information provided to uninformed financial market participants is quite ambiguous, which can enhance uncertainty and risk perceptions. It therefore seems crucial to disentangle the effects of the good and bad news. Do they significantly impact the interest rate spread in the Eurozone as investors change their preferences respectively? And if yes, in which direction do mixed signals from the European institutions influence the behaviour of market participants?

In the following section, we further discuss the role of positive and negative news and their influences on the interest spread. The news variables, ECON, POL and MERKEL and FMERKEL2W are introduced in the estimates both, as a direct determinant of the interest rate spread (the real rate of return s_t) and indirectly as a determinant of the volatility (the noise h_t). We first describe the dependent variable before elaborating the estimations strategy employed in this project.

Effect of political and economic news on the Greek's spread

Data and descriptive statistics

Our dependent variable is the Greek interest rate spread, which is the difference between the Greek and German interest rates on 10 years bonds; the data are from Bloomberg. The evolution of the Greek interest rate spread and its daily changes are shown in Figure 9.2. Volatility started to increase modestly with the global financial crisis in the last quarter of 2008 but accelerated when Papandreou's government uncovered the real situation of Greek public finances, leading to the bailout on 10 May 2010. The bailout had the immediate effect of reducing the spread by 500 base points, as the second panel of Figure 2 demonstrates. Yet, the smoothing effect of the bailout was not of a lasting nature and the spread continued to rise despite of the political efforts of the EU and the IMF to provide financial guarantees. Finally, the recent speculative attacks starting in July 2011 caused the spread to rise to over 20 per cent in mid-September.

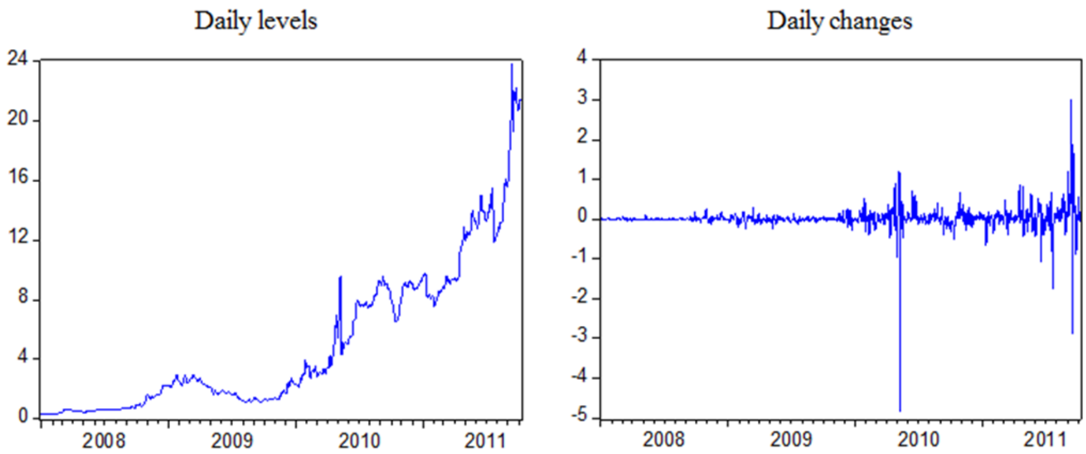

Figure 9.2: Interest rates spread between the Greek and German 10 year bonds.
Source Bloomberg.

Econometric strategy and results

In this section we test whether there is a significant noise effect of a news announcement about the profitability of Greek 10 year bonds. According to the model developed in section 2, governments know the real rate of return on Greek assets while the private sector can only infer it from the signal emitted by the informed agents. Due to a noise component the perceived rate of return on Greek assets by private investors is biased downward, causing fire sales which lead to increasing interest rate spreads and therefore to a higher risk of default.

Recalling the relation between relative bond prices and interest rate spreads $Spread = r / p - \rho$ and by substituting equation (17) into the spread equation, its change can be expressed as a function of the accurate signal of the profitability of Greek bonds s_t, the supply of Greek assets and the noise variable h_t:

$$(18) \qquad \Delta Spread = f(s, h, \overline{X}) \text{ with } \frac{\delta f}{\delta s} > 0; \frac{\delta f}{\delta h} > 0; \frac{\delta f}{\delta \overline{X}} > 0;$$

The effect described above can be estimated by financial econometrics models which allow studying the behaviour of high frequency series characterised by a strong noise component and by a time varying variance. The latter is a measure of the volatility of a time series and in the analysis of portfolio selection represents an important variable to be predicted. The most popular tool for predicting financial volatility is the class of autoregressive conditional heteroskedasticity models (ARCH) introduced by Robert F. Engle (1982). From this seminal work a number of models arose in order to better capture the different features of financial data. In order to investigate the effect of explicit political and economic news on the Greek spread we need a model where volatility has a direct effect on the mean of the spread. The ideal solution is a Mean-GARCH specification (Engle et al. 1987), where volatility enters directly into the mean equation. An additional desired characteristic of the model is the possibility to allow for asymmetry in the response to economic news. Several models, such as the Exponential-GARCH (Nelson 1990; Engle and Ng 1993) or the Asymmetric-GARCH (Engle 1990), have been developed in order to allow for this feature. Zhuanxin Ding et al. (1993) propose an Asymmetric Power Arch model (A-PARCH) in order to account for the common finding in the empirical financial literature of high serial correlations between the absolute asset returns and their power transformations. This class of models has been frequently studied in order to test their applicability to financial data (He and Teräsvirta 1999; Brooks et al. 2000; Mittnik and Paolella 2000; Giot and Laurent 2004) and to compare it with other models (Karanasos and Kim 2006). As it is often the case with high-frequency financial time series, the error distribution has fatter tails so that the assumption of normality of the residuals is rejected (see Appendix 9.1). This feature makes the A-PARCH model particularly useful as the variance in standard ARCH models has better explanatory power only when errors are normally distributed (Brooks et al. 2000). The A-PARCH representation allows us to avoid the imposition of a specific form on the variance term as the power parameter δ of the standard deviation is estimated within the model so that asymmetric effects – if present - are captured together with the potentially significant serial correlation of the power transformation of the residuals. Further, it nests different models, including the GARCH-in-mean specification and the asymmetric GARCH so that the best representation will be decided by the estimated parameters. The A-PARCH mean equation for the Greek spread over the German Bund is the following:

$$\Delta Spread_t = X_t^{'}\theta + \lambda\sigma_t^{\delta} + e_t \qquad (19)$$

Where

$X^{'} = \left[\Delta Spread_{t-1}, Merkel, FrMerkel2W, ECON, POLG, POLB, POLU\right]$,

σ^{δ} is the delta power of the standard deviation and e_t is the error term. The variance equation of the PARCH (Ding et al. 1993) is expressed as function of a constant term, q lags of the dependent variable (the GARCH structure) and p lags of the news from the previous periods. In order to capture asymmetries up to order r between positive and negative news the latter term is expressed as difference between the absolute error and its real value, weighted by the asymmetry parameters γ_i:

$$(20) \qquad \sigma_t^{\delta} = \omega + \sum_{j=1}^{q} \beta_j \sigma_{t-j}^{\delta} + Z_t^{'}\varphi + \sum_{i=1}^{p} \alpha_i (|e_{t-i}| - \gamma_i e_{t-i})^{\delta}$$

where $\delta>0$, $|\gamma_i| \leq 1$ for $i=1\ldots.r$, $\gamma_i=0$ for all $i>r$, and $r\leq p$. $Z^{'} = [Merkel, FrMerkel2W, ECON, POLG, POLB, POLU]$ is a vector of exogenous volatility determinants. The system of equations (19) and (20) is estimated via Maximum Likelihood with a backcasting parameter for the MA term equal to 0.7; the GARCH structure is p=2 and q=1 as this is the structure that maximises the information criteria. The A-PARCH model will be estimated assuming a fat tails, described by a Student-t distribution for the error term (Beine et al. 2002; Chuang et al. 2007; Zhu and Galbraith 2011) with the number of degrees of freedom (i.e. the width of the tails) to be estimated by the model.

The expected sign for the Merkel variable is positive in the variance equation, as it captures a noise effect, while it is negative in the mean equation. ECON is expected to increase the average spread because it includes only negative or uncertain news while its effect on volatility is *a priori* not certain. POLB should exert mainly a direct positive effect on the spread changes as bad news are less noisy, while a negative impact should be expected for POLG. In reality, what we classify as good news may not be considered so by the markets and the effect of POLG could potentially be positive, especially in the variance equation. Finally, the expected impact for POLU is positive but it is not clear *a priory* whether the direct or indirect effect dominate.

Estimation results are shown in Table 9.2, where we report the results for the mean equation in the upper panel and we estimate volatility in the lower panel together with the delta parameter and the degrees of freedom of the error distribution. The first five columns report the results up to end of September 2011 while columns six to ten exclude the last quarter from the estimates. This is done in order to check whether the announcement effect has changed its effectiveness when the Greek debt crisis worsened and spread to other Southern European countries, above all Italy. After several attempts with the political variables we kept POLU in the mean equation and POLG in the volatility equation; and the other variables were always insignificant. For the same reason FrMerkel2W is introduced only in the variance equation while the ECON variable has been retained in the mean equation only.

Although the explanatory power of the estimates is low, we find significant results for the signal variables in all cases. The significance of the Garch term indicates that volatility has a direct impact on spread's changes. The estimated delta is always below one, although not always statistically lower. In any case, the asymmetry of the model is confirmed and increases with the full specification, thanks especially to the POLU variable. The estimated number of degrees of freedom for the error distribution is always around 3.2 indicating the presence of particularly fat tails. The most important result is the significance of the Merkel dummy both in the mean and variance equations. A Merkel announcement has a direct negative impact on the interest rate change ranging from four to almost six base points in the full specification. The effect on volatility is positive confirming the impact of incoherent and contradictory communication that was developed in our theoretical model. FrMerkel2W is significant and with a negative sign, indicating that the noise of a news announcement decreases with more frequent statements. In other words, when Merkel makes a statement its meaning is confusing, but subsequently clarified. News about the worsening of the economic situation has the expected positive effect on mean spread changes although their impact is rather low, between two and five base points. Nevertheless, on a debt of 350 billion euros, the Merkel communication costs between 100 and 170 million euros, a non-negligible amount.[10] On the other hand, the effect of uncertain political support from EU institutions to the problem of the Greek

[10] If the impact were the same in Italy, Europe's messy governance would cost Italy between 0,5 to one billion euros.

Table 9.2: Power Garch estimates of the volatility of the Greek spread over the German *Bund*.

	01/1/2008-30/9/2011					01/1/2008-30/6/2011				
	Mean equation									
	1	2	3	4	5	6	7	8	9	10
Garch	0.231***	0.257***	0.254***	0.235***	0.212***	0.290***	0.348***	0.297**	0.311***	0.326***
	[0.084]	[0.086]	[0.086]	[0.060]	[0.074]	[0.122]	0.129]	[0.124]	[0.121]	[0.126]
D(speard) (t-1)	0.219***	0.212***	0.210***	0.205***	0.205***	0.232***	0.228***	0.228***	0.224***	0.221***
	[0.029]	[0.028]	[0.028]	[0.023]	[0.025]	[0.030]	[0.029]	[0.029]	[0.029]	[0.028]
Cost	0.002**	0.002**	0.002**	0.002**	0.002**	0.002**	0.002**	0.002*	0.002**	0.002**
	[0.001]	[0.001]	[0.001]	[0.001]	[0.001]	[0.001]	[0.001]	[0.001]	[0.001]	[0.001]
Merkel	-0.041*	-0.047*	-0.051**	-0.058**	-0.054**	-0.045**	-0.058**	-0.055**	-0.063***	-0.061***
	[0.022]	[0.025]	[0.025]	[0.022]	[0.023]	[0.022]	[0.025]	[0.025]	[0.024]	[0.024]
ECON			0.020**		0.020**			0.021**		0.020**
			[0.009]		[0.009]			[0.010]		[0.010]
POLU				0.106**	0.102**					0.086
				[0.043]	[0.042]				[0.054]	[0.054]

Note */**/*** Significant at 10, 5 and 1 per cent level.

Table 9.2: cont.

	01/1/2008-30/9/2011					01/1/2008-30/6/2011				
	Variance Equation									
	1	2	3	4	5	6	7	8	9	10
Merkel	0.025*	0.075***	0.080***	0.050**	0.058**	0.021**	0.059**	0.065**	0.046**	0.046**
	[0.015]	[0.026]	[0.026]	[0.024]	[0.024]	[0.014]	0.024]	0.025]	[0.023]	[0.023]
FrMerkel2W		-0.004***	-0.004***	-0.004***	-0.004***			-0.003**	-0.003**	-0.003***
		[0.001]	[0.001]	[0.001]	[0.001]		0.001]	0.001]	[0.001]	[0.001]
POLG				0.066***	0.066***				0.039	0.039*
				[0.025]	[0.026]				[0.025]	[0.024]
Garch order	1,2	1,2	1,2	1,2	1,2	1,2	1,2	1,2	1,2	1,2
Delta	0.916***	0.831***	0.822***	0.713***	0.756***	0.876***	0.890***	0.924***	0.840***	0.863***
	[0.192]	[0.176]	[0.174]	[0.154]	[0.161]	[0.197]	0.194]	0.201]	[0.186]	[0.198]
T dof	3.227***	3.215***	3.175***	3.236***	3.165***	3.262***	3.309***	3.179***	3.274***	3.221***
	[0.371]	[0.375]	[0.366]	[0.361]	[0.350]	[0.387]	0.396]	0.376]	[0.392]	[0.372]
Adjusted R-squared	-0.053	-0.055	-0.054	-0.039	-0.047	-0.05	-0.054	-0.049	-0.049	-0.061
DW	2.054	2.045	2.046	2.029	2.037	2.133	2.138	2.145	2.138	2.138
SIC	-1.904	-1.906	-1.907	-1.981	-1.908	-2.149	-2.149	-2.15	-2.140	-2.141
Obs.	977	977	977	977	977	911	911	911	911	911
Total Merkel effect	-0.035	-0.028	-0.031	-0.046	-0.042	-0.039	-0.037	-0.042	-0.049	-0.046

Note */**/*** Significant at 10; 5, and 1 per cent level.

debt is stronger, around 10 base points. The low effect of the economic conditions (i.e. debt rating) can be explained by the fact that markets are already aware of developments well before the rating agencies officially certify their existence while, so that political news are the novel information for the investors. Finally, news of positive EU support does not affect the spread directly but causes a volatility increase by over six base points.

The results do not change much, especially for the Merkel variable, when excluding the last quarter from the estimates. If we look at the full specification in column 10, the Garch term increases from 0.21 to 0.33, indicating a lower impact of the noise in the third quarter of 2011. The effect of political uncertainty turns insignificant and the volatility effect of good political news halves. Again, although these results may be due to a reduced explanatory power of the model when the spread increases in an uncontrolled fashion, they suggest that the effect of political indecision has been particularly severe during summer 2011. This means that stronger political actions are necessary in order to avoid a default in the Greek debt.

Summing up, the econometric analysis validates the theoretical assumption of a detrimental noise effect of Merkel announcements regarding political solutions to the Greek problem. By comparing the direct mean effect with the total Merkel effect (last row of Table 9.2) we find that the noise component reduced this effect on average by one third or approximately two base points. An additional finding is that the effect of political uncertainty has been particularly strong in the third quarter of 2011.

Conclusions

While the euro is in its deepest crisis since its creation in 1999, a policy debate is ravaging Europe about the usefulness of public debtor bailouts. We have argued that such bailouts are necessary to prevent a banking crisis, which would have devastating consequences for the real economy and employment. However, the costs of such bailouts depend significantly on the political and institutional setup. As long as intergovernmental policy making dominates, coordination failure on bailout issues is nearly inevitable. The reason is that in monetary union, bailout funds are a common resource good, which makes cooperative solutions hard to achieve: it is in the interest for each member state to withhold its own financial contribution.[11] The turning point is only reached, when the system itself is under threat.

Our study has revealed evidence for a significant political risk which substantially increases bailout costs. Our estimates suggest that Merkel's uncooperative attitude at least in the early period of the crisis, did cost Greece up to 170 million euros. If her behaviour is a proxy for the cacophony of Europe's intergovernmental governance system, the cost for Europe's South (Greece, Italy, Spain, Portugal, Ireland) would be between one and 1.6 billion euros.

If the European Union wishes to avoid such unnecessary cost, it must eliminate the institutional source of political noise and uncooperative behaviour and set up a fiscal union that centralises fiscal policy control at the European level. Former ECB President Jean-Claude Trichet (2011) got it right when he said:

> We can see before our eyes that membership of the EU, and even more so of EMU, introduces a new understanding in the way sovereignty is exerted. Interdependence means that countries *de facto* do not have complete internal authority. They can experience crises caused entirely by the unsound economic policies of others […]. In the present concept, all the decisions remain in the hands of the country concerned, even if the recommendations are not applied, and even if this attitude triggers major difficulties for other member countries.

And he asked provocatively:

> Would it go too far if we envisaged, at this second stage, giving Euro Area authorities a much deeper and authoritative say in the formation of the country's economic policies if these go harmfully astray? A direct influence, well over and above the reinforced surveillance that is presently envisaged?

A more 'direct influence' over European budget policies may not only be necessary to save the euro, it may also be cheaper for tax payers.

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[11] For the theory behind this statement, see Collignon (2003).

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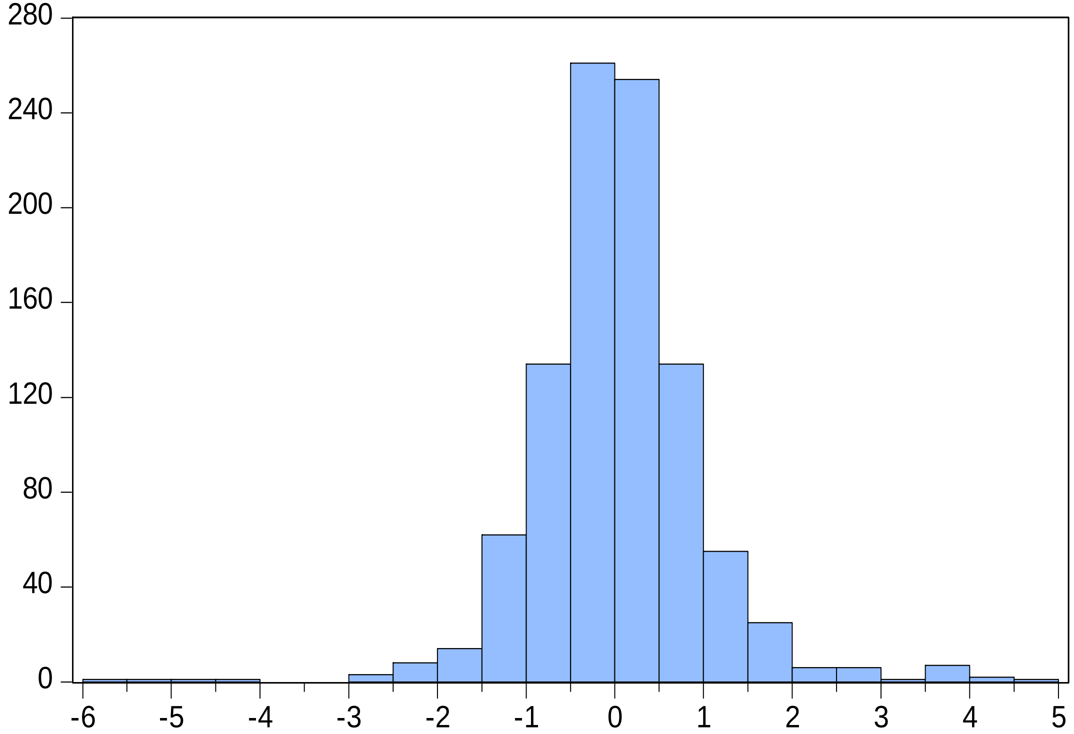
Appendix 9.1



Series: Standardized Residuals	
Sample 1/03/2008 9/30/2011	
Observations 977	
Mean	0.041629
Median	0.006959
Maximum	4.532057
Minimum	-5.924639
Std. Dev.	0.944221
Skewness	0.162853
Kurtosis	8.954886
Jarque-Bera	1447.863
Probability	0.000000

Figure 9A.1: Standardised residuals of the APARCH specification (column 5 in table 9.2).

Chapter 10

A radical strategy for Europe From the endless bailout of Europe to taking leave from neoliberalism

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The structural roots of the crisis

The course of the economic crisis that erupted in late 2007 can be simply summarised as follows: during the two decades preceding the crisis, capitalism has been reproducing itself by accumulating a mountain of debt. To avoid the collapse of the system, states have taken over some of these debts, in transferring from the private to the public sector. The project of the ruling classes is now to present the bill to citizens through budget cuts, increases of the most unfair taxes and frozen wages. In a nutshell, the majority of the population – as workers and pensioners – must sacrifice through austerity to ensure the realisation of the fictitious profits accumulated over many years.

The global effects of the crisis have been made even worse by what is happening in Europe. For thirty years the contradictions of capitalism have been overcome with the help of an enormous accumulation of phantom rights to surplus value. The crisis has threatened to destroy them. The bourgeois governments have decided to preserve them claiming that we have to save the banks. They have taken on the banks' debts and asked for virtually nothing in return. Yet it would have been possible to make this rescue conditional on some assurances. They could have banned speculative financial instruments and closed the tax loopholes. They could even have insisted that they take responsibility for some of the public debt that this rescue increased so dramatically.

In Europe, the effort to build an economic integrated area via the European Union (EU) with a single currency in the form of the euro, but without a matching budgetary capacity, was not a coherent project. A truncated monetary union became an economic framework to generate heterogeneity and divergence in the countries of Europe. Countries with above average inflation and below average productivity lose competitiveness, and are encouraged to base their growth on over-indebtedness; while countries with below average inflation and above average productivity gain competitiveness and sustain structural surpluses.

In retrospect, the choice of the euro (with its launch in 1999) had no obvious advantage over a common currency system – a convertible euro for relations with the rest of the world, and adjustable currencies inside the zone. The euro was designed as an instrument of budgetary and above all wage discipline (following on the EU's Growth and Stability Pact): the use of devaluation is no longer possible, and the wage becomes the only adjustment variable for addressing competitiveness and external imbalances.

In practice, the Economic and Monetary Union also worked through over-indebtedness and, at least initially, the decline of the euro against the dollar. These expedients eventually had to run out. Things started to go off-track with the German policy of wage deflation through the 2000s, which has led to an increase of Germany's market share in Europe. Although the euro area was broadly in balance with the rest of the world, the gap has widened between the German surpluses and the deficits of most other countries in Europe. As a result, the growth rates inside the euro zone have tended to diverge, right from the first introduction of the euro.

This market configuration inside Europe has, not surprisingly, proven unsustainable. The crisis has sharply accelerated the process of fragmentation and financial speculation and it has exposed the tensions inherent within neoliberal Europe. The crisis has deepened the polarisation of the euro area. On the one hand, Germany, the

Netherlands and Austria enjoy trade surpluses and their fiscal deficits have remained moderate. On the other, the famous 'PIGS' comprised of Portugal, Italy, Greece and Spain (Ireland being partly another case) are in a reverse situation: high trade deficits and fiscal deficits above average and rapidly climbing. Although the depth of the economic crisis has led to an increase in fiscal deficits everywhere, it has been much less in the first group of countries.

We are now in the second phase. Having shifted the debt from the private sector to the public, the working class has to be made to pay. This shock therapy is delivered through austerity plans which are all broadly similar – a cut in socially useful spending and hiking up the most unfair taxes. There is no alternative to this form of social violence other than making the shareholders and creditors pay. That is clear and everyone understands it.

The sovereign debt crisis has accelerated the move toward austerity, which was, in any case, already the neoliberal policy of adjustment and the planned policy response as the economic crisis stabilised. Speculation against Greece, then Ireland and Portugal, has been possible because no systematic measures have been taken to regulate banks in the wake of the crisis. The pooled management of the debt on a European scale, through the European Financial Stabilisation Mechanism and the European Financial Stability Facility, remained partial and always came late in the day. The central banks themselves have provided ammunition for this speculation by lending to banks, at a very low interest rate, money which the banks in turn lent to governments at the higher rates paid on sovereign debt, neatly pocketing the difference.

As sovereign debt takes over from private debt, the financial crisis moves into the public sector. The bailouts of the peripheral European countries under attack from financial capital are, in fact, the bailouts of European banks (concentrated in Germany, France and Britain, with US banks also implicated) that hold much of their debt. Speculative attacks are used as an argument in favour of moving quickly to drastic austerity plans, as in the cases of Greece and the Iberian countries. This strategy is a nonsense that can only lead to another recession, including in Germany, whose exports to emerging markets outside Western Europe might not offset its losses internal to European markets.

European governments and the European Commission have had one overriding goal: to return as quickly as possible to 'business as usual'. This goal is, however, out of reach, precisely because everything that had helped manage the contradictions of the flawed form of European integration, such as peripheral Europe indebtedness and internal European trade imbalances, has been rendered unusable by the crisis. These elements of the analysis of the current European economic conjuncture are now quite widely shared. However, they lead to quite opposite predictions and orientations, particularly on the Left: the bursting of the euro area, or overhaul of the pan-European political project.

The European working class is also being asked to pay for the collapse of the ruling class project for Europe. The ruling class thought that it had found a good system with the single currency, the budgetary stability pact ('Stability and Growth Pact'), and the total deregulation of finance and the movement of capital. By creating a competition between social models and wage earners, squeezing wages became the only means of regulating inter-capitalist competition and intensifying the inequalities that benefitted only a very narrow stratum of people in society.

However, this model put the cart before the horse and was not viable. It presupposed that the European economies were more homogeneous than they actually are. Differences between countries increased due to their place in the global market and their sensitivity to the euro exchange rate. Inflation rates did not converge and interest rates favoured property bubbles and so on. All the contradictions of a curtailed programme of European integration, which the Euro liberals are discovering today, existed before the crisis. But these are blowing apart under speculative attacks against the sovereign debts of the most exposed countries.

Underneath the abstract concept of 'financial markets' there are mainly European financial institutions, which speculate using capital that states lend to them at very low interest rates. This speculation is only possible due to the states' policy of non-intervention and we should understand it as a pressure applied to consenting governments to stabilise budgets on the back of the people of Europe and to defend the interests of the banks.

European policy: The endless bailout of Europe to shift costs from financiers to workers

The decision by former Greek Prime Minister Georgios Papandreou to put the Euro summit agreement to a referendum marks a new step in the European crisis. To understand the causes and what is at stake in this crisis, we must first situate it in the broad sweep of events.

It is not just a sovereign debt crisis. It is also, and more fundamentally, a crisis of the European construction. Today it is obvious that neo-liberal-style Europe was botched.

The single currency was supposed to serve as a wage-control instrument, since it became impossible for governments to devalue. But that constraint was in part evaded, circumvented by over-indebtedness, boosted by low real interest rates and growing external deficits.

For a decade, 1995-2005, the countries of Europe's 'South' (Spain, France, Greece, Ireland, Italy, Portugal) had growth rates almost one per cent higher than the countries of the 'North' (Germany, Austria, Belgium, Finland, the Netherlands).

That could not last, and the situation reversed from 2006. Since the crisis, and except in 2009, the growth of the countries of the 'South' has been clearly lower than that of the 'North'. The crisis has thus exposed the incoherences of the European model and deepened the divergence between the trajectories of the different countries.

The growth of public debts itself has three causes: the mechanical effect of the recession, the costs of bailing out the banks, and also the poisoned fruit of the policies carried through for many years of reducing the taxes paid by business and the richest households. The brutal shift to budgetary austerity thus sets a vicious circle going: by cutting expenditure, they slow down economic activity, and that cuts tax receipts and so the deficit is not cut.

A priori there were several possible scenarios. The austerity scenario meant getting into a long period of social regression to bring down the debt bit by bit at the expense of the living standards of the majority of the population. But it was known that a certain number of countries, in the first place Greece, could not meet their debt payments. Thus the risk of contagion to other countries, leading to a scenario of the breakup of the euro zone.

The scenario of federalisation would have meant taking responsibility for the totality of the European debts in a pooled way by various methods, of which the main one is the monetarisation of the European debts by the European Central Bank (ECB). That is in fact the only way to avoid exposing the financing of the states to speculation on the financial markets.

Finally, the radical scenario would, since the sovereign debts are in large part held by the European banks, mean nationalising those banks and organising default for the most exposed countries.

For almost two years the governments of Europe have been feeling their way between several pitfalls. The first is what economists called moral hazard: looking after a Greek default could be a signal encouraging other countries to evade austerity measures. The cost of the default would fall back on the 'virtuous' countries, especially Germany, and the financial markets would put the debt of numerous other countries under the rule of speculation. But a break-up of the euro zone is also seen as a major risk, including by Germany, which through such a break-up would lose its advantages in world competition.

The October 2011 agreement was, like the previous ones, a provisional and cobbled-together solution which confirmed Germany's refusal to accept a change in the statutes of the European Central Bank which would allow it directly to finance states. The Greek debt was theoretically cut by half, but at the cost of a veritable placing under supervision, sharpened austerity, and a massive programme of privatisation.

Technically, the weak points of this agreement, which was probably stillborn, were obvious. The debt cutback is voluntary, as the text of the agreement explains: 'We invite Greece, private investors and all parties concerned to develop a voluntary bond exchange with a nominal discount of 50%'.[1] Indeed, they wanted to avoid declaring a Greek default which would unleash the diabolical mechanism of the CDS (Credit Default Swaps), whose owners would then come to demand their dues.

To avoid contagion for other countries, appeal was made to the European Financial Stability Facility. This fund, created in May 2010, had been endowed with 440 billion euros, but after the bailout plans for Greece, Ireland, and Portugal, it had only about 200 to 250 billion left.

For it to serve as a firewall, it had to be able theoretically to command 1 000 billion euros. But the states do not want to pay, and this sum was to be got by the same methods which led to the financial crisis: leveraging and a 'Special Purpose Vehicle', with an appeal to the emerging powers and especially to China.

The banks were also to be recapitalised, but not too soon, so that they should not be obliged to cut back their profits and their dividend distributions. As one of the negotiators of the agreement puts it: 'You don't have to be paranoid to be terrified'.[2] The most terrifying thing, however, is the drive of the ruling classes to make the peoples of Europe pay the cost of the crisis.

Is quitting the euro the best radical strategy?

The offensive, which the peoples of Europe are facing, is undeniably made worse by the European straightjacket. For example the European Central Bank, unlike the Federal Reserve in the United States, cannot monetise public debt by buying treasury bonds.

Would leaving the euro allow the straightjacket to be loosened? That is what some on the left like Costas Lapavitsas and his colleagues are suggesting for Greece as an immediate step. He proposes that it is done immediately without waiting for the left to unite to change the euro zone, something he thinks is impossible. Quitting the euro is presented as a miracle solution. It would allow the country involved

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1 Euro summit statement, Brussels, 26 October 2011. Available at: <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf>, at p. 4.

2 *The Economist*, 29 October 2011, 'The euro deal: No big bazooka'. Available at: <http://www.economist.com/node/21534851>.

to devalue and re-establish its competitiveness. It is certainly true that the merging of national currencies within the euro zone has removed a crucial adjustment variable, namely the exchange rate. Countries with declining price competitiveness have no other options than a wage freeze and fiscal austerity or a further headlong rush into over-indebtedness.

This idea is put forward elsewhere in Europe and is met with an immediate objection that even though Britain is not part of the euro zone it has not been protected from the climate of austerity. It is also easy to understand why the far right, such as the *Front National* in France wants to leave the euro. By contrast it is hard to see what could be the merits of such a slogan for the radical left. If a liberal government were forced to take such a measure by the pressure of events it is clear that it would be the pretext for an even more severe austerity than the one we have experienced up to now. Moreover it would not allow us to establish a new balance of forces, which is more favourable to the working class. That is the lesson that one can draw for all the past experiences.

Still, the 'exit from the euro' scenario is inconsistent economically and politically miscalculated. Leaving the euro would not solve the issue of sovereign debt loads in peripheral Europe, but worsen it insofar as the debt owed to non-residents would be immediately increased by the rate of devaluation. The return to a national currency would directly expose the countries with a large external deficit to speculation. In any case, the debt restructuring should be made in the first place.

Devaluation makes a country's exports more competitive, at least against the countries which do not devalue. It is a non-cooperative solution in which a country seeks to gain market share against its trading partners. Moreover, by increasing the price of imports devaluation leads to inflation, which partly offsets the initial gains in competitiveness. Jacques Sapir, a French economist who supports the exit from the euro for France, acknowledges that inflation will impose 'devaluations every year or every 18 months to keep the real exchange rate constant'.[3] This means accepting an endless inflation-

[3] Jacques Sapir, 'S'il faut sortir de l'Euro…', working document, 6 April 2011, author's translation. Available at: <http://gesd.free.fr/sapirsil.pdf>.

devaluation loop. Yet, a country's competitiveness depends on many other elements: productivity gains, innovation, industrial specialisation, and so forth. To suggest that the manipulation of exchange rates may be sufficient to ensure competitiveness is an illusion, and, by the way, a central postulate of the 'Pact for the Euro'. There is little or no experience of devaluation that has not resulted in an increase in austerity that ultimately falls on workers.

A different distribution of income and an alternate mode of growth require as a prerequisite a profound change in the relation of social forces: this cannot be achieved by a currency devaluation. Taking devaluation as a starting point is equivalent to the reversal of priorities between social transformation and exchange rates. It is an extremely dangerous mistake. In his essay, Sapir stresses that the 'new currency should be embedded in the changes in macroeconomic policies and institutions [...] if it is to give all the desired effects'.[4] Among these changes, he cites a recovery of wages, the perpetuation of social systems, strict control of capital, requisition of the Bank of France, and state control over the banks and insurance companies. But all these measures should be imposed before any political project for leaving the euro.

A government of social transformation would, indeed, commit a terrible strategic mistake by leaving the euro, exposing itself to all kinds of speculative retaliation. The political risk that it would give legitimacy to the programmes of the far right is great. In France, as already noted, the exit from the euro is one of the cornerstones of the National Front. The exit strategy revives a national-socialist logic that combines xenophobia and a discourse denouncing European integration as the ultimate cause of all economic and social ills.

Moreover, while it is true that globalisation and neoliberal European integration has strengthened the balance of power in Europe in favour of capital, it is not the only factor. It is, therefore, a fundamental error to suggest that an exit from the euro would spontaneously improve the balance of power in favour of workers. It is enough to consider the British example: the pound keeps Britain out of the European Monetary Union and the euro, but that has not protected the British people from an austerity plan which is among

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[4] Ibid., at p. 3 (author's translation).

the most brutal in Europe. It is hard to see how such measures could, as if by magic, re-establish a fairer distribution of income: it is not a border tax that will make the profiteers give up their privileges. In any case, competitiveness depends on many other factors besides commodity prices.

And, above all, this approach would mean getting into a doubly perverse logic. First into the logic of competition: but a country can improve its situation by better competitiveness only by taking market share (and thus jobs) from neighbouring countries. And then into the logic of productivism, which sees no way to create jobs other than more economic growth.

Supporters of the exit from the euro advance another argument: it would be an immediate measure, and relatively easy to take, while the strategy of a refoundation of the European project would be out of reach. This argument misses the very possibility of a national strategy that does not presuppose a simultaneous rupture in all European countries.

Other solutions exist which need a complete recasting of the European Union: a budget which is financed by a common tax on capital and which finances harmonisation funds and investments which are both socially and ecologically useful and richer countries help poorer ones with their public debt. But again this outcome is not possible in the short term, not through lack of alternative plans but because implementing them requires a radical change in the balance of forces at the European level.

We have to make sure that the resistance is strengthened by arguing for an alternative project and work out a programme which offers both ‘practical’ answers as well as a general explanation of the class content of the crisis.

The specific task of the radical, internationalist left is to link the social struggles happening in each country with arguing for a different kind of Europe. What are the ruling classes doing? They are facing up to the policies they have to follow because they are defending interests which are still largely nationally based and contradictory. Yet as soon as they have to impose austerity measures on their own working classes they present a solid united front. There are better things to do than emphasise the very real differences that exist between the countries. What is at stake is having an internationalist point of view on the crisis in Europe. The only way of really opposing the rise of the far right is by suggesting other targets than the usual scapegoats. We can affirm a real international solidarity with the peoples who are suffering most due to the crisis by demanding that the debts are shared equally across Europe. Thus we have to oppose an alternative project for Europe to that of the European bourgeoisie, which is dragging every country backwards socially. How is it possible not to understand that our mobilisations, which are faced with coordination of the ruling class at a European level, need to be based on a coordinated project of our own? While it is true that struggles happen in a national framework they would be strengthened by a perspective like this instead of being weakened or led down nationalist dead ends. The students who demonstrated in London chanting 'all in this together, all in this together' are a symbol of this living hope.

The best radical solution: The refoundation of Europe

As often put, the dilemma seems to be between a risky adventure of 'exit' from the euro and a utopian European harmonisation giving 'voice' to workers' struggles. The central political issue for socialists is to get out of this false choice. The main distinction here is between ends and means. The objective of a programme of social transformation is to guarantee all citizens a decent life in all its dimensions — employment, health, retirement, housing, and so on. This can be achieved by a change in the primary distribution of income between profits and wages and by tax reform. But advancing the struggles for these goals implies the questioning of dominant social interests, their privileges and their power. This confrontation takes place primarily within a national framework. But the resistance of the dominant classes and their possible retaliatory measures exceed the national framework.

The only viable strategy is to rely on the legitimacy of progressive solutions that arise from their highly cooperative nature. All neoliberal recommendations are ultimately based on the search for competitiveness, such as reducing wages, trimming social contributions, and cutting taxes to win market share. As European growth levels will continue to be weak in the period that has begun with the crisis in Europe, the only way for any individual country to create jobs will be by competing for them with neighbouring countries, especially since the largest part of foreign trade of European countries is within Europe. This is true even for Germany as the second largest world exporter: it cannot rely only on emerging countries. The neoliberal way out of the crisis is inherently non-cooperative: you can only win against the others, and this is the ultimate cause of the deepening crisis of European integration.

In contrast, progressive solutions are cooperative; they will work even better if they are generalised to a larger number of countries. For example, if all European countries reduced working time and charged taxes on capital income, such coordination would avoid the backlash that the same policy would undergo if adopted in only one country. It is incumbent, therefore, that a government of the radical left follow a strategy of extension:

(1) 'good' measures are implemented unilaterally as, for example, with the taxation of financial transactions;
(2) accompanying plans for protection such as capital controls are adopted;
(3) the political risk of breaking European Union rules to implement these radical, initially nationally-based, policies is accepted and challenged;
(4) the proposition is made to amend these rules by extending them on a European scale to allow these measures to be adopted by member states, for example, in the extension of a European tax on financial transactions; and
(5) the political showdown with the EU and other European states is not avoided and thus the threat of exit from the euro is not excluded as a viable option.

This strategic scheme acknowledges that the making of a 'good' Europe cannot be the precondition to the implementation of a 'good' policy. The retaliation measures must be neutralised through counter-measures which effectively involve resort to a protectionist policy arsenal if needed. But the strategy is not protectionism in the usual sense: this protectionism defends an experience of social transformation emerging from the people and not the interests of the capitalists of a given country in their competition with other capitalists. It is, therefore, a 'protectionism for extension' whose very logic is to disappear once the 'good' measures have been generalised across Europe.

The rupture with European rules is not based on a petition of principle, but rather on the fairness and legitimacy of measures that correspond to the interests of the majority and are equally proposed to neighbouring countries. This strategic challenge for change can then rely on social mobilisation in other countries and hence build a relation of forces that can influence EU institutions. The recent experience of the neoliberal rescue plans implemented by the ECB and the European Commission has shown that it is quite possible to bypass a number of the provisions of the EU Treaties.

For this strategy of rupture, exit from the euro is not a prerequisite. It is rather a weapon to use in the 'last resort'. The immediate break should proceed on two points which would allow real room for manoeuvre: the nationalisation of banks and the restructuring of debt.

The first point of support is the ability to harm capitalist interests: the innovating country can restructure its debt, nationalise foreign capital, and similar steps, or threaten to do so. Even in the case of a small country, such as Greece or Portugal, the capacity of response is considerable, given the intertwining of economies. Many could lose; the showdown is not wholly unequal. But the main point of support lies in the collaborative nature of actions taken. It is a profound difference than the classic strategy of protectionism which occurs on the plane of a single state striving to succeed against its competitors.

Quite the contrary, all progressive measures are most effective when they are generalised to a larger number of countries. This strategy of rupture is ultimately based on the following discourse: we affirm our will to tax capital and we take the necessary protective measures to do so. But we propose the extension of this measure to the whole of Europe. It is on behalf of another Europe that the rupture with really existing Europe would be initiated. Rather than seeing them as opposing courses of action, we must consider the relationship between the rupture with neoliberal Europe and a project for the refoundation of Europe.

The main objective of any Left alternative for Europe must be the optimal satisfaction of social needs. The starting point is, therefore, the distribution of wealth. From the capitalist point of view, the way out of the crisis requires a restoration of profitability through additional pressure on wages and employment. But that approach does not take into account the real causes of the crisis. It is the decline of wage share which has fed the financial bubble. And the neoliberal fiscal counter-reforms have deepened deficits, even before the eruption of the crisis.

The political equation for the Left is simple: we will not emerge from the crisis on top without a radical change in income distribution. This question comes before economic growth. Certainly, higher growth in itself could lead to more employment and higher wages, although such a growth-fixated strategy needs to be assessed from an ecological point of view. In any case, we cannot rely on growth if, at the same time, income distribution becomes increasingly unequal.

We must therefore squeeze inequalities from both sides: by an increase in the payroll for workers and by a tax reform. The upgrading of the wage share could follow the rule of three thirds: one third for direct wages, one third for socialised wages (or welfare) and one third to create jobs by reducing working hours. This rise of wages would be at the expense of dividends, which have neither economic justification nor social utility. The fiscal deficit should be gradually reduced, not by cuts, but by a re-fiscalisation of all forms of income (bringing them back into public finances), which have gradually been exempted from taxes. The immediate cost of the crisis should be borne by those responsible: this means that the debt should be in large part cancelled and the banks nationalised and socialised.

Unemployment and job insecurity were already two of the most serious social ills of neoliberalism and the capitalist system. The crisis worsens both of them as the austerity plans hit the living conditions of the poorest. Here again, a return to some hypothetical new growth regime should not be considered as the solution – producing more in order to create more jobs. This is to take things in reverse. What is needed is a total change of perspective that takes the creation of useful jobs as a starting point. Whether by reduction of working time in the private sector, or by *ex nihilo* creation of public jobs, the objective must be to respond to social needs, and create ‘true wealth’, not necessarily in the form of commodities. Such an approach is both economically coherent and consistent with environmental concerns:

the priority to free time and useful employment are two essential elements of any radical programme to fight against climate change.

The issue of income distribution is the correct starting point for a socialist response to the crisis based on the simple – but entirely correct – principle: 'we will not pay for their crisis'. Such an approach has nothing to do with a Keynesian 'wage stimulus', but with a defence of workers' wages, employment and social rights, none of which should be a matter of discussion. A socialist strategy would then also highlight the complementary notion of control: control over what they (the capitalists) do with their profits (dividends versus jobs) and control over the use of taxes (subsidise banks or finance public services). Such an approach would allow, in turn, the indictment of the private ownership of the means of production, and the central anti-capitalist message to acquire a mass audience in Europe.

As Özlem Onaran puts it:

> A consensus among the anti-capitalist forces for a strategy against the crisis is emerging across Europe around four pillars: i) resistance against austerity policies and all cuts, ii) a radically progressive/redistributive tax system and capital controls iii) nationalisation/socialisation and democratic control of banks, and iv) debt audit under democratic control followed by default.[5]

A programme aimed only at regulating the capitalist system at the margins would not only be undersized but insufficiently motivating. Conversely, a radical perspective can seem discouraging because of the sheer magnitude of the tasks at hand. What we need, as socialists, is somehow to determine the optimal degree of radicalism in this conjuncture. The difficulty is not, as so often suggested, to develop technical devices: such capacities are obviously essential and many of these capacities well advanced. But no clever measure can avoid the inevitable political clash between conflicting social interests.

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[5] Özlem Onaran, 'An Internationalist Transitional Program towards an Anti-Capitalist Europe: A Reply to Costas Lapavistas', *International Viewpoint*, IV Online magazine, IV435, April 2011. Available at: <http://internationalviewpoint.org/spip.php?article2096>.

Concerning the banks, the strategic range of possible departures stretches from full nationalisation to more or less restrictive regulations, through the establishment of a public financial entity. Similarly, public debt could be cancelled, suspended, renegotiated, all along innumerable lines. Full nationalisation of banks and the renunciation of public debt are measures that are both legitimate and economically viable. But they seem out of reach, due to the current balance of forces. Herein lies the real debate: what is the degree of radicalism in the strategy of rupture that is most capable of mobilising workers and the political movements? It is clearly not for economists to decide. That is why, rather than proposing a complete set of economic measures and plans, the emphasis here has been to ask questions of method and highlight three essential ingredients for a radical Left response to the crisis: (1) a radical change in the distribution of income; (2) a massive reduction of working time; and (3) a rupture with the capitalist world order, starting with 'really existing' Europe.

This debate cannot – and should not – be summarised as an opposition between anti-liberals and anti-capitalists, or between Europeanists and progressives. These distinctions obviously have a sense, depending on whether the project is to get rid of finance or of capitalism. But this tension should not prevent us from beginning a long journey together, with the Left leading this debate. Such a 'common programme' as presented here could be based on the will to impose other rules on the functioning of capitalism. And this is, indeed, a dividing line between the radical Left and the social liberalism of centre-left political forces. The priority today for the radical Left is, in any case, to build a common European horizon as a basis for a genuine internationalism.

Quitting European neoliberalism, not quitting the euro

The preconditions for a way out are to establish a balance of forces favourable to the working class and to wipe out at least a portion of the debt. A feasible strategy is thus composed of unilateral measures which clash with the rules of neo-liberal Europe but which would aim at the extension of progressive measures across Europe.

The technical responses exist and are based on this coherent triangle:

(1) Monetarisation of the debts by the European Central Bank;
(2) Nationalisation of the banks;
(3) Cancellation of the illegitimate portion of the debts.

This combination of measures would allow for settling the crisis by way of making those who profited from the frenzies of financialised capitalism pay. But the issues at stake are above all social, and the situation is in the last analysis simple to sum up: thanks to deregulation, financialisation, etc., a small minority grabs the wealth produced, as the rise of inequality shows.

It goes further: that minority organises economic and social life in line with its interests, and has the power to decide social priorities and deprive the peoples of any say in their fate. That minority will not give up those privileges without a powerful social intervention which must combine a global point of view with local or sectoral initiatives.

In any case, capitalism is in an impasse: the neo-liberal model can no longer function, and return to capitalism of the 'golden age' of 1945-75 is impossible.

A progressive solution must therefore involve a radical questioning of this system: the redistribution of wealth is the immediate point of leverage, but the approach must include a total inversion of the capitalist logic.

We must make the satisfaction of social needs the decisive priority, and from that work out what are the necessary and useful jobs, and prioritise non-market public services and the development of free time above the search for profit and individual consumption. Those are, besides, basic preconditions if we want to meet aims for the reduction of greenhouse-gas emissions.

Since such a project puts the very logic of capitalism in question, a very broad alliance is necessary, between the social movements defined in the broad sense.

For a European strategy

The task is as difficult as the period which the crisis has opened. However the radical left must not get locked into the impossible choice and start the risky adventure of leaving the euro and a utopian idea of currency harmonisation. We could easily work on some intermediate targets which challenge the European institutions. For example:

- The states of the European Union should borrow directly from the ECB at very low rates of interest and private sector banks should be obliged to take over a certain proportion of the public debt.
- A default mechanism should be put in place, which allows public sector debt to be written off in proportion to tax breaks for the rich and money spent on bank bailouts.
- Budgetary stabilisation has to be reformed by a fiscal reform which taxes movements of capital, financial transactions, dividends, large fortunes, high salaries and incomes from capital at a standard rate across Europe.

We have to understand that these objectives are neither further nor closer away than an 'exit from the euro' which would be beneficial to working people. It would definitely be absurd to wait for a simultaneous and co-ordinated exit by every European country. The only strategic hypothesis that one can then conceive of must take as its starting point the experience of a social transformation which starts in one country. The government of the country in questions takes measures, for example imposing a tax on capital. If it is thinking clearly it will anticipate the retaliation for which it will be the target and will impose controls on capital. By taking this fiscal reform measure it is openly in conflict with the rules of the European game. It has no interest in unilaterally leaving the euro. This would be an enormous strategic mistake since the new currency would immediately come under attack with the aim of pulling down the economy of the 'rebel' country.

We have to give up on the idea that there are 'technical' shortcuts, assume that conflict is inevitable and build a favourable balance of forces of which the European dimension is a part. One point of support for that is the ability to damage capitalist interests. The

country, which starts, could restructure the debt, nationalise foreign capital etc, or threaten to do it. The 'left' governments of Papandreou in Greece or Zapatero in Spain have not even dreamed of doing this.
The main point of support comes from taking the measures cooperatively. This is completely different from classic protectionism, which basically always tries to gain ground by nibbling at parts of the global market. Every progressive measure on the other hand is effective to the extent that it is shared across a number of countries. We should therefore be talking about a strategy, which is based on the following idea: we are willing to tax capital and we will take the necessary steps to protect ourselves. But we are also hoping for these measures, which we propose, to be implemented across Europe.

We can sum up by saying that rather than seeing them in opposition to each other we have to think hard about the link between breaking the neoliberal European project and our project of creating a new Europe.

Chapter 11

How does the financial crisis affect the independence of the European Central Bank?

Nicola Scotto[1]

Introduction

Before the financial crisis bursting in 2008, a large majority of stakeholders and academics assumed the central bank independence as an essential feature of the modern monetary policy. The idea to split monetary policy from the political decision-making process, is based on historical evidence that expansive monetary policy has been used to do away with the goal of price stability, so favouring economic growth in the short term, but economic crisis in the middle to long term.[2] At the beginning of the 20th century, in fact, several central banks were nationalised and subordinated to the state treasury, thereby becoming exposed to strong political pressures to behave in accordance with the government's preferences (Bordo 2010). Following the Second World War, governments, aware of the

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[1] This chapter is based on the author's MA thesis, submitted for the degree of Master of European Business at *Hogeschool-Universiteit Brussel* on 5 September 2011. All opinions expressed are personal to the author.

[2] In the economic literature this theory is well known as 'long-term neutrality of money'. This theory proves that a growth of money supply, on long term, has an impact only on prices (by creating inflation), without any impact on other real variables (like real output, employment, etc.). For further details, see MacCandless and Weber (1995).

negative consequences of central bank subordination, opted for granting a higher level of independence to the National Central Banks (NCBs). It views central bank independence as a positive value, because it takes away monetary policy from the political influence, thereby neutralising one of the main threats to the macroeconomic stability of a country: high inflation.[3]

However, the financial crisis that started in 2008 forced central banks to make use of unconventional monetary tools to advocate financial stability. In other words, central banks have provided large liquidity to private and public institutions, allowing them to come out from the temporary illiquid situation caused by the financial crisis. Given the large impact of the financial crisis in various fields, it has been logic that also started the debate on how the financial crisis should affect the independence of central banks started also. In the case of European Central Bank (ECB), this debate has become prominent due to the bank's high level of independence and its narrower mandate in comparison with other central banks, which is mainly focused on achieving price stability. To properly address the main features of this debate, the chapter will be divided in three main parts.

The first part of the chapter deals with the close link existing between central bank independence and price stability, through the analysis of different policy and institutional arrangements employed by central banks to achieve price stability.

The second part discusses the ECB independence model, by analysing not only all the aspect of ECB independence, but also how ECB independence is counterbalanced by transparency and accountability procedures practised within the European institutional framework.

The third part, finally, analyses how the unconventional monetary measures,[4] taken by the ECB to face the negative effects of the financial crisis, affect directly and indirectly its independence model.

[3] For an empirical study over the inverse correlation between inflation and independence degree of central banks, see Debelle and Stanley (1994: 199).

[4] As non-standard measures, we refer to those monetary policy actions aimed to overhaul the procedures and tools normally used to implement monetary policy. Those measures aim to re-establish the correct functioning of monetary transmission mechanism.

The direct impact concerns whether unconventional monetary policy measures, as for instance the purchase of sovereign bonds, have jeopardised the financial independence of the ECB; while the indirect impact refers to whether the financial crisis is going to weaken the ECB commitment to low inflation for the future, and if the ECB should be more involved in safeguarding financial stability.

Finally, in the conclusions, this chapter proves how an eventual change in the order of priority of ECB goals could be acceptable only by introducing new institutional arrangements, reflected in a future treaty reform, to enhance the actual accountability of the ECB. In fact, if an eventual treaty reform would not enhance the transparency and the accountability over the ECB action, the widening of ECB tasks, following the model of other main central banks, would weaken the democratic legitimacy of EU monetary policy rather than the ECB independence.

Central bank independence and price stability

Central bank independence and low inflation rate

As we mentioned in the introduction, central bank independence has become one of the main concepts in monetary theory and policy. Most literature (see Daunfeldt and de Luna 2003), in fact, finds an inverse relationship between central bank independence and inflation, but then, other scholars (Posen 1993) came up with studies where they found that economic fundamentals, like openness, political stability, optimal tax considerations, have a much stronger impact on inflation than central bank independence has. Moreover they argue that, among developing countries, central bank independence has showed a small impact on price stability. The main question has been: Does central bank independence 'cause' low inflation? Or is the low-inflation social preference push towards an institutional arrangement based on central bank independence?

Some argue that central bank independence really leads to a reduction of inflation in countries only when it reflects an underlying agreement in the society about lowering the inflation. The idea that by simply creating an independent central bank in a country, you

automatically achieve a low inflation goal, is deemed an illusion[5], therefore social compromise with low inflation is fundamental.
The starting point for reducing the inflation is not the introduction of central bank independence arrangements, but the decision taken by society to pursue price stability. In order to understand differing inflation records of the countries, Bernd Hayo and Carsten Hafeker (2007) suggest looking at the inflation culture of countries.

Although society's aversion to inflation is to be deemed as a relevant element to achieving price stability, it remains true that for a given degree of inflation aversion, a country that institutes an independent central bank will do better than a country which simply endows the central bank with the social welfare functions of that society. In this sense, the proposition that central bank independence enhances economic performance remains valid despite the endogeneity of the central bank independence (Debelle and Stanley 1994: 213).

Although part of the doctrine has underestimated the impact of central bank independence on price stability, it seems that politicians and public opinion have internalised the idea of the beneficial effects of central bank independence. In fact, in the period between 1980 and 2003, the average worldwide index of central bank independence has doubled. It means that national institutions have assumed stronger compromise towards central bank independence. Table 11.1 shows evidence of increased independence for central bank across all countries. This table presents the mean scores for each component and the overall index for all countries in the sample and for two subgroups: advanced economies and developing and emerging market economies. The four components used to measure central bank independence relate to, respectively: the appointment procedures for the head of the central bank (component 1), the resolution of conflict between the central bank and the executive branch of government (component 2), the use of an explicit policy

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[5] Japan is the main example taken by those who support this argument. However, the Japanese central bank depends on its government but, institutionally speaking, Japan has been able to achieve low inflation rates over the years. The last Japanese law on central bank was passed in the Japanese parliament in 1998. It strengthened the central bank's autonomy and provided greater transparency more in line with the US model than the European one. To get an interesting comparison between the Bank of Japan and the European central bank models, see Bebenroth and Vollmer (2007).

target (component 3), and rules limiting lending to government (component 4) (Crowe and Meade 2008). Based on Table 11.1, both advanced and emerging economies show an increased level of central bank independence.

Table 11.1: Mean level (2003) and change in central bank independence (CBI) (standard deviations in parentheses) since 1980.

	All countries		Advanced economies		Emerging markets and developing countries	
CBI	Level	Change[1]	Level	Change	Level	Change
Component 1	0.57	0.08***	0.55	0.03	0.58	0.11***
	(0.18)	(0.20)	(0.18)	(0.17)	(0.18)	(0.21)
Component 2	0.63	0.40***	0.69	0.46***	0.61	0.36***
	(0.29)	(0.35)	(0.33)	(0.35)	(0.27)	(0.36)
Component 3	0.55	0.15***	0.51	0.08	0.56	0.19***
	(0.23)	(0.33)	(0.22)	(0.36)	(0.24)	(0.31)
Component 4	0.65	0.30***	0.67	0.34***	0.64	0.29***
	(0.31)	(0.32)	(0.39)	(0.41)	(0.27)	(0.26)
Total	0.61	0.25***	0.62	0.25***	0.61	0.24***
	(0.20)	(0.21)	(0.24)	(0.25)	(0.18)	(0.19)
Obs.	99	69	26	26	73	43

Note [1] */**/*** denotes significance at the 10, 5, and 1 per cent levels respectively.

Inflation targeting

The concept of central bank independence should be viewed as granting the bank a mandate as well as an authority to pursue price stability as its primary objective. In recent years, in fact, a growing consensus has emerged asserting that price stability – or to be more precise, a low and stable inflation rate – provides substantial benefits to the economy. The price stability, hence, lowers the uncertainty about relative prices and the future price level, rendering it easier for firms and individuals to make appropriate decisions, thereby increasing economic efficiency. Furthermore, the price stability also lowers the distortions from the interaction of the tax system and inflation.[6] Given those benefits, central bank independence has been linked with the most important monetary policy goal: price stability. To achieve this objective central banks have started adopting a policy model targeting the inflation.

[6] This interaction, in a progressive tax system, provokes higher tax burden thanks to artificial rising earnings as a result of inflation. This mechanism has in the literature been named 'fiscal drag'.

Inflation targeting is a monetary policy strategy, which started becoming wide-spread in the 1990s. The main idea of the policy is it a commitment by the central bank to achieving a medium-term numerical target for inflation. Inflation targeting has two key advantages: (a) it is easily understood by the public and, thus, it is highly transparent; (b) it improves the predictability of monetary policy run by central bank, which should have a smaller chance to use inflation surprises to obtain a temporary boost to output and employment.

The evidence shows that inflation-targeting countries have been able to reduce their long-run inflation below the levels that they would have attained in the absence of inflation targeting (Mishkin 2001).

It is true that also countries not under this regime, achieved a reduction in their inflation rates, but the improvements, in terms of inflation reduction, are larger for the countries, which have adopted the inflation target model (Neumann and Von Hagen 2002).

This result suggests that, in inflation target countries, the inflation target may serve to anchor expectations, whereas in non-inflation target countries, lagged inflation may serve that role. For countries without an explicit inflation target, private sector inflation forecasts for periods up to 10 years are significantly correlated with the three-year moving average of lagged inflation. This correlation is largely absent from inflation-targeting countries, indicating that those central banks were generally successful in breaking the link between expectations and previously realised inflation (Sneddon and Foy Romano 2006). The inflation-targeting model is not only used by developed countries but it is spreading across undeveloped countries as well. From Table 11.2 we can see how an increasing number of central banks in emerging markets are planning to adopt inflation targeting as their operating framework (Epstein and Yeldan 2008).

Table 11.2: Inflation targeting countries: Initial conditions and modalities.

Developing Countries (in order of adoption)	**IT adoption rate**	**Inflation rate at start** (% yearly)	**Current inflation target** (% yearly)	**Officially declared policy instrument**
Israel	1997Q2	8.5	1–3	Headline O/N rate
Czech Republic	1998Q1	13.1	3 (±1)	2-week repo
Poland	1998Q4	9.9	2.5(±1)	28-day intervention
Brazil	1999Q2	3.3	4.5 (±2)	Selic O/N rate
Chile	1999Q3	2.9	2–4	O/N rate
Colombia	1999Q3	9.3	5 (±0.5)	Repo
South Africa	2000Q1	2.3	3–6	
Thailand	2000Q2	1.7	0–3.5	14-day repo
Korea	2001Q1	3.2	2.5–3.5	O/N call rate
Mexico	2001Q1	8.1	3 (±1)	91-day Cetes
Hungary	2001Q2	10.5	3.5 (±1)	2-week deposit
Peru	2002Q1	−0.8	2.5 (±1)	
The Philippines	2002Q1	3.8	5–6	Reverse repo
Slovak Republic	2005Q1	3.2	3.5(±1)	
Indonesia	2005Q3	7.8	5.5 (±1)	1-month SBI
Romania	2005Q3	8.8	7.5 (±1)	
Turkey[a]	2006Q1	7.8	5 (±2)	CB O/N rate
Turkey[b]	2001Q2	82.0	n.a.	CB net domestic assets
Industrial countries				
New Zealand	1990Q1	7.0	1–3	Cash rate
Canada	1991Q1	6.2	1–3	O/N funding rate
United Kingdom	1992Q4	3.6	2	Repo
Sweden	1993Q1	4.8	2 (±1)	Repo
Australia	1993Q2	1.9	2–3	Cash rate
Iceland	2001Q1	3.9	2.5	
Norway	2001Q1	3.7	2.5	
Candidate countries				
Costa Rica, Egypt, Ukraine	Near term (1–2 years)			
Albania, Armenia, Botswana, Dominican Republic, Guatemala, Mauritius, Uganda, Angola, Azerbaijan, Georgia, Moldova, Serbia, Sri Lanka, Vietnam, Zambia	Medium term (3–5 years)			
Belarus, China, Kenya, Kyrgyz. Rep., Moldova, Serbia, Sri Lanka, Vietnam, Zambia, Bolivia, Honduras, Nigeria, Papua New Guinea, Sudan, Tunisia, Uruguay, Venezuela	Long term (> 5 years)			

Notes [a] Official adoption date for Turkey.
[b] Turkish CB declared 'disguised inflation targeting' in the aftermath of the 2001 February crisis.
O/N: over-night interest rate; CB: Central Bank; SBI: 1-month Bank of Indonesia Certificates; n.a.: not available.

Source Batini et al. (2006), cited in Epstein and Yeldan (2008: 133).

However, not everyone agrees that the focus on price stability represents the only proper goal for the central banks. Some (see e.g. King 2008) argue that there is too little evidence concerning the success of inflation targeting in its promotion of economic growth, employment creation and poverty reduction, particularly in developing countries. They do not deny the importance of inflation stabilisation, but they advocate a move back toward a more balanced approach where employment, economic growth and inflation stabilisation are at the same level in the priority schedule of the central bank. In other words, inflation stabilisation should not have primacy over the rest of monetary policy goals, particularly in developing countries.

One of the most important emerging economies, namely India, seems to agree with this argument. India, hence, has been supporting the argument that inflation targeting is not practical in its own case, because the drivers of inflation, as it happens in some developed countries, are not from the money supply side (Duvurri 2011). In fact, in a country like India, the main inflationary source use to be food, or better said, raw material, so inflation often emanated from supply shocks. Moreover, in emerging countries as India the monetary transmission is not as effective as in developed countries. That makes the setting of inflation targeting useless, as it, in order to be successful, requires a smooth monetary transmission structure.

Regardless of all the arguments questioning inflation as the main focus of monetary policy, everybody, including the critics, recognise that inflation targeting model has had a crucial role in lowering the inflation and making it relatively stable by historical standards in many countries.

Who sets the inflation target? Goal-independence vs. instrumental independence

One of the most extended debates has been focused on who has the right to set the target level of inflation. This debate, obviously, has a direct impact on the actual degree of central bank independence. On the one hand, you find those who support the argument that elected politicians are entitled to set the inflation target, while the central banks should have the independence of choosing the most appropriate policy instruments to achieve the goal. This institutional arrangement is well known as *instrumental independence*. On the other side you find *goal independence*, which refers to the central bank's ability to determine the goals of its policy without the direct influence of the government.

Goal independence supporters assert that instrumental independence represents a rather 'minimalist' view of the meaning of central bank policy. In fact, if key monetary policy goal, such as the inflation target, could be changed at will by politicians, how could this be reconciled with real central bank independence? Some, like Alberto Alesina and Andrea Stella (2009: 12), argue that instrumental independence is essentially a refinement of the idea that central banks should not be independent.

On the other hand, the instrumental independence supporters assert that the institutional commitment to price stability should come from the government in the form of an explicit, legislated mandate for the central bank to pursue price stability as its overriding long-run goal (Mishkin 2000).

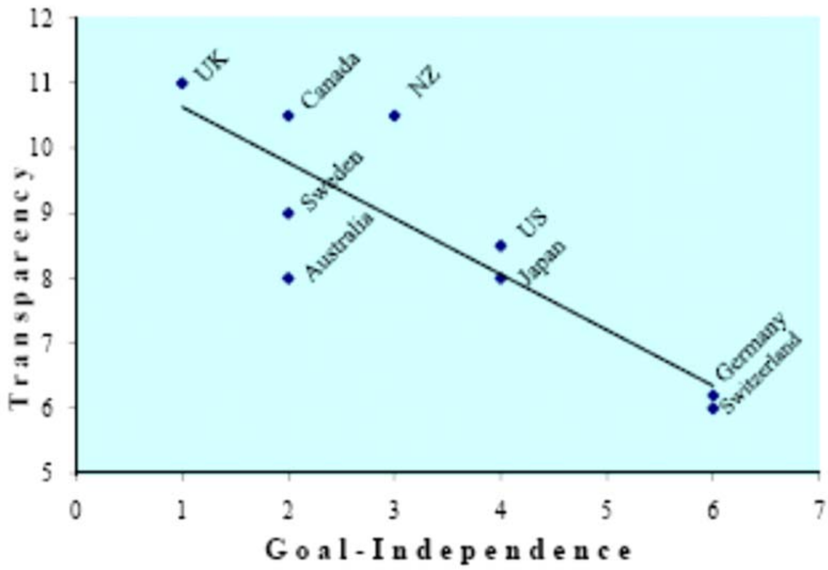

Figure 11.1: Relationship between instrumental independence and transparency

Note The correlation coefficient equals -0,86 (t= 4,46).

Source Goal-TR is from Eijffinger and Geraate (2006) for the year 1995.

The way through which the central bank set its inflation target could have an impact not only on its independence degree but also on its transparency. Studies by important scholars postulated a negative relationship between independence and accountability in the central bank institutional setting, in particularly when goal independence is adopted. Figure 11.1 shows how countries placed on the left part of the graph (like the UK), employing the instrumental independence model, present a higher degree of transparency than countries placed on the right (as Germany and Switzerland), which opt for the goal independence model (Huges and Libich 2009).

This is because instrumental independence is seen as a complement to the inflation-targeting model, whereas goal independence is found to act as a strategic substitute to inflation-targeting and hence may be a 'foe' to the regime. Both models proved to be able to tackle rises in inflation and to enhance central bank credibility, instrumental independence seems to be socially preferable. Instrumental independence, hence, leaves some room to the representatives of people (i.e. politicians) in laying out the goal (or target) of monetary policy, but enough freedom is also given to the central bank as to allow them to take the best measures for the attaining of those goals and also to ensure the good long-run performance of the economy.

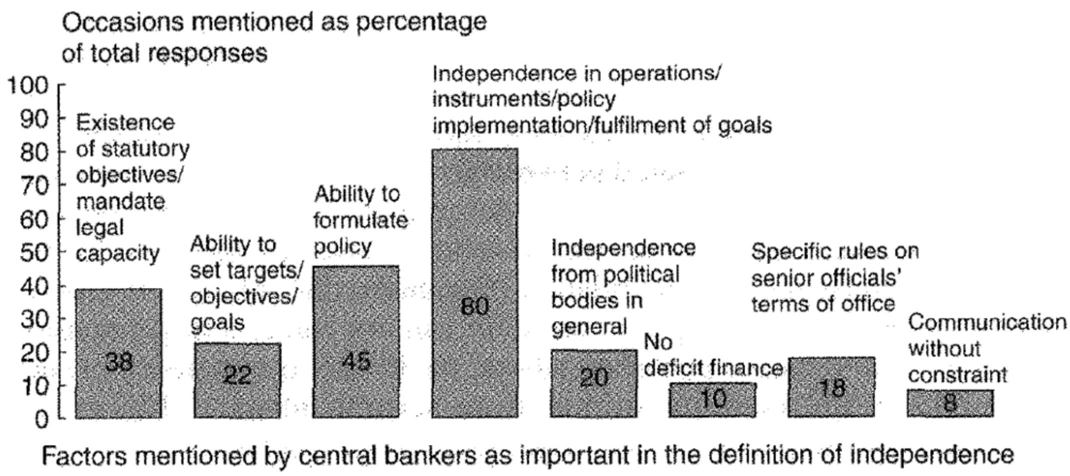

Figure 11.2: Central banks' definition of independence.

Source Survey conducted by the Bank of England asking central bankers the question: "How would you define central bank independence?". There were 60 usable responses (23 from industrialised economies and 37 from developing and transitional economies). See Fry et al. (2000: 111).

Beside the different positions outlined above, we also need to examine the position of the central banks on this. Looking at Figure 11.2 we see that 80 per cent of stakeholders interviewed define central bank independence as the capacity to set instruments and operating procedures; almost all central bankers considered instrumental independence to be an important aspect of independence. By contrast, the same figure shows that only 22 per cent of respondents have stressed the ability to set targets, objectives or goals as an indispensable aspect of central bank independence. These respondents belong to central banks which have used explicit inflation targets as part of a disinflation process, and as it is easy to imagine, the responsibility to set the inflation target by central banks has resulted key for disinflation.

Instead central banks under the inflation-targeting model, with a given low inflation rate, do not generally regard the ability to set the inflation target as a key element of their independence. This suggests that when the inflation is low, there is little scope for disagreement about what the target should be, so the responsibility for the setting of main monetary policy goals can be successfully shared between government and the central bank. By contrast, when the inflation is high, it has proved to be more difficult for government and central bank to split responsibilities for inflation targeting. All in all, which model deserves to be adopted is determined by the inflation level of the country concerned.

ECB independence

The first steps of the European Monetary Union

The founding treaty of the European Union, the Treaty of Rome, contained limited provisions on European monetary and economic policy, because at that time the main goal of the Treaty was the establishment of a single market. Since the 1970s, member states have been preparing for the project of Economic and Monetary Union. The first concrete step on the way to realising the project was the introduction of the European Monetary System (EMS), which for the first time created a monetary co-operation mechanism within Europe, as member states' currencies could fluctuate within established margins. After the monetary crisis in 1992, the member states decided that monetary co-operation had to move towards a single monetary policy, with the final goal of establishing a single European currency.

To achieve such an ambitious goal, the Maastricht Treaty established the European Monetary Union (EMU), which required states to fulfil two basic conditions: (1) triggering economic convergence process among states, inspired by the well-known 'Maastricht Parameters'; (2) transferring monetary and exchange rate policy from member states to European Community.[7]

While the economic policy still remains in the hands of the member states, for monetary policy it was suggested to transfer this competence from the member states to the Union. This clearly entails the establishment of an institutional framework in order to put into practice the new European monetary policy. Here the establishment of the European Central Bank was critical. In fact, the decision to create a single currency without the integration of the member states' central banks could result inconsistent and be a source of inefficiency. The new single currency, hence, needed to be supported by single-interest type policies and a centralised monetary policy. But the creation of the new European Central Bank as such could not assure the success of this historic monetary experiment.

In fact, before the establishment of the EMU there existed a deep asymmetry between high inflation countries and low inflation countries within the European Economic Area. In order for the low inflation countries to accept to be part of the new common currency, they required that the ECB was set up with the assurance of price stability as a primary goal. The monetary policy run by this new European monetary authority was required to be extremely counter-inflationist, and it relied on an obligation of the public sector to borrow money at market interest rate value, by forbidding access to privileged financial credits at better condition in comparison with the private sector.[8] To make the ban of monetary financing of the public

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[7] Article 4(2) TEC states: "Concurrently with the foregoing, and as provided in this Treaty and in accordance with the timetable and the procedures set out therein, these activities shall include the irrevocable fixing of exchange rates leading to the introduction of a single currency, the ECU, and the definition and conduct of a single monetary policy and exchange rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Community, in accordance with the principle of an open market economy with free competition".

[8] See Article 124 TFEU: "Any measure, not based on prudential considerations, establishing privileged access by Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions shall be prohibited".

deficit effective,[9] thereby convincing countries with low inflation, such as Germany, to be part of the rising European Monetary Union, the new ECB had to comply with two main requirements: (1) a high degree of independence; (2) the settling of price stability as the primary goal.

The main features of ECB independence

As mentioned in the introduction of this chapter, the some have argued that there exists a close relationship between central bank independence and monetary stability. As a matter of fact, for the central bank to be independent it only has to comply with one single goal: price stability. The more different goals are to be achieved, the less independence is held by the central bank; this is an equation that many scholars have considered over the years. Particularly, the monetarism doctrine has asserted that it should be impossible for central banks to achieve different macroeconomic goals (growth, full employment, low inflation, etc.) by using only money supply instruments (Alesina and Summers 1993). European institutions, by forming the European monetary policy, have followed monetarism thought to tie closely ECB practice to monetary stability.[10] The Treaty of Amsterdam establishes a clear hierarchy of monetary policy goals to be achieved, where price stability clearly holds the first rank.

Obviously independence is a basic requirement of guaranteeing a proper monetary policy capable of securing price stability. Central banks, indeed, by being independent from government and parliament, should, through price stability, develop a mid-term monetary policy to protect the purchasing power of the currency.
The independence of central banks is a conception prompted by the lack of interfering powers by the political institutions. The EU member states, thus, by strictly following this concept when setting up the new European monetary policy, have separated the ECB from

[9] See Article 123(1) TFEU: "Overdraft facilities or any other type of credit facility with the ECB or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments".
[10] See Article 127(1) TFEU.

all types of political pressures and influences, as the new monetary policy should be reliable and consolidated from the beginning.

Proof of that is Article 130 of the Treaty on the Functioning of the European Union (TFEU, ex Art. 108 TEC) where is clearly stated that neither the ECB nor NCBs, shall seek or take instructions from Community institutions or national bodies. In order to make the independence actual and real, it has to be realised in all different areas: personal, institutional and financial.

Personal independence

This aspect of central bank independence concerns the guarantees enshrined in the Treaty of Amsterdam and the Statute of the European System on Central Banks (ESCB) to avoid political influence in the appointment of the governor and other members of the Executive Board and Governing Council of the ECB. The Lisbon Treaty introduced an important change regarding the appointment of Executive Board members. Article 283 TFEU (ex Art. 112 TEC) rules that the President, Vice-President and other members of the Executive Boards shall be appointed by the European Council, acting by qualified majority, while the former Article 122 TEC uses the formula "by common accord of the governments of the Member States at level of Heads of State or Government". Since the Lisbon Treaty, on this aspect, the ECB is more similar to national central banks where executive members are chosen by qualified majority.[11] However, the unanimity practice has still been in use during the appointment of the new ECB governor Mario Draghi.

In the appointment of Executive Board members, the Council chooses among persons of recognised professional experience in monetary and banking matters. This requirement stresses again the technical nature of ECB and aims to sterilise any political influence in the appointment procedure.

In order to safeguard the independence of the Executive Board members, three other important requirements are comprised in the Treaty of Amsterdam: (a) the office shall not be renewable, thus avoiding that members, close to the end of term, take accommodating decisions to please national governments in the light of re-election;

[11] See Article 283(2) TFEU (ex Art. 112(2) TEC).

(b) the terms of office does not correspond with the legislative term of neither the EU nor national Governments, so avoiding the creation of a connection between appointer and appointee;[12] (c) the decision for dismissing the governor and other members of Executive board is taken by the European Court of Justice, thereby avoiding that other European institutions (in particular the Council) could use revocability as a weapon to hamper the practice of ECB independence.

Obviously a member of the Executive Board may be relieved from office if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct;[13] only the Executive Board and the Governing Council can start the dismissal procedure against one member of the Executive Board on grounds of infringement of the Treaties or of any rule of law relating to its application. Therefore, the European institutions (the Council, the Commission and the Parliament) can neither remove nor initiate a dismissal procedure against Executive Board members, so that the Treaty ensures their actual personal independence.[14]

Political-institutional independence

The second aspect of independence refers to the political-institutional feature of ECB independence. Legally speaking, the first factor to stress is that the ECB, although part of the EU, holds a legal personality under public international law. The ECB has sufficient legal capacity (such as the capacity to trade assets or to appear before courts of law) to carry out its own tasks. Thanks to legal personality, the ECB can maintain a high degree of autonomy, which is central to the realisation of its functions. Moreover, the ECB is endowed with original competences, i.e. competences neither linked to nor derived from other European institutions.

Beside the factors mentioned above, the institutional independence of the ECB is ensured by Article 130 TFEU (ex Art. 107 TEC). This article clearly supports institutional independence of the ECB by prohibiting

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[12] In the ECB case, the term of office of all Executive Board members is eight years and is not renewable.

[13] See Article 11(4) and 14(2) of the ESCB Statute.

[14] Article 11(4) ESCB Statute states: "If a member of the Executive Board no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct, the Court of Justice may, on application by the Governing Council or the Executive Board, compulsorily retire him".

its decision-making bodies to take or seek instructions from Community institutions or member state authorities. Furthermore, other national and European institutions do not have any voting rights in the decision-making process, neither in reviewing nor suspending legal decision taken by the ECB. Therefore the Treaty has created the legal framework to properly separate the ECB from other government bodies both at the national level (governments and parliaments) and at EU level (institutions and other organisations) (Pisha 2009).

With regard to the political independence profile of the ECB, we underline the fact that the Treaty drafters decided to endow the objective of monetary policy with precise traits, thereby reducing the occurrence of contesting understandings of the role of the ECB as much as possible. The already mentioned Article 127 TFEU (ex Art. 105 TEC) clearly states that the primary objective of the ECB shall be to maintain price stability. Without prejudice to this objective, the ECB shall support the general economic policy in the Community to achieve important goals like full employment and economic growth. Thus price stability has supremacy over other objectives, and has to be constantly taken into account in ECB decision-making.

This hierarchy of objectives has been introduced to avoid any misunderstanding about the core macroeconomic objective of ECB: price stability. More than national banks, new transnational central banks, like the ECB, needed a clear-cut commitment against inflation, which can be hampered by stating objectives with smearing traits, as it sometime happens in national laws regulating central banks. In order to isolate the ECB even more from any political influence on the monetary policy goals, the TFEU allows the ECB to determine the content of price stability, thereby avoiding any kind of direct influence by the governments. Hence it is up to the ECB to specify price stability and translate it into an operational goal, according to the independence model called *goal independence* already touched upon on the first part of this chapter. The ECB Governing Council has quantified price stability objective with the following formula: 'price stability is defined as a year-on- year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term'.[15] Obviously, the ECB is fully entitled to overrule this price target in the future.

Economic-financial independence

Beside institutional and legal aspects, the real independence of the Central Bank requires a definition of clear rules governing the relationship between the Central Bank and the government in the treatment of Central Bank losses and profits. In case of losses, the government should commit to maintaining the Central Bank's capital such that monetary policy is implemented without financial restrictions, while bank profits should be transferred to the government after an appropriate accumulation of the Central Bank's legal reserves.

The drafters of the European monetary policy were fully aware of how important the financial aspect of central bank independence is. For that reason they established some important bans in the Statute of the European System of Central Banks.

The first one prohibits overdrafts[16] or any type of credit facility with the ECB or NCBs in favour of European or national institutions. As national institutions, according to the European Court of Justice's (ECJ) extensive understanding, also have to be considered bodies governed by public law and public undertaking of member states, it does not matter whether they are formally governed by private law.[17] The ECB and NCBs should only allow extending the intra-day credits facility to the public sector,[18] with the aim of fostering the good functioning of the payment system. This prohibition, thus, avoids

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[15] In May 2003 the definition of price stability changed slightly, adding the words '*but close to*' before the figure of two per cent. This clarification aims to make clear that price stability aims to avoiding not only high inflation, but also deflation. See ECB (May 2003) *Monthly Bulletin*, Available at: <http://www.ecb.int/pub/pdf/mobu/mb200305en.pdf>.

[16] Overdrafts facilities means any provisions of funds to the public sector resulting or likely to result in a debit balance.

[17] This rule shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.

[18] See Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty. Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31993R3603:EN:HTML>.

materially that national governments should have a direct control over monetary supply.

The second ban disallows the direct purchase of national debt securities by the ECB and NCBs. The aim of this provision is to avoid that the ECB or NCBs should be subjected to pressure by national government to alter the interest rate structure by reducing the cost of debt services. However, purchases of government bonds on the secondary market by the ECB is allowed, and during the financial crisis the ECB bore on this instrument, as we will see later, to floating the public debt of peripheral EU countries, who suffered a kind of credit crunch on the national bonds market.

The third ban forbids privileged financing to private banks by the ECB. If national governments should pressure the ECB to grant favourable interest rates in favour of those private banks who accept financing government expenditure, this obligation indirectly entails a cut of the ECB independence. Thus, it should be a mandatory transfer for private banks who decide to finance states at more favourable conditions than those set by the market. For that reason, the Treaty also bans these kinds of tools, thus protecting the effective ECB independence as much as possible.

The other important aspect of financial independence refers to the budget of the ECB. Its capital is subscribed and paid up by the euro area NCBs. As it so happens for other EU bodies, the ECB budget does not depend on the approval of the EU general budget provisions by the Council and the Parliament. The ECB is hence able to self-finance itself thanks to capital subscription of NCBs in accordance with population and gross domestic product criteria.

In order for the financial independence of the ECB to be real, it obviously requires a certain degree of economic independence. The aim of the provision contained in Article 126 TFEU (ex Art. 104 TEC) '*Member States shall avoid excessive government deficits*', is not only facilitating the work of the ECB, but also protecting against the cost of member states bailouts. In this way, the restricting rules over public deficit and debts represent an important added value for ECB independence and the effectiveness of its monetary policy. The observance of the deficit rule should eliminate any disturbances over monetary policy provoked by excess public deficit of member states.

Unfortunately this aspect, the economic independence of the ECB, has been highly hampered since the financial crisis started, forcing the ECB, as we will see next, to take measures at the edge of its powers, so casting a doubt over its actual independence.

ECB transparency and accountability

The independence of the Central Bank brings with itself the well-known issue of democratic deficit. There is nothing anti-democratic in setting up independent agencies to pursue certain political goals. More and more executive powers are, because of their technical complexity, delegated to independent agencies with the argument that the general interest is better taken care of in this way rather than by relying on the government or the parliament.[19]

The movement towards independence for the central banks is supported by many stakeholders and requires a strengthening of transparency and accountability. No public institution, in particular when non-elected, can be totally independent in the sense that it does not have to report to anyone. Greater transparency allows better understanding of decisions, while better accountability imposes firmer discipline on decision-makers; together they contribute to higher-quality decisions in central banks and also safeguard the system of 'checks and balances', which is the cornerstone of a democratic institutional setting. Let us have a look at how the European institutional setting 'counterbalances' ECB independence.

ECB transparency

As seen in the introduction to this section, central bank independence requires transparency to be socially and institutionally acceptable. Transparency, in monetary policy means that the central bank provides in an open, clear and timely manner all relevant information on its mandate, strategy, assessment and policy decisions, as well as procedures, to the general public and financial markets (Posen 2002). In fact, where reasons for certain decision on monetary policy lay open, it is easier for the public and the market to judge central bank behaviour. Usually, a central bank should be required to report at

[19] Notwithstanding the structural similarity, it is worth to point out that the 'redistributive nature' of central bank decision-making is the main aspect which differentiates the central bank from other independent regulatory authorities. For further details, see Everson and Rodrigues (2010).

regular intervals on its past performance and future plans for the monetary policy in accordance with the monetary objective. In the national case, the law prescribes certain procedures on how to explain monetary policy. In the ECB case, the Treaty and ESCB Statute establishes only that ECB has to publish reports on its activities at least on a quarterly basis. Whether and to what extent these reports should include details on past performance and projections on the future development of monetary policy, is left to the ECB to decide.

Aware of the importance of transparency for monetary policy, the ECB has decided to arrange a communication strategy, consisting of the following (Ehrmann and Fratzscher 2005): (1) the publishing of a monthly report. By doing that more frequently than the Treaty requires, the ECB shows that it enhances transparency; (2) the holding of a press conference following the first meeting in every month of the ECB Governing Council ; (3) the publishing of all non-confidential legal instruments governing the relationship between ECB and NCBs; (4) twice per year releasing the economic projections done by ECB staff; (5) including arguments for and against cutting or raising interest rates in its statements following the monetary policy meeting of ECB. The explanation of the decision taken by the Governing Council has represented one of the most important steps to pursuant transparency.

Thanks to those measures, the ECB has accomplished significant transparency improvements during its first decade. In an international comparison of 100 central banks; done by Dincer and Eichengreen (Geraats 2008: 17) and using the transparency index by Eijffinger and Geraats (2006); the ECB ranks in the top 10. This index, which covers several transparency aspects of monetary policy-making (political, economic, procedural, and operational), indicates that the ECB has made most progress in economic transparency, which refers to the economic information that is used for policy decisions, but still performs poorly on procedural transparency, which pertains to the way monetary policy decisions are taken.

This gap is due to the fact that the ECB does not release the minutes from its meeting but only hold a press conference, while several other central banks post comprehensive minute of meeting within eight weeks. Those minutes are generally non-verbatim and unattributed, with the exception of reservations against the policy decision raised by dissenters. The ECB model could in principle be an adequate and even more timely substitute for minutes, but the question and answer session could identify transparency gaps; in fact the value of press conferences is limited when the central bankers' responses are reticent (Geraats 2009: 25). In addition, the ability to appropriately ask questions about delicate monetary policy issues requires considerable communication skills. Actually it would be preferable to extend the minutes of meeting rather than to hold a press conference. But on this point ECB has ruled out issuing minutes, because making it public that a decision has been taken by only a slightly majority could put pressure on presidents and governors of National Central Banks (Von Hagen 1998), who make up the Governing Council.

Finally, it is evident that the ECB tried to broaden the extent of the transparency obligations contained in the Treaty, but, on some aspect as procedural transparency, it still remains below the marks achieved by other important central banks.

ECB accountability

The institutional structure of the EMU has been criticised for showing an alleged democratic deficit, which is partially justified by the low degree of legal accountability of the ECB compared with its high level of independence.

Applying the *De Haan* central bank accountability index (De Haan et al. 1998), we observe that the ECB is less accountable in what concerns to the 'final responsibility for monetary policy' aspect, and more accountable in the case of the 'ultimate objectives', namely price stability (De Sousa and Pedro 2001).

As was already established at the begin of this chapter, it is widely accepted that monetary policy is best managed by an independent agency, like a central bank, where the role of the democratically elected body (parliament and government) is limited to appointing a group of experts to decide and implement monetary policy, granting operational independence to achieve some established objectives. As the monetary policy effects on society are not negligible, the central bank is required to explain and justify its actions and decisions by giving an account of them to the government and/or parliament which is in charge of reviewing the same.

Besides that, those elected organs, before which the monetary authority must be accountable, needs to have *instruments to sanction* a poor performance. In the case of the ECB, it must be accountable to the elected representatives of the European society, the European Parliament (EP).

Formally speaking, the European Treaty has provided the European Parliament with soft tools for exercising an influence on ECB activity. The only 'strong' power of the EP over monetary policy refers to the simplified revision procedure of the ESCB Statute, where an amendment of the ESCB Statute needs European Parliament assent.

Despite this marginal role assigned to it by the Treaty, the EP has tried to maximise the interpretation of its limited powers to scrutinise the ECB. For example, it has sought to turn its right to be consulted on the appointment of the ECB's executive into a power akin to that of the US Senate to 'hear' and confirm nominees for the Federal Reserve (FED). In fact the right to be consulted enshrined in the Treaty, is applied through EP internal rules of procedure which require nominees to ECB's Executive Board to make declaration before the Economic and Monetary Affairs Committee of the European Parliament (EMAC) and answer its questions. Then EMAC extends a recommendation to the Parliament, who in plenary session vote on whether to accept or reject the candidate concerned. However, although a negative result does not have any legally binding effect on the appointment decision of the Council, it is evident that a negative vote expressed in Strasbourg could result in a public pressure from on the Council to withdraw the candidate rejected by the EP and present a new nominee.

The European Parliament's powers over ECB activities are very limited as well, and consist more or less of hearings of President of the ECB before the Parliament. The President of the ECB appears five times per year before the European Parliament. Once a year to present ECB's annual report to plenary. The other four times, he appears before the EMAC to explain the ECB's policy decisions and to answer questions by Committee members. All these hearings before EMAC are open and public. Regarding the submission of the ECB's annual report to the EP, a debate and a vote on the ECB's performance has to be in accordance with Article 284 TFEU (ex Art. 113).[20] The EP vote over the annual report presented by ECB governor is intend to be a comprehensive, *ex post* assessment of the ECB's activities and policy conduct.

Obviously the EP resolution does not have any incidence from a legal point of view, but, given the importance of market credibility to effective central banking, a negative vote cast by the EP or an unscheduled appearance before EMAC could be a powerful source of accountability and a considerable deterrent against poor performance by the ECB.

Despite the steps taken by EP in this regard, to make ECB accountability comparable with that of the main Western central banks, it still clearly misses a single European figure, who can represent an integrated European economic policy and act as a counterbalance with respect to instances of monetary policy advocated by ECB. Neither the Council nor the Commission has assumed this role.

The direct and indirect impact of the financial crisis on ECB independence

The direct impact

ECB sovereign bonds purchases: A threat to ECB independence?

As we saw in the last section, the direct purchase of sovereign bonds was explicitly banned in the Treaty of Amsterdam by the drafters of the European monetary policy in order to ensure the real financial independence of the ECB. The aim of this provision is avoiding that the ECB or NCBs should subject to national government pressure to alter the interest rate structure by reducing the cost of debt services. The financial crisis, by turning into a sovereign debt crisis, has shaken the foundations of this conventional thought. The bursting of the Greek sovereign debt crisis created a liquidity restraint also for the sovereign debts of those peripheral countries (well-known in the

[20] See Article 284 TFEU: "The European Central shall address an annual report on the activities of ESCB and on monetary policy of both previous and current year to the European Parliament, the Council and the Commission, and also the European Council. The President of the Central Bank shall present this report to the Council and to the Parliament, which may hold a general debate on that basis".

press by the acronym 'PIIGS'[21]), who did not find acceptable financial terms on the market to re-fund maturing debt and to issue new debt. Starting from the consideration that monetary policy transmission was at stake, the ECB decided to deviate from its principle of not lending to any public authority and launched the purchase of sovereign bonds on the secondary market.[22]

Despite the arguments provided by the ECB countering the accusation that it should monetise government debt (Trichet 2010), the literature finds several shortcomings (Whelan 2010: 15). Some observers argue that, by bond purchases, national fiscal policies could from now on dominate the common monetary policy. The purchase of sovereign bonds issued by highly indebted euro area governments by the ECB contains an element of subsidy, which tends to severely weaken their fiscal discipline. In fact, the interest rate premium on bonds of fiscally weaker countries declines and the premium for stronger countries increases (Belke 2010a: 4).

In other words, the ECB acts like a fiscal agent by taxing other euro area creditors through higher bond rates in order to support a government which finds itself in a financial emergency. Fiscally solid countries are punished and less solid ones, in turn, are rewarded for their lack of fiscal discipline and excess private and public consumption. Additionally, by supporting the purchase of government bonds of troubled countries, the ECB may weaken the incentives for countries to behave properly in the future, as they know they will be 'saved' somehow by the ECB. This is the classical 'moral hazard' situation where an institution does not take the full consequences and responsibilities of its actions, because it expects that others share some responsibility for the consequences of those actions.

With the recent aggravation of the sovereign bond crisis of Spain and Italy, it seems that the ECB will be forced to even enlarge its bond purchases. Furthermore, it will also be called upon to purchase the bonds issued by the new European Stability Mechanism (ESM),[23]

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[21] Portugal, Ireland, Italy, Greece and Spain.

[22] The sovereign bond purchase has been done by ECB under the programme named 'Securities Market Programme'.

[23] On 11 July 2011, the finance ministers of the 17 euro-area countries signed the Treaty establishing the European Stability Mechanism. The Treaty follows the European Council decision of 25 March 2011 and builds on an amendment of Article

which will replace the European Financial Stability Facility (EFSF) in 2013. Hence, up to now, the ECB should not purchase bonds issued by the EFSF, because it is a company governed by private law but owned by the member states; so the Treaty bans ECB from purchase those bonds directly from it. But in July 2013, the ESM will replace the EFSF, and its legal status[24] will be that of an intergovernmental organisation, just like the International Monetary Fund (IMF), and it will be able to raise funds by issuing bonds. It is worth reminding that in 2009 various European central banks granted a loan to the IMF to finance its assistance to governments, as Table 11.3 shows. For that reason, once the ESM is introduced, the ECB will find it a lot more difficult to continue to refuse its credit to contain the euro-zone public debt crisis (Broyer et al. 2011).

Table 11.3: Loans granted to the IMF by the euro system since the crisis.

Bank / Government	Amount (EUR)	Date
Bank of Slovenia	0.28 billion	12 October 2010
National Bank of Austria	2.18 billion	10 October 2010
Bank of Finland	1.30 billion	26 April 2010
Swedish Central Bank	2.47 billion	7 April 2010
Czech National Bank	1.03 billion	31 March 2010
Central Bank of Malta	0.12 billion	12 February 2010
National Bank of Belgium	4.74 billion	12 February 2010
Bank of Portugal	1.06 billion	30 November 2009
National Bank of Denmark	1.95 billion	4 November 2009
Dutch Central Bank	5.31 billion	5 October 2009
German Federal Bank	15.00 billion	22 September 2009

Source IMF, in Broyer et al. (2011: 6)

Beside the perception that ECB seems to be more dependent in political terms, the other argument considered is the lack of transparency in the ECB sovereign bond purchases. The lack of transparency consists of the fact that the public is not informed about the composition of the debt securities the ECB is buying, the criteria being used to select bonds to purchase, the ECB's bond purchase

136 of the Treaty on the Functioning of the European Union. The Treaty now needs to be ratified by the euro-area member states before 31 December 2012 to enter into force, following approval of signatories representing no less than 95 per cent of the total subscriptions.

[24] Article 1(1) of Treaty establishing the European Stability Mechanism, which it states: "By this Treaty, the Contracting Parties establish among themselves an international financial institution, to be named the 'European Stability Mechanism'".

strategy during periods of primary issuance, and how long the programme is going to last and how much may be spent. Therefore, all those facts and circumstances create the general perception that the ECB has become more dependent in political terms and less credible to the general public due to a lack of transparency.

On the other hand, we find stakeholders who support the actions taken by the central banks, among those the ECB, to face this financial crisis (Posen 2010). They argue that central bank independence is about the ability to say 'no' to demands for bond purchases when they are economically unjustified. Central banks, therefore, are committed to delivering the best economic results, and not to guarding their reputation of appearing to be independent. When the nominal rate is already at *de facto* zero bound,[25] and the financial transmission mechanism is damaged, buying bonds is the only tool central banks have to try to deliver price stability against deflationary pressure. The financial independence of central banks, therefore, has to be interpreted as the capacity of central banks to refuse demands to purchase sovereign bonds coming from politicians, because the macroeconomic landscape does not justify such purchases.

Given these considerations, the before-mentioned critics' voices over the ECB action to support sovereign debt, are not justified. The bond purchases realised by the Central Bank are not by itself a danger to the central bank independence. Initiating the right kind of bond purchase under the right circumstances is part of running a responsible monetary policy. This is what the ECB did by complying with the Treaty and the spirit of its task.

Those who support the ECB action argue that the core of debate should be focused not on assessing the effectiveness of the ECB sterilisation measures taken to counteract the monetisation effect of the outright purchases of sovereign debt,[26] but on evaluating whether

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[25] The negative effects caused by zero bound nominal interest rate over the central bank capacity to face deflationary shock will be discussed in depth further in the chapter.

[26] To keep the overall money supply unaffected, bond purchases, thus, must be offset through sales of other bonds or money market instruments. To avoid money supply swell, each week the ECB drains the amount of extra liquidity it has created by offering banks seven-day term deposit. This serves to counter accusations that the ECB is monetising government debt. Beside the critique of the actual effectiveness of

sovereign bond purchase contributed to restoring the correct functioning of the monetary policy transmission mechanisms.

Finally, these two different views on the ECB's support to sovereign bond provide interesting arguments to the debate about the actual impact of the financial crisis on ECB independence. From my point of view, both camps share the assumption that the ECB, to face the financial crisis, has understood its mandate, enshrined in the Treaty, in a more flexible way than in the past. This does not automatically mean that ECB independence is weakened, but more questions will for sure be raised and doubts cast on the ECB independence because of the widened ECB action.

Unconventional monetary policy: Which risks for the ECB?

The whole unconventional monetary policy tools employed by central banks, have led some commentators to argue that the central banks' monetary policy hereinafter should be constrained in achieving its objectives by the expansion of their balance sheet as Figure 11.3 depicts (Tesfaselassie 2009: 4).

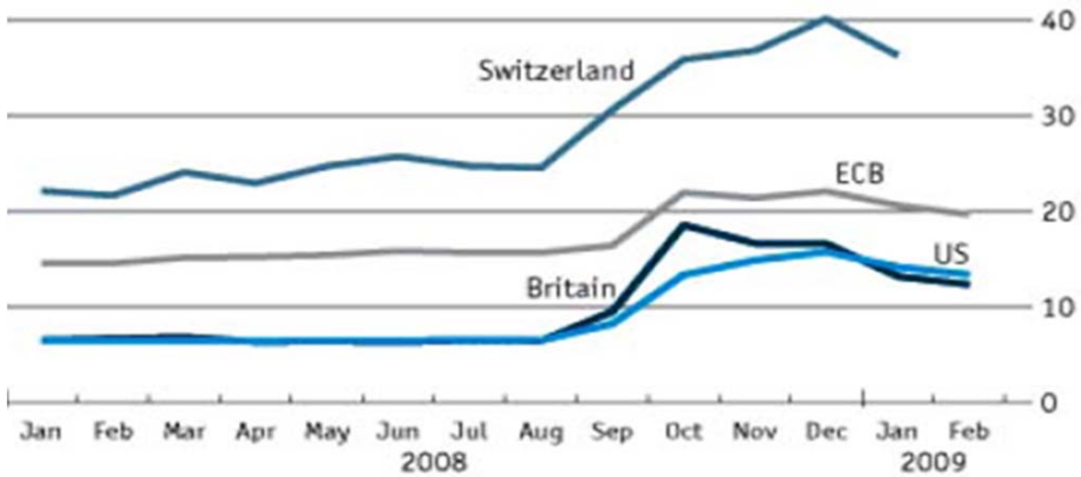

Figure 11.3: Assets of selected central banks, per cent of GDP.

Source *The Economist*, in Tesfaselassie (2009: 2).

To improve the market liquidity in important segments of the private and public debt securities market, central banks, hence, have not only expanded their balance sheets, but also changed the compositions of

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the stabilisation measure, it must be reported that the ECB has recently failed to fully neutralise the monetary impact of the funds it had spent buying government bonds. See Atkins and Oakley (2011).

their assets, meaning the acquisition of more risky assets with higher exposure to losses.

Some authors, such as Willem Buiter (2008), launched a defiance question: *Can central banks go broke?* This question makes sense if we consider that the size of the equity and the size of the balance sheet of central banks appear small in comparison to the possible exposure of the Central Bank to credit risk stemming from its 'lender of last resort' activity realised since the beginning of the crisis.

Although the hypothesis of central bank failure is less theoretical than before the crisis, central banks of advanced countries do not seem to run this kind of risk. Due to the fact that advanced countries' central banks do not have significant foreign exchange-denominated liabilities, it will always be possible for them to ensure their solvency though monetary issuance, seigniorage (Stella 2010: 2). Even under very adverse macroeconomic and financial assumptions, the central bank's ability to generate seigniorage, owing to large stock of banknotes, is sufficient to face significant shock without losing control of inflation.

According with this argument, the central bank could take over financial stability tasks without losing its capacity to achieve the goal of price stability. In fact, stress tests based on the assumption that the central bank could suffer a 35 per cent loss on total local currency assets, showed that central banks should not be concerned with macroeconomic level of losses. Figure 11.4 depicts this situation (Stella 2010: 5).

Only in the case of the Bank of England there is reason to be concerned with the macroeconomic level of losses. However, it is fair to remind that the Bank of England has the lowest buffer, as seigniorage from banknote issue is directly transferred to Treasury, while for the other central banks mentioned in Figure 11.4, it does not work like that. Based on this figure, central banks should not suffer losses that would prevent them from attaining their inflation target.

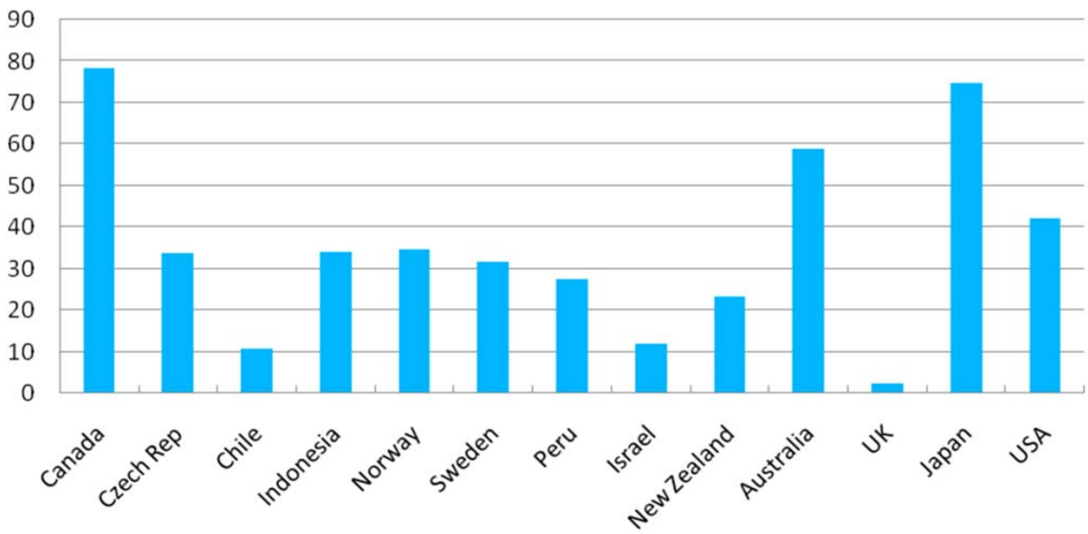

Figure 11.4: Currency plus Adjusted Capital as per cent of Total Assets (2009 or most recent available data).

Sources: Various central bank annual reports; author's calculation.

Obviously, also the ECB seems to not be running any downturn risk of its balance sheet, although the euro system has some shortcomings on that point.[27] While each national fiscal authority stands financially behind its own national central bank, there is a lack of a 'fiscal backing' in the euro system. In cases when the euro system suffers from capital losses, this gap calls into question the ECB capacity to conduct its monetary policies with effectiveness and in accordance with ECB mandate to secure price and financial stability (Belke 2010b).

As long as there remains some uncertainty concerning its recapitalisation, the ECB could not be as aggressive as necessary when implementing non-standard measures – in particular when providing central bank liquidity in the euro system monetary market operations.

The current crisis reminds us that a central bank without adequate fiscal backing can be powerless in the pursuit of macro-prudential

[27] In December 2010, the ECB decided to increase its subscribed capital by five billion euros, from 5.76 billion to 10.76 billion euros. The ECB Governing Council decided that the euro area national central banks should pay their additional capital contributions of 3 489 575 000 euros in three equal annual instalments, to facilitate the ECB capital increase. However, this capital increase proceeds from national central banks and not national governments. See the ECB press release at: <http://www.ecb.int/press/pr/date/2010/html/pr101216_2.en.html>.

stability and even in the pursuit of price stability. Without a fiscal indemnification for the resulting credit risk, the ECB, thus, will be unable to address the excessive private-public yield spreads and the credit rationing, which both indicate dysfunctional credit markets. Currently there is a vacuum behind the ECB and the euro system with respect to losses incurred as a result of monetary operations, liquidity interventions and credit-easing policies (Sibert 2009).

All in all, however unlikely an ECB failure still seems, an agreement on a formula for dividing the fiscal burden of recapitalising the European Central Bank could for once allow the euro system to be ahead with respect to a highly negative hypothesis.

The indirect impact

Will financial crisis force ECB to raise inflation target?

Stable and low inflation was presented as the primary mandate of the central banks. Over the years, the Central Bank had to focus more on reaching low inflation rates and to achieve that, they started adopting the inflation targeting model, as we saw in the first part. This monetary policy setting has allowed various countries to reduce their long-term inflation rate and at same time to respond properly to shocks within the domestic economy.

However, when central banks face a protracted deflationary slump, low inflation rate target increase the probability of falling into a liquidity trap (Klaeffing and Lopez Perez 2003), which consists of combination of significant deflation and low nominal interest rates. In this case, central bankers should be concerned about the zero bound on nominal interest rates, because it may render nominal interest rate policies unable to create the stimulus needed by an economy in recession. The main consequence of the zero bound on nominal interest rate is that the central bank policy rate becomes less effective to lead the economy out of deflation. In other words, the zero bound negatively affects the central bank’s ability to reduce nominal interest rates in response to negative shocks to the economy. The magnitude of the recession, hence, after deflationary shock, would be relatively small if the central bank had ample room to cut rates, while if the policy rates were close to zero the magnitude of the recession would be much larger. This limit on reducing real interest rates as low as desired impairs the capacity of monetary policy to stabilise output and inflation after deflation shock.

Aware of this potential risk, the conventional wisdom in central banking circles has been that the two per cent inflation target should provide a sufficient cushion to reduce the negative impact of zero bound on nominal interest rate. Several simulations predict that with an inflation target of two per cent, the constraints caused by zero bound on the effectiveness of central bank monetary policy should be relatively mild (Leigh 2009: 2). To sum up, up to the present crisis, stakeholders and scholars found the two per cent inflation target an adequate buffer to reduce the negative implication of zero bound for monetary policy in case of deflation shock. But the economic crisis that started in 2007 is challenging this conclusion.

In fact, many central banks had to cut short-term interest rates effectively to zero and were therefore forced to implement unconventional monetary policy to support the recovery. It is worth saying that zero bound did not materially contribute to the sharp decline in the output of several countries, but it has been a significant factor slowing recovery. For example, some counterfactual simulation suggests that the zero bound on nominal interest rate has engendered a significant cost on the US economy in terms of lost output. To be precise, this lost output equals 1.7 trillion dollars of foregone output over four years (Williams 2009: 3). A comparable simulation done for other western economies has showed equivalent results in terms of lost output.

Given this landscape, some important stakeholders within the IMF, such as Olivier Blanchard, recommend central banks to start considering raising its inflation target rate (Blanchard et al. 2010: 10). Because the recent macroeconomic climates seems worse than that of the last 20 years, it seems that the inflation target of two per cent is going to be insufficient to limit the negative impact of zero bound on nominal interest rate.

Thus, by having a higher inflation target, when the inflation rate becomes very low, central banks should carry out a more lax monetary policy, so as to minimise the likelihood of deflation, even if this means incurring the risk of higher inflation in the event of an unexpectedly strong pickup in the demand.

Following this argument, the ECB should get rid of one of the most recognised tool that has characterised the ECB credibility over the years: the inflation target of two per cent.

As we saw in the previous section, the ECB, by having a goal-independence model, could raise the inflation target on its own, based only on technical findings without depending on government decisions at all. An eventual ECB decision to overhaul its inflation target would not harm the ECB independence from any point of view; while in the instrumental independence central banking model, it could cast some doubt that government raises the inflation target to monetise its own debt, hence undermining the monetary policy commitment to price stability.

However, it is not difficult to foresee that if ECB should raise its inflation target, many stakeholders will start questioning the credibility of the European monetary policy and its commitment to a low inflation rate. Someone could argue that the ECB is surrendering before the political pressure exercised by governments concerned with sovereign debt problems. However, as we showed in this section, a higher inflation target would have made it possible to cut interest rates more, probably reducing the drop in output and the deterioration of fiscal positions. The more adverse macroeconomic situation should be a proper technical argument to provide stakeholders with to justify the raise of the inflation target, thereby refuting the speculation over an inflation exit-strategy from the crisis. All in all, the figure of two per cent is not written in the stone, but an eventual ECB decision to raise the inflation target should give the impression that the ECB commitment to a low inflation rate is becoming weaker.

The new European financial stability supervision: Which role for the ECB?

There is now a broad consensus that the shortcomings in the regulatory and supervisory framework have been at the root of the current financial problem. Restoring confidence in the financial markets, thus, requires a substantial overhaul of the supervisory framework, both at national and European level.

The financial crisis, hence, has revealed the overreliance on micro-prudential regulation with a harmful neglect of macroeconomic stability. Micro-prudential regulation refers to the oversight and stability of individual entities within the financial system, such as individual banks and other financial institutions. The strong reliance on micro-prudential regulation in the pre-crisis era was based on the belief that stability within each financial entity would result in stability of the system as whole, since it is composed of single actors. However, this view is flawed, because it ignores that the "risk of a financial system is more than an aggregation of risks in individual institutions; it is also about endogenous risks that arise as a result of the collective behavior of institutions" (De Larosière 2009: 12-13).

This statement, contained in the Larosière Report, highlights the lack of macro-prudential supervision entitled to ECB. Before the crisis, the economists used to advise against the instalment of financial stability supervision upon the central bank, the main argument stressing the potential conflict of interest between price stability and financial stability. There is the risk that the goal of financial stability could be achieved at the cost of inflation control, particularly when the central bank, like in this crisis, is obliged to provide liquidity to avoid a banking crisis. The classical example given is that central banks might be reluctant to raise interest rates if a raise threatens to further weaken an already frail banking sector, thus preferring to run the risk of high inflation in the mid-term.

The adoption of financial stability could complicate the central bank governance model also for reasons such as: (1) in the case of financial stability there is no single, quantifiable objective as in the case of price stability, so central bank accountability become more difficult; (2) the financial stability decisions tend to be more politically sensitive than monetary policy (Crockett 2010: 19). In fact, committing public resources to a failing institution would seem to require much more direct involvement of governments and parliaments.

After the crisis, the above-mentioned classical arguments have been mostly overruled. First of all, it is argued that the objectives, tasks and governance of central banks are not set in stone and have evolved in the light of experience in order to address the different issues emerging in different periods. As the 'great inflation' of the 1970s and 1980s contributed to the adoption of price stability as primary objective of monetary policy, the financial crisis, nowadays, has raised an important issue linked to the role of the central bank in safeguarding financial stability (Papademos 2010: 25). In many countries, hence, the reaction against this crisis has implied the assignment of new responsibilities upon central banks regarding the financial supervision.

This reaction lead to a reform of the financial stability institutional settings, which can be split in two main groups: (1) countries who endow the central bank with both macro-prudential and micro-prudential supervision, thereby assuming an integrated model;[28] (2) countries who still maintain separate macro-prudential and micro-prudential supervision, thereby assuming a cooperative model where information-sharing and activity coordination is agreed within a statutory inter-agency committee.[29]

After the financial crisis bursting, the integrated model of supervision gained some support in the literature. Two arguments are often stressed: (1) the first argument refers to the fact that a central bank, to act properly before signs of an emerging crisis, needs information, which could flow freely and speedily from micro-prudential supervisors to those inside the central bank who are in charge of the macro-prudential supervision; (2) the second argument refers to the fact that a central bank, as an operating bank, could give more help rather a public administration, to encourage financial institutions to focus on the right questions in the accomplishment of the supervisory duties (Bini Smaghi 2009).

Notwithstanding those arguments, the main central banks (ECB and FED) have preferred to keep maintaining separate macro- and micro-prudential supervision tasks mainly because of the risk of moral hazard. Moral hazard, in fact, supports reckless risk-taking by such institutions, and provides them with an unfair competitive edge over the rest of the financial industry by having the certainty to get easy credit or even getting bailed out.

Therefore, by adopting the cooperative model, the ECB has maintained the principle of separation between monetary policy and financial stability policy. However, in the new European Systemic

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[28] An example of that is found in the UK where a subsidiary of the Bank of England will conduct micro-prudential policy under the authority of a dedicated board chaired by Central Bank Governor, but with majority of its membership drawn from outside the central bank.

[29] One of the best efficient applications of this model is found in the Bank of Canada. See Carney (2011).

Risk Board (ESRB),[30] entitled to carry out macro-prudential supervision tasks, the ECB plays a prominent role,[31] while the equivalent US Financial Stability Oversight Council, established by the *Dodd-Frank Act*, is dominated by the Treasury, i.e. the government.

By the way, the reform implemented in the euro system represent a coy step towards further ECB involvement in the task of financial stability supervision, but arguments as the potential conflict with the price stability and moral hazard, are still strongly considered by European stakeholders (Jurkowska-Zeidler 2011: 5).

This crisis, however, proves that the lack of macro-prudential supervision was the main cause which had not allowed the detection of the early signals of the potentially systemic crisis. Based on this evidence, I consider appropriate that next round of Treaty reform will rely on giving an explicit macro-prudential mandate to the ECB as regards both crisis prevention and crisis management, due to these main reasons: (a) from its privileged position, the ECB should have seamless access to direct market information, thus performing the macro-prudential supervision better than anyone else; (b) the ECB should have strong incentives to minimise the risk of being pushed towards the use of unconventional monetary policy tools; (c) the growing number of cross-border financial institutions requires the establishment of a 'regulator' acting at same (European) scale, so eliminating the problems risen from the fragmented national rules.

Conclusion

As we have seen in this chapter, the issue of central bank independence has been debated extensively by economists and policy makers during the past three decades. Several countries have changed their monetary policy frameworks to strengthen the degree of central bank independence, because it has been proven that a more

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[30] See Council Regulation (EU) No 1096/2010 of November 2010, conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board (ESRB).

[31] It is worth reminding that the ESRB does not have any binding powers to impose measures on national authorities concerned about macro-prudential activity. Notwithstanding the lack of binding powers, the ESRB shall draw its legitimacy from its reputation for independent judgements, high quality analysis and sharpness in its conclusion.

independent central bank can deliver lower inflation in the medium- to long-term.

With the bursting of the current financial crisis, the ECB, as well as the other central banks, had to intervene by putting its capital at risk providing easy liquidity to financial institutions, their depositors or other creditors. The chapter demonstrates how those measures, well-known as unconventional tools, have raised an intense debate within the scholarly literature on the impact on ECB independence.

Several scholars sustained that the whole range of unconventional monetary tools put into place by the ECB is going to have an impact on the financial independence of the bank itself, thus putting its anti-inflation credentials at stake.

On the other hand, the ECB defends its decisions by sustaining that before systemic financial crisis, the central bank is called to act as a lender of last resort to restore the correct monetary transmission mechanisms. Following this argument, ECB had complied with its task of providing monetary stability by using the policy tools available, so without putting at risk neither its independence nor price stability.

From my point of view, the financial crisis will not jeopardise the core-independence of the ECB, but it is going to affect two main aspects of European monetary policy: price stability and accountability.

Some commentators have stated that, since the ECB's balance sheet is expanding and it is allegedly taking on large risks, it may turn into a 'bad bank',[32] thereby reducing its financial independence. It is true that the lack of 'fiscal back-up' for the ECB create a *legal vacuum* with respect to eventual balance sheet problems, but through the seigniorage resulting from currency issuance, the ECB can cover those losses with only one potential side effect: higher rates of inflation.

[32] Moreover, an ECB default seems unlikely, because not being a liquidity-constrained institution; it can hold risky assets up to maturity, so that only default risk could impact on ECB profit and loss accounts. For further details, see Bini Smaghi (2011).

So the ECB remains independent, but what it is changed is the rank of the monetary policy priorities. The pressure coming from the IMF to increase the inflation target, as we saw in the third part, is another proof that right now the ECB is asked to use its independence not to focus on maximising price stability, but also on other crucial monetary policy objectives, such as the restoration of the mechanism of monetary transmission and the financial stability through macro-prudential supervision.

While the FED and the Bank of England are set to achieve different monetary policy goals, the ECB, on the contrary, has been entitled with a narrower range of goals, where price stability has been explicitly declared as the primary goal by the Treaty of Amsterdam. This means that the ECB is called to cover a wide range of monetary policy goals, without having any tested transparency and accountability mechanisms as the FED or the Bank of England have, although the improvement recorded on those aspects over the last years.

Therefore, the second aspect affected by the financial crisis is ECB accountability. First of all, the institutional architecture mainly focused on price stability, make the assessment of Central Bank performance more objective and easy to check, but if the ECB commitment to price stability would become weaker in the future, the assessment of ECB would become more complex.[33] Second, by using unconventional monetary tools, the ECB is allocating large quantities of public funds to supporting private and public asset prices, so making multiple credit decisions affecting particular securities, particular institutions and particular markets.

In fact, as ECB replaces private sector intermediation, it may favour some borrowers over others, tilting the level playing field, and could risk making the private sector unduly dependent on public support. Besides unequal effects on the financial market stakeholders with the serious risk toward the moral hazard stance, the ECB also becomes a

[33] According with the *Haan* central bank accountability index mentioned earlier, the strongest feature of ECB accountability is the accomplishment of the 'ultimate objectives' (namely price stability). Before weakening the price stability commitment by ECB, it is evident that also the ECB accountability could worsen, unless an eventual Treaty reform should enhance the ECB accountability by introducing a new decision-making procedure and institutional settings akin main Western central banks.

quasi-fiscal agent, which subsidises the national fiscal policies of member states with fiscal troubles. This lax monetary policy endangers the fiscal discipline required to give credibility to the European Monetary Union, and, in turn, could undermine the anti-inflation ECB commitment in the medium term.

Given the political impact of such kind of provisions, all ECB acts should be fully transparent and accountable, but we are far from that. For example, the general public is neither informed about the debt securities the ECB is buying nor the criteria chosen to select bonds to purchase.

In a nutshell, although the main concern of the literature is about the ECB independence, the ECB has maintained the operative autonomy in its decisions intact during this financial crisis. What it is changed, instead, is a stronger commitment to restoring monetary transmission mechanisms in detriment of the price stability in the medium term. Up to now the main justification for central bank independence refers to low inflation rates. It may happen that this relationship, hereinafter become weaker, and the independence could be used to achieve financial stability. The conflict of interest between price stability and financial stability could become more acceptable if both rank at the same level in the ECB hierarchy of objectives. But this change in the ECB goal-agenda should be enshrined in the Treaty and come with new accountability mechanisms well suited to assess ECB performance, which, not being focused only on price stability, should not be summarised by one figure, i.e. the inflation rate.

A wider ECB mandate as such, without a new decision-making procedure and increased transparency and accountability mechanisms, would only foster the outbreak of additional democratic deficit issues within the EU.

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Chapter 12

The European rescue of the European Union

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Introduction: In crisis, again

It is a platitude to say that Europe is in crisis. It is much less of a platitude to define what we mean when we say that Europe is in crisis. On the standard public narrative, abundantly reflected in the media, the European crisis is equated with both the financial crisis since the fall of the Lehman Brothers in September 2008 and with the sovereign debt crisis since the Greek state became incapable to finance its huge deficit and massive debt in late 2009. Yet, is this an adequate characterisation of the crisis? Can we reduce the European crisis to its financial and 'public debt' dimensions? Or is not the European Union (EU) as a polity challenged? And can we trust the capacity of European leaders to turn these crises into an occasion to advance European integration, as is widely perceived to have been the case in previous crises in the days of old? How can we assess the multiple responses that Europe has provided to the crisis during the last three years? Are we actually having a 'European Spring' or will we soon be mourning the death Europe and of the EU (perhaps to be followed by a European war, as already prophesised by an American economist in 1997)?

In order to address these uneasy questions, this chapter proceeds in three steps. Firstly, we unpack the origins of the current European crisis and distinguish among several long-term processes that in our view represent its fundamental roots. These historical processes explain the present crisis and illustrate its complex and multi-dimensional nature. Secondly, we reconstruct the main policy decisions and the legislative reforms by the EU and its member states with a view to overcome the financial and sovereign debt crisis. In particular, we propose to group the European responses to the crisis in a number of institutional phases and we point to certain tensions underlying these responses and to their highly problematic implications. Thirdly, we argue that a number of essential elements of the traditional European project are currently in the process of being deeply reshaped. While we are not in the position of concluding that the EU has already turned into a new type of polity, we suggest that we are currently facing a progressive mutation of the European legal and political order as it has been gradually shaped in the last fifty years and a foundational period of a new mode of European integration. We conclude by arguing in favour of the European rescue of the EU, which inevitably is the result of a federalist vision. Drawing on the three steps of our analysis, we put forward the three conditions that need to be met for the rescue.

Unpacking the origins of the European crisis: five crises, not just one

In this section, we argue that the origins of the current European crisis should be unpacked. In particular, we claim that the present crisis may be traced back to five different but inter-connected processes of the European contemporary history: the neoliberal turn of Europe in the 1970s; the subsequent financiarisation of the economies of European states; the sustained growth of public debt; the establishment of an asymmetric monetary union within the context of the EU; and the substantial failure of the attempts to clarify the nature of the EU as a polity.

These historical processes well predate the fall of the Lehman Brothers in September 2008, have mutually affected each other over the years, and represent the fundamental roots of the current crisis. They also explain why the current crisis, far from being merely a financial and sovereign debt crisis, is also an economic and a constitutional one, and should therefore be regarded as multidimensional in nature.

In the following, we offer a brief account of the sequence of these historical processes and of the way in which they have combined in the present multi-dimensional crisis. Only by means of introducing a modicum of analytical clarity would it be possible to avoid over-simplistic or one-sided analyses of the current crisis.

The 'neoliberal' turn and its inner contradictions

In the 'economy of turbulence' following the collapse of Bretton Woods in the early 1970s, the rates of growth of Western economies, including those of the EU member states, slowed down significantly. The major structural and asymmetric shock resulting from a sudden and steep rise in the price of oil unleashed the infamous stagflation of the Seventies. In this context, uncoordinated 'state Keynesianism' failed to revive national economies as the structural capacity of nation-states to control their socio-economic environment had dramatically decreased as a consequence of trade liberalisation and of the slow but steady recovery of international money markets.

Both social-democratic and conservative politicians across Europe abandoned their commitment to 'state Keynesianism'. The fight against inflation and the search of 'price stability' superseded full employment as the top policy priority. This structural shift was very marked after the second oil crisis of 1979. But in some European countries it took place much earlier. This was the case of Germany, where the dominance of ordo-liberal ideas and the constitutional role acknowledged to the Bundesbank had kept Keynesianism at bay until the late 1960s. The Keynesian moment under Kurt Schiller as Chancellor of the Exchequer was a rather brief one. For different reasons, the turn was also visible in the UK from the mid-Seventies. The balance of payment problems of Britain deteriorated markedly in the early seventies and led to the UK government seeking financial aid from the International Monetary Fund (IMF) in 1976. In other countries, the abandonment of state Keynesian policies took place only in the 1980s.

Once inflation became the ultimate goal of macroeconomic policy, the ground was ready for the progressive shift in the economic policy paradigm, from 'State Keynesianism' to one form or another of 'neoliberalism.' This resulted in the progressive weakening of the structural position of labour, especially intense in some states (characteristically, the UK) as well as in a decline of the labour share of income and in a recovery of the margin of companies. However, this was a short-term solution to one problem (the declining rate of profit) at the price of creating a long-term one, namely, the problem of structural viability of the economic model. Expanding the share of capital re-established profitability in the short run, but created two obvious problems. The first was that the pool of capital in search for a good enough profitable investment increased, aggravating the scarcity of investment outlets. Second, a higher level of unemployment turned private consumption weaker and depressed economic activity, thus reducing investment opportunities even further.

This basic contradiction at the core of neoliberalism explains three other policies which have come to be closely associated to it, and which have been progressively endorsed by European states (more rapidly in the case of the UK and Ireland, more slowly in the case of core Euroland countries, and markedly late but then in earnest by the GIPSI[1]). The first policy is privatisation, a means of creating new investment slots, new domains where capital could be invested and result in profits, either through the full privatisation of companies or by means of opening the private provision of public services. The second policy is globalisation as the renunciation of economic borders, which expanded the scope of investment opportunities. The third, and perhaps fundamental policy, is the growth of private debt. This created a situation where a lower labour share did not immediately contract consumer demand. The expansion of debt was thus used as a (temporary) substitute for the stabilizing role of the state under 'state Keynesianism'. This is why it is proper to refer to neoliberalism as implying a form of 'private' Keynesianism.

Both privatization and massive private indebtedness increased the weight of the financial sector in the economy, and in the mid-term allowed it to obtain levels of profitability much higher than those in the non-financial sector. The more the financial sector became an alluring investment opportunity offering rates of return much higher than those of the non-financial sector, the higher the amounts of capital looking for a financial placement, and the more the

[1] Greece, Italy, Portugal, Spain and Ireland.

relationship between production, service provision and financial activities were transformed, as a result of the dramatic growth of the latter (as can be seen in the spectacular rise in the proportion of debt to the GDP). Indeed, as financial and non-financial activities became all the more mixed, corporations increasingly engaged in financial activities as a way of boosting profits.

Privatisation, globalisation and private indebtedness reconcile the contradictions inherent in the neoliberal model. But only for some time. There are obvious limits to the geographical expansion of markets. There are obvious limits to what can be privatised. Finally, there are obvious temporal limits to how much debt can be piled before the debt is shown to have lost contact with economic reality, as the present crisis illustrates painfully well.

The financiarisation of the economies of European states

Three structural transformations converged to trigger a process of financiarisation of the economies of European states, and later to accelerate the process. First, the increase of the income capital share, in the terms that we have already discussed. Second, the momentous decision to alter the normative discipline of free movement of capital, which multiplied by many the size and relevance of offshore finance as the conduit for financial investment and/or speculation. Third, the development of mathematical models which created the illusion that the endemic instability which plagued financial markets could be overcome.

The growth of the financiarisation process tended to feed itself. The higher the degree of return on financial products, the bigger the capital surplus in search for a reinvestment slot, and thus the higher the demand for financial products. This led to structural shifts, such as an increasingly important role played by rating agencies, which became fundamental gatekeepers in the process of money creation. Several private actors acquired a power that should immediately have attracted the attention of political scientists and constitutional lawyers. Too large to fail banks, with liabilities exceeding by far the economic might of their state of incorporation, and rating agencies became for all material purposes constitutional actors. The fact that such powers did not turn up in the public radar released them from any companion obligations.

As the regulatory framework of the financial sector became increasingly weakened, and as the growth of offshore activities allowed to circumvent the remnant regulations, financiarisation exploded. This is the context in which all the financial innovations of the last three decades emerged, including subprime mortgages transformed into derivatives and later into synthetic financial products. From a maiden role in the 1970s, finance had outgrown the non-financial sector at the end of the 2000s.

This created the conditions under which a major financial crisis was due to happen. While financiarisation was based on the illusion of financial markets becoming emancipated from non-financial activities, the longer this was believed to be the case, the harder the fall was bound to be.

Structural public deficits: a public debt crisis in the making

While levels of public debt tended to decline steadily in the *trente glorieuses*, public debt rose significantly once the 'economics of turbulence' became entrenched in the 1970s. This growth of public debt was closely associated with the contradictions inherent to the new 'neo-liberal' economic model. While the stagnation of the non-financial sector of the economy reduced the sustainable tax base of national exchequers, social expenditure increased and ironed out the social consequences of the structural growth of unemployment; similarly, discretionary fiscal policy was used to foster economic growth. This led to a sustained increase in the levels of public debt in most EU member states.

Such a trend seemed to be halted and reversed at some point in the 1990s. The disciplinary effects of the Maastricht criteria of access to monetary union (later spelled out in the Stability and Growth Pact) may account for a part of this decrease. Most importantly, this decrease was facilitated by a progressive adaptation of the state's tax capacity to the growth of finance, resulting in an apparent robust growth of the financial tax base (in spite of the decrease in the structural power of states to monitor financial income flows in the absence of coordination at the European level), clearly noticeable in states such as the UK, Ireland or Spain. Perhaps even more crucially, the decrease was facilitated by the emerging pattern of 'private indebtedness' and 'private Keynesianism', which resulted in an alternative process of social pacification through credit aimed at unsustainable real estate investment or unsustainable levels of private consumption.

At the same time, however, the levels of the structural deficit continued growing despite figures pointing to the contrary. National accounts were not registering these two silent but very problematic developments.

In the case of the GIPSI states, the late but radical turn towards the model of private indebtedness created an appearance of growth at the cost of major future financial burdens for the state. A model of growth based on unsustainable growth drivers hampered the sustainability of public finance, as tax revenues were increasingly extracted from non-sustainable economic activities. This trend was fuelled by the perspective of short-term political advantage. By means of reducing the actual burden resulting from personal taxation while keeping or improving the level of provision of public goods, politicians increased the chances of being re-elected, only at the price of weakening the capacity of the state to make use of conjunctural macroeconomic policies when the downturn came. Furthermore, an unsustainable pattern of economic growth could not but result in a sudden and dramatic increase of unemployment when the financial bubbles were punctured. This did not only reduce overnight the revenue at the disposal of the state, but also resulted in a sharp increase of the financial cost of the welfare state in terms of unemployment benefits. Finally, the rapid growth of financial institutions, in some cases (for example, in Ireland) outstripping by far the economic basis of the home state, created massive contingent liabilities for the exchequer.

An asymmetric monetary union

The period of economic turbulence in the early seventies created a major constitutional problem for the EU. Community policies were built on the assumption that the Bretton Woods international architecture would provide financial stability through steady exchange rates. This in turn was supposed to have rendered protectionism through currency manipulation close to improbable, hence paving the way for the creation of the internal market. The snake in the tunnel, the snake without the tunnel and the ERM were attempts at recreating Bretton Woods at the European scale. For a while these provided a modicum of stability, but in the end these failed. Thus there was always a sizeable political and economic constituency pressing for monetary integration (although those participating in it changed over time). The actual realization of monetary integration took so long because even though it provided a remedy for the turbulence caused by free floating currencies, going forward with monetary union required decisions on how monetary and fiscal policy would be related; an issue which affected the sinews of the social Rechtsstaat, the tax system and the expenditure structure of the state.

There was wide agreement over monetary union requiring fiscal union and fiscal union inevitably leading to political union. The crux of the matter was, however, that different understandings of fiscal union were in conflict. 'State Keynesians' favoured the transfer of sizeable taxing powers to the Union and the creation of a full-fledged constitutional government at the European level, with the European Parliament playing the key role in the new configuration. For them, monetary union should be the driver of political integration through the redistributive force of the European state. That clashed strongly both with the traditional German ordo-liberal ideas and with the emerging neoliberal economic paradigm. In the case of ordo-liberals, monetary union should be the 'crowning' of a process of economic convergence, which in practice meant the transformation of the socio-economic constitutions of all other member states in the semblance of the German model. Neoliberals were largely sceptical of monetary Union as a whole, in the absence of a community we-feeling (something which reveals the strong communitarian component underlying neoliberalism).

This impasse was not solved when fiscal and monetary Union was decided in 1992. Under the strong pressure of the fall of the Berlin Wall, it resulted in a hybrid monetary union *without* a political union. Federal and depoliticised monetary policy went hand in hand with several national fiscal policies shaped by discretionary political choices. The reconciliation of these apparently incompatible models was said to result from a series of governance arrangements characterised by a set of constitutional principles, informal common action norms, a low degree of institutionalisation and the renunciation of collective means of enforcement other than *positive morality* sanctions (group-pressure, shaming and naming).[2]

There were five basic constitutional principles of the European fiscal constitution: (1) full political autonomy for the European Central Bank (ECB) and the national central banks; (2) a 'rigorous' model of public finance, which restricted state revenues to either taxes or borrowing at market conditions (excluding not only the 'printing' of money, but also borrowing from the central banks, and forced borrowing from financial institutions and citizens); (3) exclusive national control of, and responsibility for, national finances (which ruled out any transfer mechanism either in terms of revenue or debt); (4) monetary policy that was aiming for the stability of prices, and was ancillary to the realization of other basic goals of the EU; (5) fiscal policy could not result in deficits of more than three per cent or the accumulation of debt over 60 per cent.

The effective implementation of these principles was based on the decision-making processes of the European System of Central Banks and on the national fiscal decision-making processes, in which governments typically play a leading role but in which national parliaments have the final say through the annual budgetary process. The monitoring of the constitutional limits imposed on national fiscal policies were thinly defined in the Stability and Growth Pact, and were in fact developed through the years, periodically reflected in the Code of Conduct guiding the process.

The institutional structure of the Eurozone was the result of inserting national central banks into a federal structure, and of formally (but not really substantially) joining national governments with the European decision-making process. The system was intentionally lacking a central unit of decision. The Eurogroup emerged in constitutional practice as the meeting of the Eurozone member states' treasuries,, but was expected only to police the quantitative

[2] On the latter point, it is true that both the Treaties and the Stability and Growth Pact did foresee hard-law sanctions. But as the 2003 crisis of the French and German excessive deficits showed, these sanctions were merely symbolic, as applying them would result in massive negative consequences *for all* European citizens, and not only for the government which breached the Pact, or even for the citizens who were responsible of the election of such a government.

development of deficits. And national fiscal processes remained purely national.

Finally, there were no means of enforcement of the informal action norms that made up the fiscal constitution of the Union. In that regard, governance could be seen as an *élite* variant of positive morality. As already indicated, the formal sanctions foreseen in the Treaties and on the Stability and Growth Pact to be imposed upon states running excessive deficits were meant to be symbolic.

This model of asymmetric monetary Union was designed to be crisis-prone for at least three reasons. Firstly, it resulted in a monetary union deprived of active means of ensuring economic convergence. Ordo-liberalism promised that by means of conditioning monetary integration to complete economic convergence. Social-democratic and Christian democratic conceptions pointed to institutional structures capable of redistributing resources and reducing economic divergence. None of these models were followed, and actual convergence was trusted to the free play of market forces, helped by what were in overall terms modest and temporary structural and convergence funds. Secondly, no crisis resolution mechanism was foreseen. Crises were expected to be largely ruled out by market discipline over the euro area governments. Thirdly, the removal of the ability of national treasuries to print money, borrow from the central bank or force loans, would prevent the formation of fiscal imbalances. However, for this to work, the expansion of the single financial market would have required transferring the function of the lender of last resort to financial institutions to the European level. Retaining national competences was partly a factor in the sovereign debt crisis.

An ambiguous polity

Since its very beginning the EU has been a complex and ambiguous political community. It represents a novel experiment, integrating already constituted democratic and Social Rechtsstaats in a wider polity, and aims to become a democratic and constitutional polity that is oriented towards the principles and values of its constituent parts. While it is highly dubious that the EU transcends the state form, it clearly aims to transcend the *nation*-state form. The cunning of the project lies in opening a new constitutional path to establish a democratic constitution: a path in which the collective of national constitutions become the deep-rock fundamental law, partially explicated in the founding Treaties. This leaves the final shape of the EU rather undetermined.

This constitutional ambiguity has probably served the EU very well for decades. But it has had clear downsides. In the absence of a clear constitutional template, it was unavoidable that a long-winded and protracted process of integration followed, and that different decisions at different times reflected different conceptions of what the EU should be. The economic constitution of the European Union is a clear example. The principle of national control and responsibility of fiscal policy clearly corresponded with an inter-governmental understanding of the Union. The assignment of monetary policy to the ECB clearly fitted into a federal conception of the Union, while the governance arrangements through which monetary and fiscal policy were coupled responded to the 'post-national' vision of European integration.

The more the process of integration went forward, the more a need for disambiguation was felt. This accounted for the long series of Treaty reforms, which in reality constituted a long and unfinished constitutional season of the EU. When the financial and economic crisis hit European shores, the EU was in a very delicate moment. The Laeken process, which originally held the promise of becoming a genuine constitutional moment in European integration, became a hybrid process itself, and was petered out as French and Dutch citizens rejected the draft Constitutional Treaty. The more the different crises advanced, the more that the inconsistencies of the 'collage' EU, especially on fiscal matters, became evident. The lack of a proper clarification of the visions of integration, and consequently, of the constitutional theory of the EU, provided background conditions for the explosion of the current European crisis.

The crisis explodes

The fact that capital returns of financial investments well exceeded the capital returns of investments in non-financial activities may probably have led many to believe that financial activities have become emancipated from non-financial activities. The continuous exponential growth of financial activities reached the dimensions of a generalised Ponzi scheme in the early 2000s. The burst of the dot.com bubble did not have the effect of dispelling the myth of the 'new economy', but merely resulted in a change in perception of what was 'new' in the economy. The technological bubble was substituted by a real estate bubble that was based on the massive production of new mortgages (many of which were structured in such a way that foreclosures were closed to guarantee to happen within two to three years of the sale of the house); the transformation of scores of mortgages in derivative financial products; rating agencies accepting the financial products as fully safe due to complex mathematical models used, and the selling of these derivatives (and synthetic products based on them) to financial institutions all over the globe, and especially in Europe. The unsustainable character of this set of economic activities was revealed rather suddenly in 2006 and 2007, leading to Lehman.

Public intervention proved absolutely necessary to stabilise financial institutions. Simultaneously, the effect of the automatic stabilisers, reinforced by conjunctural measures aimed to foster economic activity put forward by governments, and lax monetary policies by central banks prevented the financial meltdown becoming a great depression. Still, the means and scale of the intervention could not avoid a major economic slump. Within the EU, as the structural imbalances of the economic model of the GIPSI plus the inadequacy of their socio-economic arrangements to absorb structural shocks were revealed, the asymmetric character of the economic crisis became obvious.

The sovereign debt crisis is foremost a crisis of the GIPSI (and among them, of some more than others).[3] While the transfer of liabilities has been a process that has happened in all member states, including the core member states of the Eurozone, it has proceeded further in the case of the GIPSI, generating a vicious circle and downwards spiral in which public and private debt mutually endanger each other. This is paradigmatically clear in the case of Ireland, as the public debt of this state has increased more than threefold as the result of the guarantee of all bank deposits (the debt may increase even further as the full extent of the contingent liabilities assumed by Ireland remains still

[3] Greece was (together with Italy and Belgium) one of only three member states that had public debts exceeding or close to 100% of their GDP. Any dynamic of debt increase is bound to be much more problematic if the state departs from such high levels of indebtedness.

uncertain). When it comes to conjunctural anti-cyclical expenditure, GIPSI have incurred in more expenditure because unemployment has increased significantly (Spain, Greece and Portugal; to a lesser extent, Ireland).

Finally, the presence of a large structural fiscal deficit is rather exclusive to the GIPSI. Debt growth of these states was fast and consequently affected not only the economic structure of the country as a whole, but also resulted in silent reconfiguration of the financial basis of the state. Personal income taxes burdening sustainable economic activities were lowered while the level of provision of public services was increased. The gap was covered by the growing tax returns of the unsustainable economic activities, creating the illusion that high levels of public provision could be sustained with light touch tax systems. When the financial crisis halted the unsustainable economic activities related to private indebtedness, the hidden structural fiscal deficit became a very real one. Hence the extremely fast deterioration of the public finances of these states. The catch 22 of the public debt crisis is that when debt creation reaches the Ponzi stage, economic activity can only be restarted by bringing the debt back to levels coherent with productive economic activity. That can only be done by means of repudiating debt, either explicitly or implicitly.

The economic, the financial and the public debt aspects of the European crisis have exposed the shortcomings of the fiscal and monetary EU institutional architecture.

Firstly, its structural features created the conditions under which fiscal policy was used in ways which materially contradicted the aims of a monetary union. This can particularly be traced back to the lack of unity of decision and the compartimentalisation of tasks. Governance arrangements that were designed to be applied with a goal to realise the most basic precondition for monetary integration (and even more so for asymmetric monetary union), namely actual economic convergence of the member states of the Eurozone, led to the opposite results. The economic and financial crises have revealed that the fiscal constitution of the Union has only fostered policies which created the illusion of convergence in the mid run, but which have resulted in divergence in the long run.

Secondly, the constitution of monetary Union was based on the expectation that the mere prohibition of certain states of affairs (large deficits and large debts) would be enough to turn these events impossible. But law has no such magical power. Consequently, the governance arrangements were simply utterly ineffective when it came to dealing with the crisis, as this was not only not foreseen, but also seemed to have been ruled out by law. Not only was there no specific resolution mechanism (as had been the emergency provisions which existed before Maastricht, the balance of payments fund and the possibility of member states applying safeguard measures); the fundamental principles of the fiscal constitution of the Union were suddenly revealed to be a serious obstacle to any crisis resolution.

The responses to the financial and public debt crisis: Drifting outside Europe

The financial crisis unfolded in Europe in July 2007 with the first reports of sub-prime related losses suffered by the European banks. It undermined market confidence in the soundness of banks and ultimately led to the freezing of interbank markets when BNP Paribas announced the freezing of three of its investment funds. On 9 August 2007, as the first European response to the crisis, the ECB announced that it had provided 95 billion euro of liquidity to banks.[4]

Since the fall of Lehman Brothers on 15 September 2008, the financial crisis in Europe involved momentous events of financial instability which included a loss of confidence in the soundness of European banks, bank-runs, the failures of cross-border and domestic financial institutions, and even the collapse of Iceland – which was part of the single financial market as a member of the European Economic Area. The financial crisis was followed by a sovereign debt crisis in the euro area. It started with Greece in early 2010 and quickly spread to Ireland, Portugal, as well as Italy and Spain at the time of writing (November 2011).

The successive European responses to the crisis thus far may be grouped in the following five legal and institutional phases.

[4] For a full chronology and description of the global financial crisis, see the 79th Annual Report of the Bank for International Settlements (1 April 2008-31 March 2009), Basel, 29 June 2009, available at <http://www.bis.org>.

Institutional paralysis and re-nationalisation at the start of the crisis

First we find a phase of institutional paralysis and re-nationalisation of markets. This is well evidenced by the fact that there was no response within the Treaty after Lehman Brothers – no proposal by the Commission, decision by the Council and the Parliament, and not even common measures agreed among member states.

Instead there was a domino effect of national measures as each Member State took unilateral measures to safeguard their respective national financial systems. This included bank rescues in the UK, Germany, Belgium, Netherlands and Luxembourg; and deposit guarantees in Ireland, Germany, Belgium, Greece, Luxembourg, Netherlands, Portugal and Spain. The financial support was provided only domestically and in uneven terms and conditions across member states.

A major consequence of this phase was a structural shift from the principles underpinning the single market, which at the time laid the seed of the sovereign debt crisis. The fact that financial institutions depended on the support of their respective national governments implied that their soundness was perceived as being directly related to the budgetary capacity of the Member State backing them. This led to an immediate re-nationalisation of both financial institutions and their respective liabilities in national governments' balance sheets. This particularly affected large cross-border banking groups whose balance sheet exceeded the GDP of their respective home countries – such groups could not be rescued by their home country and were therefore likely to fail. In the Fortis case it led to the breaking-up of the group into national components given the unwillingness of member states to share the costs of a financial rescue.

The 1985 White Paper's paradigm of European integration through the unlimited expansion of the provision of services on basis of home-country control and mutual recognition (the single passport) was abolished as a result. Such paradigm was accepted as the cornerstone of the single market since it spread the benefits of the pooling of financial resources, thus feeding economic development through member states. However, no provision had been made for managing the different scope and nature of risks that emerged from market integration. The justification was that any burden-sharing mechanism would conflict with fiscal sovereignty, on whether and how to deploy taxpayers' funds in a crisis situation. Accordingly, in the lack of any such mechanism, the first phase of the European response to the crisis led to a rapid re-nationalisation of the single financial market. The spiral of disintegration reached a peak in October 2008 with the failures of several banks and the domino effect of national protective measures across member states triggered by Ireland's unlimited guarantee of the deposits in Irish banks. The single financial market was effectively shutdown.

The 'European branding' of national measures to address the financial crisis

As fully defensive national measures were quickly leading to a breakdown of the single market, with all the economic and financial consequences that would follow, member states resorted to a 'European branding' of national measures, since there was no agreement or Treaty framework for sharing the risks and costs of the crisis.

Such European branding started on 6 October 2008, when the members of the Council issued a statement pledging to take whatever measures necessary to safeguard the financial system.[5] The ECOFIN of the following day took a number of mostly empty commitments, which basically corresponded to the measures already taken, such as recapitalising financial institutions, while also pledging to put the burden on their shareholders and managers, and protecting retail depositors. It reflected the very late acknowledgement of the seriousness of the financial crisis at the level of the Council as well as the fact that the crisis at that stage was affecting mostly a few member states, which made an agreement on a common response impossible.

[5] Statement of the 27 European Heads of State and Government on the Stability of the Financial System (6 October 2008): "All the leaders of the European Union declare that each of them will take whatever measures are necessary to ensure the stability of the financial system – whether by injecting liquidity from central banks, by measures targeted at certain banks or by enhanced measures to protect deposits. No depositor in the banks of our countries has suffered losses and we will continue to take the necessary measures to protect the system and depositors. In taking these measures, European leaders acknowledge the need for close coordination and cooperation". Available at: <http://www.ue2008.fr>.

As the re-nationalisation of the single financial market was increasingly affecting the integrity of the euro area – and as it was clearly difficult to reach agreement among all the twenty-seven member states for concrete actions with substantial impact for national taxpayers – Sarkozy called the first ever meeting (in almost ten years since the introduction of the euro) of the euro area Heads of State and Government in Paris on 12 October 2008. In substance, they merely agreed at the summit to take a number of national measures within a broadly coordinated framework in terms of conditions for financial support. As they put it, in order to "avoid that national measures adversely affect the functioning of the single market and the other member states."[6] The only remaining European policy instrument in this context was the application of state aid rules, but the Commission was requested to act quickly and apply flexibility in state aid decisions, providing in practice a wide discretion to member states.

Throughout the remainder of 2008 and 2009, member states implemented their respective programmes of financial support, mostly in the form of recapitalisation and nationalisation of their respective financial institutions. In turn, the restructuring of these institutions led to a large divestment from their holdings in other member states, thus consolidating the reversal in financial integration. At the same time, as mentioned above, the costs of financial support fell on the governments' balance sheets inflating their liabilities to an extent that financial assistance was ultimately required (particularly in the case of Ireland).

The emergence of the 'union method' to provide assistance to Greece

The third phase in the European response corresponded to the rise of the intergovernmental mode to address the Greek crisis, after the attempt to present national measures under European branding[7] This

[6] See 'Summit of the euro area countries: declaration on a concerted European action plan of the euro area countries', 12 October 2008, available at: <http://www.ue2008.fr>

[7] Three Eastern European countries (Hungary, Latvia, Romania) also entered into crisis between the end 2008 and early 2009. The rescue packages set the pace of how the EU reacted to the crisis. (1) Decisions were adopted by the European Council on the framework of Art 143 TFEU and Regulation 332/2002. (2) The lack of proper financial means forced the Union to partially decomunnitarise the answer, by means of sharing the financial burden. In all cases, the IMF played a major role and there

was made explicit with the 'Union method', coined by Chancellor Merkel in a speech in Bruges on 2 November 2010. She argued that the Community method could only manage EU competences explicitly transferred by member states, while the intergovernmental mode should be followed for coordinated action of member states in areas of non-EU competence. Accordingly, the Community method could never have been used to address the crisis in Greece.

On 20 October 2009, the finance minister of Greece disclosed at the ECOFIN that his nation's deficit would reach 12,7 per cent of GDP from an estimated six per cent provided by the former government. On 7 May 2010, following a significant deterioration in the ability of the Greek state to fund itself in the markets – due to rising bond yields and following successive rating downgrades – a summit of the Heads of State or Government of the Euro Area agreed to provide bilateral loans to Greece in the amount of 80 billion euros in a joint package with the IMF reaching 110 billion euros.

The economic and monetary constitution of the Economic and Monetary Union (EMU) lacked any mechanism to address the crisis. This was an intentional choice, as it was assumed that the commitments made in the Stability Growth Pact together with market discipline would provide the appropriate incentives for fiscal discipline. In this context, the 'no bail-out' principle of Article 125 of the Treaty prevents the Union or any Member State to be liable or assume the commitments of another Member State. This limited the scope for providing financial assistance to Greece considerably. The lack of a crisis resolution mechanism, together with the no bail-out principle, was therefore expected to be a virtue-fostering mechanism. Yet, the crisis revealed that this was an unrealistic assumption of

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was a variable geometry in all three cases: in the Romanian case, funds were mobilised from the EBI and the EBRD; in the Latvian case, help was also coming from other Baltic States (Sweden, Denmark, Finland, Norway and Estonia) and from Central European States (Czech Republic and Poland); (3) The structural model of the assistance was the IMF conditionality model, i.e. credit line in exchange for structural reforms. (4) The rescue packages were articulated in the IMF soft law with hard financial sticks: Memorandum of Understanding plus periodic reviews on which the further credit depends. Latvia undertook a drastic internal deflation program; Romania introduced half way structural reforms; and Hungary, once the new Orban government reached power, it removed itself from the conditionality framework by not renewing the loan with the IMF.

what could have been achieved through market discipline without any transfer of fiscal sovereignty to the EU.

Accordingly, there was a stalemate from October 2009 to March 2010 in which the crisis was simply not addressed. The EMU framework of the Treaty implied that member states had to be largely left on their own to solve their fiscal problems. The German Constitutional Court's Lisbon judgment was also widely quoted as preventing any further steps in economic and fiscal integration, which could address the emerging sovereign debt crisis in the euro area (however, the key judgement of the Court in this regard is the Maastricht decision).

The debate on the rescue of Greece was concerned with whether the solution should be fully internal to the EU (reflective of the constitutional implications of monetary Union) or whether it should be external to the EU, namely through recourse to the IMF. The latter would replicate the solution opted for Hungary, Latvia, and Romania and which also had been used in the 1960s when Italy experimented a balance of payments crisis and in 1976 when the United Kingdom had requested assistance from the IMF.

From March 2010 it became increasingly clear that any solution would have to square several circles. A European solution had to fit in the constitutional space – even constitutional niche – which could allow providing financial assistance to Greece. Any solution had to be minimally compliant with both the present Treaty framework and the German constitutional framework, something which reduced extraordinarily the number of available options.

A non-Community solution was thus chosen. It consisted of the collection of bilateral loans (to some extent replicating the framework of bilateral diplomatic sanctions to Austria in 2000, and also of the coalition of creditors in the case of Latvia in 2008), complemented by the IMF. The solution was made compliant with the no bail-out principle by subjecting the loans to rather strict conditions. Loans were conditional upon an adjustment plan, compliance with which was to be followed quarterly. The actual disbursement of each of the tranches of the 'assistance' will only take place if the creditors were satisfied that the assisted state had complied with its commitments under the adjustment plan. The interest rate included a penal component in the form of a rate of interest (five per cent), which was higher than that applied by the IMF and even higher than that applied under the balance of payments fund to the Eastern European Countries. While the loans were extended for long periods of time (up to 7.5 years), funding was available only for a limited period of time, after which Greece was expected to return to the markets. The loans were supposed to be articulated and supervised by the IMF, with the European Commission and the ECB playing a role, both in the agreement on the adjustment programme and in the supervision of its implementation.

Greece formally requested aid on 23 April 2010 and the rescue agreement was concluded on 2 May. It provided the Greek authorities with funding to meet their needs until the end of 2011, for a total of 110 million euro (30 lent by the IMF, 80 by Euroland states save Greece, according to their quota in the ECB capital). The Greek Parliament approved the agreement on May 5th, together with a new austerity package.

The institutionalisation of the 'union method'

The fourth phase of the European response to the financial and public debt crisis is the institutionalisation of a new intergovernmental 'method' working in parallel and not fully within the Treaty framework. It started with the establishment of the European Financial Stability Facility (EFSF) on 9 May 2010.

Since the sustainability of public finances in the euro area continued to be questioned by the markets, leading to a rise in the bond yields of Ireland and Portugal, the Heads of State and Government of the euro area decided to respond with a new instrument, explicitly temporary and outside the EU framework. The EFSF was established as a private company in Luxembourg for three years and authorised to borrow up to 440 billion euro. All the national parliaments were asked to ratify the EFSF framework agreement. The EFSF was complemented by a European Financial Stabilisation Mechanism (EFSM) as a Commission fund authorised to borrow up to 60 billion euro (drawing on the Treaty's balance of payments' mechanism). The total of up to 500 billion euros (with the IMF providing an additional amount of 250 billion euros) would be available to provide financial assistance in the form of loans or credits to member states in difficulties.[8]

On 18 October 2010, Chancellor Merkel and President Sarkozy agreed in Deauville that from 2013 bondholders could suffer losses in euro area member states deemed insolvent. It implies that a country in the euro area can default, which has not happened in Europe since Italy in 1940 (Reinhart and Rogoff 2009). This move also aimed at increasing market discipline in the future euro area economic governance. The result was, however, that it undermined market confidence in the sovereign debt of the euro area even further. Financial assistance to prevent defaults of euro area countries had been effectively denied.

Following further market deterioration, the temporary nature of the EFSF did not suffice. The constant market pressure, on 28/29 October the European Council agreed to set up a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole, the European Stability Mechanism (ESM), replacing the EFSM/EFSF in mid-2013. For this purpose, they agreed to an amendment of Article 136 of the Treaty allowing for the creation of the ESM by the euro area member states from 2013, thus dispelling any doubts as to the compatibility with Article 125. At the same time, the amendment also institutionalised the Union method in the Treaty, since it legitimised member states to establish mechanisms through intergovernmental cooperation with the purpose to fulfil purposes inherent to the functioning of the EU.

The EFSM/EFSF were activated for the first time at the request of Ireland on 28 November 2010 to cover financing needs of up to 85 billion euros.[9] On 30 March 2011, Portugal also requested financial assistance.[10]

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[8] Statement of Heads of State or Government of the Euro Area, Brussels 7 May 2010; and Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism, OJ L 118/1, 12.5.2010.

[9] See Statement by the Eurogroup and ECOFIN Ministers, 28 November 2010, available at: <http://www.consilium.europa.eu>.

[10] At the time, the ECB also adopted a Securities Markets Programme (SMP) for the acquisition in open market of government bonds to ensure depth and liquidity in those market segments which are deemed dysfunctional. This was criticised by some circles as an infringement of the monetary financing prohibition of Article 123 TFEU.

A further step in the institutionalisation of the Union Method was the Euro Plus Pact. In March 2011, the euro area member states, together with six non euro-area states, agreed a Euro Plus Pact, which was adopted as part of the European Council conclusions of 24/25 March 2011. The Pact represents the voluntary and self-binding commitment of these member states, with mutual monitoring, to implement reforms in the areas of competitiveness, employment, sustainability of public finances and financial stability. It is also not anchored in the Treaty or EU legislation, although it clearly aims at fulfilling the key objective of the EU to increase competitiveness among member states.

The European responses were however not limited to the Union method. The Union method was paralleled by a process of reform of economic governance in the EU and the euro area. The underlying aim is to attempt to repair the lack of credibility of the system of economic governance, based on loose intergovernmental procedures, notably the Stability and Growth Pact (SGP), which provided no effective surveillance and control of imbalances, as demonstrated by the crisis in Greece. On 29 September 2010, in particular, the Commission put forward a package of legislative proposals on (1) strengthening the Stability and Growth Pact, (2) preventing and correcting macroeconomic imbalances, (3) strengthening national fiscal frameworks, and (4) a stronger enforcement of fiscal discipline by imposing sanctions on non-compliant member states.[11] Almost at the same time, on 21 October, a Task Force chaired by President Van Rompuy – which comprised the EU finance ministers – set out

[11] The Commission put forward on 12 May a Communication which called for reinforcing compliance with the Stability and Growth Pact and extending surveillance to macro-economic imbalances, as well as setting-up a crisis management framework for the euro area. Communication from the Commission on Reinforcing economic policy coordination, COM(2010) 250 final, 12 May 2010. The proposals in this Communication were further developed in the Communication from the Commission on Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance, COM(2010) 367/2. The Communication was then translated on 29 September 2010 into six legislative proposals: three regulations and one directive on the reform of the Stability and Growth Pact and budgetary surveillance, and two regulations for detecting and correcting, also through sanctions, emerging macroeconomic imbalances within the EU and the euro area. The Commission proposals are available at <http://www.ec.europa.eu>.

recommendations for strengthening economic governance, which were largely in line with the Commission's proposals.[12]

The Commission proposed a wide use of the reverse majority voting, so as to make enforcement mechanisms quasi-automatic and not subject to political discretion. This includes voting on the adoption of the Commission's economic policy proposals and country-specific recommendations and, most importantly, on the imposition of financial sanctions on member states deviating from fiscal targets and not complying with recommendations. The economic governance package also includes the institutionalisation of the so-called European semester where member states' budgetary, macro-economic and structural policies are coordinated in time to allow better interplay between these and EU-wide goals. In addition, a new surveillance framework for addressing emerging macro-economic imbalances is also proposed. The so-called 'six pack' legislative proposals were adopted on 4 October 2011 and will enter into force in 2012.

Finally, in addition to reviewing the instruments for coordinating national economic policies, the EU reformed the architecture for financial supervision. The reform was aimed both to prevent further financial crises and to support monetary and fiscal policies, as the crisis of private finance may obviously hit and further weaken fragile public budgets by forcing governments to rescue banks, financial institutions and strategic companies. The reform replaced the so-called Lamfalussy framework of committees with new European agencies: the European Systemic Risk Board (ESRB) and three new European independent authorities (the European Securities and Markets Authority, the European Insurance and Occupational Pensions Authority, and the European Banking Authority[13]). The new legislation did not establish a radically new institutional framework. Rather, it confirmed the Commission and member states' reluctance to establish genuine supranational authorities, distinct from member

[12] 'Strengthening Economic Governance in the EU', Report of the Task Force to the European Council, 21 October 2010, available at www.consilium.europa.eu.

[13] See, respectively, regulations 1093/2010 (establishing a European Banking Authority), 1094/2010 (establishing a European Insurance and Occupational Pensions Authority) and 1095/2010 (establishing a European Securities and Markets Authority), in OJEU 2010 L 331. An account of the new institutional framework for financial supervision is provided in Teixeira (2011: 9ff); Verhelst (2011), and Recine and Teixeira (2009).

states' authorities and provided with regulatory powers. The overall rationale of the institutional reform was to improve coordination among national regulators within the limits of national fiscal sovereignty.

The change of national governments and the technocratic move to undertake economic and structural reforms

The last and current phase relates to the failure of successive Euro summits and respective decisions to stem the sovereign debt crisis by themselves, particularly in Greece, Italy and Spain. The emphasis now turns to the swift and credible enactment of economic and structural reforms at the national level.

These dynamics started with the Euro summit of 21 July 2011, which was confronted with the continuous lack of confidence in the ability of Greece to fulfil its economic programme, and with the increase in the bond yields of member states spreading to Spain and Italy. The summit decided to (1) support a new financial assistance programme to Greece through the EFSF (instead of bilateral loans) with lower interest rates and extended maturities to improve the debt sustainability and refinancing profile of Greece; (2) accept private sector involvement in the financing of Greece through debt exchanges and roll-overs; (3) improve the effectiveness of the EFSF and of the ESM by allowing them to act on the basis of a precautionary programme, finance recapitalisation of financial institutions through loans to governments including in non programme countries, and intervene in the secondary markets on the basis of a decision by mutual agreement of the euro area member states to avoid contagion; and (4) extend to Ireland and Portugal the lending rates and maturities applied to Greece.

However, this again continued to prove to be insufficient to stem contagion. In early August, the spreads of the government debt of Italy and Spain reached levels which could put at stake the sustainability of their respective public debt. The ECB announced on 7 August that it would actively implement the Securities Markets Programme, and on 8 August it reportedly started purchasing Italian and Spanish government bonds in secondary markets bringing down the market yields of these securities.

Another round of Euro summits took then place on 23 and 26 October 2011 to address the Greek problem and the lack of confidence in the ability of the euro area to stabilise the sovereign debt crisis. There was a need for two summits since Chancellor Merkel needed to obtain prior consent of the Bundestag to agree to increase the financial capacity of the EFSF through leveraging of its resources. The need for such prior consent was reinforced by a decision of the German Constitutional Court of 7 September 2011, which assessed whether the financial assistance to Greece infringed the Bundestag's budgetary autonomy (which the Court replied in the negative).

Accordingly, on 26 October the euro area member states agreed: (1) to contribute to a new financial assistance programme to Greece depending on the willingness of private investors to take a 50 per cent nominal discount on their Greek government bonds; (2) to leverage the resources of the EFSF, so as to increase its ability to support other member states, if need be; and (3) on ten measures to improve the economic governance of the euro area, including more regular Euro summits with a more permanent administrative infrastructure. Furthermore, they agreed that each euro area Member State would introduce rules on a balanced budget at constitutional level or equivalent by the end of 2012.

Once again, the Euro summit failed to stabilise the markets. On 1 November, Georges Papandreou announced a referendum in Greece. The following day, at the Cannes G-20 Summit, Merkel and Sarkozy declared that if there was a referendum, it should be on the exit of Greece from the euro area. They opened thus the door to a possibility that had been refuted until then, particularly in the absence of Treaty mechanisms for such exit. Papandreou resigned on 11 November to enable a national unity government led by Lucas Papademos, a technocrat former ECB Vice-President.

In Italy, the continuing rise of government debt spreads led to the resignation of Silvio Berlusconi on 12 November. The political parties agreed to support a technocratic government led by Mario Monti, which took office on 16 November.

At the time of writing, five countries of the euro area changed government before their respective term as a direct consequence of the sovereign debt crisis: Ireland, Portugal, Greece, Italy, and Spain.

Three of these changed their governments following early elections and two new governments stemmed from parliamentary agreements on technocratic governments. These all changed as a result of not only the lack of market confidence, but also due to the increasing pressure from other member states and EU institutions to undertake economic and structural reforms to restore fiscal discipline.

Three inherent institutional tensions: in and out from the EU legal framework; the rise of the union method; an incomplete institutionalisation

Admittedly, the European institutional response to the financial and public debt crisis is an extraordinarily complex institutional process, which tends to escape neat representations. Yet, three main dimensions of such process deserve to be highlighted, together with the problems that they raise.

Firstly, the European response to the financial and public debt crisis has been, and still is, a contradictory and problematic combination of responses external and internal to the EU legal framework, i.e. external and internal to the constitutional architecture of the fiscal and monetary Union. Among the various possible examples one is May 2010, when the clear political will to comply with the existing Treaty framework, from the 'no bail-out clause' to the preservation of financial stability, paradoxically led to searching for a non-EU solution to the Greek crisis in the form of the collection of bilateral loans, complemented by the IMF. A second example is the Euro Plus Pact. As it has been previously observed, this Pact, agreed by the euro area member states together with six non euro-area member states, is not anchored in the Treaty or EU legislation. It was adopted as a part of the European Council conclusions of 24/25 March 2011 and it is aimed at fulfilling the EU objective to increase competitiveness among member states. Thus, it is formally outside the EU legal framework, but substantially internal to it.

This legal ambiguity of the European institutional response to the crisis is particularly relevant because of its alarming implications. Two of these are prominent. To begin with, the European response has implied in certain cases an open breach of the EU constitutional standards. For example, in May 2010 both the principle of exclusive national responsibility for public debt and the 'rigorous' model of public finance were simply set aside, as the Greek bailout and the temporary structure of the European Financial Stabilisation Mechanism and the European Financial Stability Facility broke away from the principle of purely national public debt. Moreover, the 'in and out' from the EU constitutional framework operates as a precondition for the rise of executive emergency constitutionalism, as it tends to minimise public debate and to avoid the ordinary filters of the democratic constitutional state. The European institutional response to the financial and sovereign debt crisis, in other terms, brings along the breach of the EU constitutional standards and may open the way to executive emergency constitutionalism. In this sense, while aiming to solve a financial and public debt crisis, the European response generates or feeds other European crises, which can be characterised as institutional crises, thus making the European crisis a multidimensional crisis.

Secondly, the European response to the financial and public debt crisis has been developed mainly through an intergovernmental mode (but one, as we will argue, where the reality of socio-economic power has trumped even formal equality). The Union method was subsequently consolidated and institutionalised in several moves, one of which was the agreement within the European Council on 28/29 October 2010 to amend Article 136 TFEU: the new provision, as it has been already said, institutionalises the Union method in the Treaty by providing the member states the power to establish mechanisms through intergovernmental cooperation with the goal to fulfil purposes inherent to the EU.

Pointing to the intergovernmental mode of the European response is important because of the implications of such a mode. The main implication for our purposes is the possible renationalisation of the EU, the prominence of the interests of the States over the general interest of the Union, the search for a balance between the will forged within EU political institutions and the will forged intergovernmentally.

Thirdly and finally, the European response to the crisis has consisted in a partial and incomplete attempt to modify the existing EU fiscal and monetary institutional architecture. The European response has tried in several ways to correct the existing institutional architecture: for example, by reviewing the instruments for coordinating national economic policies, and by establishing a number of crisis management mechanisms, in parallel with the reform of the architecture for financial supervision. This type of institutional response has its own merits, in particular in so far as certain crisis resolution mechanisms are established. At the same time, however, it has proved unable to correct the fundamental asymmetry of the EU fiscal and monetary union. The fiscal and monetary architecture had and still has a composite nature: federal monetary policy is accompanied by several national fiscal policies shaped by discretionary political choices, which reflects an inter-governmental understanding of the Union. And the governance mechanisms still provide the glue for the overall system, for example through monitoring the constitutional limits imposed on national fiscal policies.

Due to the lack of a European response aimed at establishing a political union in the form of a true economic government for the euro area allowing for federal taxation, the path has been towards the renationalisation of the EU, away from basic constitutional principles and institutional framework defined in the Treaty. This has been largely the result of the well-diagnosed political, democratic and institutional deficits of the EU, which prevented the institutional architecture of a 'community of mutual risks' to emerge and tackle the fallout from the 'community of mutual benefits' at the origin of the EU and EMU.

A process of institutional and constitutional mutation

We have attempted in this chapter to put forward an analytical framework to start making sense of the 'crisis' of the EU. We distinguished several origins of the broader European crisis, offered a reconstruction of the institutional and legal (ultimately, constitutional) steps taken by Europe so far to address its financial and sovereign debt crisis, and pointed to the fundamental institutional tensions underlying the European responses.

It seems to us that the EU has drifted into a path of constitutional mutation. Indeed, the crisis and the way in which Europe has responded to it directly challenge some fundamental features of the European legal and political order, which has been gradually shaped in the last fifty years. That does not necessarily lead to the Union collapsing or being abolished, but more likely to a progressive mutation of the underlying political and economic project of European integration.

In this section we will point to four fundamental elements of the European project that in our view are in the process of being deeply reviewed or reshaped. Admittedly, it is too early to ask whether the EU has already mutated into something else. What we can do, though, is to attempt to conceptualise certain essential aspects of the European project that are currently going through a process of transformation and mutation, and to reflect on their possible implications.

Losing the equilibrium between the legal and the political

The first element of mutation is the loss of the equilibrium between the legal and the political lying at the heart of the European integration process.

As reconstructed by Weiler (1999) in his rightly famous narrative, in the foundational period until the middle of the 1970s, the crises – such as the 'empty chair' crisis – were overcome by reaching an equilibrium between the legal and the political. On the legal side, the Community legal order was progressively constitutionalised. Firstly, with the Court jurisprudence on the direct effect and supremacy of Community law. Secondly, with a reinforced enforcement of Community through the system of judicial review, particularly under the preliminary reference procedure of Article 177. On the political side, member states acquiesced to a strengthening of the Community as long as it led to their own strengthening through increased political and economic benefits, which in turn were safeguarded by the legal discipline imposed by the Treaty and the veto power of each Member State (particularly, with the Luxembourg Accord of 1966).

In the compromises reached under the Union Method to tackle the current European crisis we cannot observe any equilibrium between the legal and the political.

The rise of the Union method is indeed, in Hirschmannian terms, an expression of the Voice of member states in addressing the crisis outside, and sometimes in denial, of the Treaty. The motivation to avoid the Community method, as made explicit by Chancellor Merkel, was the need to avoid any transfer of competences to the EU as a result of the crisis. The recourse to taxpayers' funds, and the related involvement of national parliaments and the German Constitutional Court, was certainly an additional motivation.

However, the latest developments already reveal the shortcomings of the Union method. Successive intergovernmental deals, led by Germany and France, do not provide lasting solutions and therefore fail to stabilise the markets.

On the legal side, markets do not seem to have confidence in the future of the euro area without a new constitutional framework for EMU. Governance, as the paradigm followed for managing market integration without a federal transformation, has proved unable to properly articulate an effective decision-making process. Law, not governance, is actually efficient when it comes to taking and implementing decisions under stress that can then be implemented. Contrary to what is assumed, the Union does not have *primarily* a democratic deficit, but it actually suffers from incapacity to decide caused by a deficit of law – by an insufficient degree of juridification of power relations. In the view of the markets and some academics and policy-makers, a new constitutional framework for EMU should consist of a hardened constitutional structure for economic governance. It should include the transfer of fiscal responsibilities to the European level, accompanied by direct and automatic enforcement of fiscal rules. This, in turn, should allow the pooling of fiscal sovereignty in instruments such as Eurobonds. Punishment mechanisms for non-compliant states, as well as provisions for the exit from the euro area, could also be contemplated. The Court would be entrusted with the judicial review of economic governance. Within this framework, the Loyalty of member states to EMU would be guaranteed, finally leading to the permanent state of the euro.

On the political side, it seems clear that member states, in particular creditor member states, would only agree to a hardened constitutional structure for EMU if it strengthens their respective influence, and thereby the political and economic benefits from participating in the euro area. The debtor member states, on the other hand, appear more willing to further integration as their respective economic benefits are abundantly clear. Thus far, member states are attempting to circumvent the need for reinforced European economic governance by engaging in intergovernmental agreements, such as the EFSF/ESM and the Euro Plus Pact, and by amending their respective national constitutions as agreed at the Euro summit of 26 October (rather than accepting fiscal discipline through European law). However, none of these seem to ensure as much Loyalty to EMU as it would be achieved by subjecting fiscal sovereignty to European competences. Therefore, they will in all likelihood fail to achieve the degree of economic governance to stabilise the euro area.

Setting aside the principle of equality

The second fundamental element challenged by the current crisis is the principle of *equality among member states*.

The tension between the form and the substance of such principle, which has since the beginning of the process of European integration been at the heart of the 'European ideology' of integration, was considerable *even* before the crisis. Building on long-standing precedents, and especially on those established at Maastricht, the Lisbon Treaty included extremely odd opt-outs to the Charter of Fundamental Rights (granted to the UK and Poland, promised to the Czech Republic). 'Multispeed Europe', 'reinforced cooperations' or a Europe of variable geometry never really took off because any formal break from equality was seen as problematic (and because in certain areas, like economic policy, required restricting the breadth and depth of economic freedoms). A too formal attachment to equality among member states has only led to a Europe of opt-outs and materially unequal states.

The principle of equality, though, is put at stake now more seriously than ever before by the current division between creditor and debtor member states requiring, or close to, financial assistance. Such division is not only based on economic might. It is exacerbated by the inability of some member states to implement reforms not only due to social discontent, but also to shortcomings in the political and administrative structure of the state itself. In a way, some member states are perceived as 'failed states' which were neither able nor willing to reap the benefits and opportunities created by EMU.[14] Accordingly, in a new constitutional framework, a core of member states will inevitably be de facto or de jure endowed with political

[14] For example, a common economic denominator to the vulnerable euro area countries is the extreme level of youth unemployment, which matches that of the countries engulfed in the wave of the Arab Spring.

rights over the others so as to be able to enforce the rules of economic governance over 'weaker' states. The crisis and the responses have increased substantive economic, social, political and constitutional inequality within the whole EU. The principle of equality has been superseded by a 'Multi-Europa' in the constitutional, political, social and economic dimensions, in which some states risk becoming more equal than others.

This could be said to be the typical mode of evolution of the Union. However, there are limits to pluralism, which become lower, not higher, when crisis/crises hits/hit the polity and there is a need to re-stabilise its socio-economic order. This is especially the case when the crises themselves have an asymmetric impact on the member states of the Union. When less, not more, pluralism seems to be required (so as to restore the necessary uniformity without which political bonds will become too stressed to resist), increasing pluralism is bound to trigger processes of disintegration.

The mutation of the principle of equality of member states also has implications for citizens, which will naturally be affected in the exercise of political and economic rights within their respective state. There is the risk that citizens become *materially and politically stateless within Europe*. Fiscal redistribution among member states could ease the pain but, at the limit, the only way to compensate such potential loss of political rights would be to 'abolish' national citizenship in favour of a new fundamental European citizenship. Otherwise, mass migration could be the only way for some states to recover their political and economic equality. This would be a reversed, dark version of free movement of people and would lead to many other tensions.

From a community of benefits to a community of risks

Linked to the principle of equality, another principle at stake is the one contained in the no bail-out clause of member states in Article 125 of the Treaty. This encapsulates the concept of the EU single market and of EMU, in particular, as a 'community of benefits', where all can share the increased economic opportunities from the expansion of business activities, the pooling of financial resources, and a single monetary policy. However, it is prohibited to share the associated increased risks, since this could give rise to moral hazard problems in the lack of legally binding enforcement of prudent economic behaviour by member states.

In this context, also the principle of mutual recognition as the engine of market integration is being challenged. The approach of the 1985 White Paper was to foster the unlimited expansion of the cross-border provision of services, regardless of the country of origin (also as a corollary of the principle of equality). This, however, was based on a conception of the single market as a 'win-win framework' which would lead to permanent economic and financial growth. With the crisis, the companies and financial institutions became intrinsically linked to their country origin. As a result, some are considered more or less valuable and risky than others, undermining the free single market framework.

Therefore, as the crisis overthrew the ideology of the community of benefits, Europe is called to turn into a 'community of risks', where the costs of economic imbalances and disturbances should be mutualised among member states in exchange for a hard economic governance framework. Otherwise, EMU and the single market will simply be abrogated. Such mutualisation, which could also involve fiscal redistribution as mentioned above, will pose constraints to fiscal sovereignty and also challenge the fundamental tenet of no taxation without representation.

Breaking the principle of European unity

A final example of a constitutional principle in mutation is the unity of the EU. The Treaty framework is all encompassing and inclusive, to an extent that a legal principle of European Unity may be conceived (Van Bogdandy and Bast 2010).

Thus far, EMU has not affected the legal and institutional integrity of the EU, for the following reasons: (1) it is considered an inclusive and mandatory stage of integration (except for the UK) and therefore any mismatch between the EU and EMU is legally temporary; (2) the EMU was designed as fully functioning within the EU's institutional framework – no new institutions were necessary other than the ECB; and (3) the fact that it is short in institutionalisation as argued above, prevents and prevented until the crisis any conflict with the EU.

These legal assumptions, however, have fundamentally changed. The crisis in the euro area raised doubts over the willingness of out-member states to ever join EMU. The EU institutional framework is not deemed sufficient to govern EMU. And the emergence of parallel institutions – notably the Euro Summits, the Eurogroup, and the EFSF/ESM – has constrained the political and legal role of EU institutions, including the Council, the Commission, and the Parliament. Indeed, how can the EU-27 institutions, and even the Court, ever function effectively for an EMU-17? Signs of attempts to conciliate EU and euro area institutions are visible but they are limited to symbolic decisions such as designating at the same time the President of the Euro Summit and the President of the Council, as well as the President of the Euro Working Group and the Chair of the Economic and Financial Committee (as decided at the Euro summit of 26 October).

A deviation from the principle of constitutional and legal unity with a differentiation of the euro area from the rest of the EU will lead to further disintegration. It will strengthen the enforcement of Loyalty in EMU and will relax it across the EU as a whole. It will lock-in the euro area member states but it may lead to a concomitant increase of Selective Exit of the other EU member states. The political and economic benefits of the EU will be much less apparent, thus diminishing the incentives for Loyalty. This is already clearly emerging from the recent policy positions expressed by the UK government regarding the renegotiation of European policies.

Conclusion: More integration, again?

We started this chapter recalling that European integration has progressed through crises. Will this be confirmed once again? Our answer is that this might be the case only if Europe engages in an ambiguous federalist project and proves able to move from the current state of emergency to the emergence of a European state.

As mentioned above, previous crises of integration have been overcome by a combination of (1) a hardened constitutional, institutional and legal structure, with (2) the granting of more political and economic benefits to member states. For instance, the ERM crisis was only overcome with the transfer of monetary policy to the European level on the basis of a fully federal structure safeguarded by the Treaty, while providing member states with the political benefits of equal participation in the ESCB and the economic benefits of being part of a stable single currency.

At the current stage, the crisis does not seem to subside as the loose economic governance of EMU does not ensure the cohesion of member states, while the discourses of national politics question the benefits of European integration. As a result, exit from the euro and the EU is now discussed as a real possibility.

Therefore, Europe faces the hopefully not impossible task of achieving further integration significantly constraining – if not transferring – one of the cores of national sovereignty (fiscal sovereignty), while paradoxically increasing the political and economic benefits of member states of being part of the EU and EMU. All this has to be done within an enhanced democratic framework that is able to legitimise the further transfer of competences to the Union.

It follows from our chapter that the following three fundamental conditions have to be met in the way forward.

First, the framework for EMU should be based on law and new institutions (e.g. economic government, financial regulator), not on governance structures, because we need enforcement of rules and not power relations. Flawed soft economic governance arrangements, with extremely low degree of institutionalisation, are partly at the origin of the crisis, and are central to the continuing instability. The seemingly paradoxical fact that the euro as a currency is not questioned by markets is partly due to the strength of its Treaty-based institutional framework.

Second, it will only be possible to achieve hardened integration if member states accept that there are substantial political and economic benefits in being loyal to the euro rather than exiting. This may only take place by openly recognizing the limits of the political, institutional and legal underpinning of European integration as a project directed towards the establishment of a community of benefits that are spread and shared among member states and the citizens of Europe. The mutualisation of risks, for instance through Eurobonds and other mechanisms, as well as the preservation of the principle of equality of member states and the unity of Europe may underpin such benefits, as they did to some extent for the transfer of monetary policy and the abolition of national currencies. If there is a lesson to be drawn from the crisis, it is that a 'community of mutual risks' should emerge to tackle the fallout from the 'community of mutual benefits' at the origin of the single market and EMU.

Finally, the above conditions, in turn, are not possible to fulfil without a democratic underpinning, a legitimisation process for a move in integration that will involve the transfer of core sovereign tasks, potentially leading to redistribution policies. Furthermore, the democratic process is not only essential for the transfer of powers, but even more for the exercise of such powers at the European level if we want to avoid an advance in integration leads to another deepening of the democratic deficit. This implies that the Union has to set-up the necessary constitutional structures to control its socio-economic environment and become a unit of political and democratic decision-making. Some suggestions seem to move in this direction, such as proposals for direct election of the President of the Commission. Such a move is however challenged by the synthetic nature of the Union as a pluralistic polity, which is thus apt to disperse power, but not to concentrate it.

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Appendix I

Economic aspects of federation

Lionel Robbins

Introduction

It will be generally agreed that, in any project of federation or indeed of any form of close union of states, the provisions relating to economic affairs must have a critical importance. The existence of clashes of economic interest between independent sovereign states provides one of the most important reasons for the creation of wider organizations; and the acceptability of such organizations will depend, in large measure, upon their capacity to eliminate such disharmonies. It would be wrong to say that economic advantage was the *raison d'etre* of union; the *raison d'etre* of union is the preservation of justice and civilization; and justice and civilization involve much more than economic advantage. But it is none the less true that without a solid basis of harmonious economic relations, these values are likely to be jeopardized. It is no exaggeration to say that a federation will stand or fall by the adequacy of its economic constitution.

Principles of federal structure

It is the object of this paper to examine some of the problems which arise in this connection. What should be the division of power

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* This appendix is a reprint of Lionel Robbins (1941) 'Economic aspects of federation', *Federal Tracts Series,* no 2, London: Macmillan. Copyright held by the Federal Union, which has kindly given us permission to reprint Robbins' text here.

between states and federation as regards inter-state migration and trade? What kind of monetary system is desirable in a federal union? What powers should be given to the federation as regards taxation and expenditure; to what extent will a federal system permit national differences of industrial structure? What should be its economic relations with other political units? These are questions which must be settled before any detailed draft of a federal constitution can be begun to be constructed; and they are the subject of investigation in what follows.

Before proceeding to discuss any particular question, however, it is desirable to be as clear as we can concerning the general nature of our objective. Our aim is to discover certain necessary principles of the constitution of a federation. We are not legislating for a unitary state or for an association of states retaining independent sovereignty. Can we find any working rules which will aid the realization of this aim?

Two such rules seem to follow from the nature of our general objective and to have particular importance in relation to the economic constitution:

- Firstly it is desirable to leave to the constituent states as much freedom as possible.
- Secondly it is necessary to eliminate the possibility of those conflicts of sectional interest which, under independent national sovereignty, might be causes of international friction.

The rationale of these rules is obvious.That the states should have as much freedom as possible follows clearly from our federal intentions. We are not creating a unitary state. We desire to preserve local initiative. The federation exists, not to enforce uniformity, but only to assume such functions as cannot be discharged by the constituent states without giving rise to disunity.

But at the same time we are creating a permanent political entity. The constituent states are surrendering their right to independent armaments. It is fundamental, therefore, that, within the federation, there should not persist the possibility of those sectional disadvantages against which independent armaments might be thought to have been some defence. It is fundamental that the federation should not come to be regarded as a trap and that surrender of the right of violent resistance should not carry with it a stereotyping of unequal rights. Federation must not merely involve the surrender of the right to make war, it must involve also the elimination of those disabilities which make war appear to be worthwhile. It must not involve the reproach directed against the League of Nations that it was an apparatus for safeguarding the status quo; to the extent that state initiative involves the creation of unequal privileges, the federation must assume full powers.

If these considerations are correct, there follows immediately a conclusion of the utmost significance as regards the division of powers between the states and the federal authority. The powers of the states need not be laid down in advance; for only those powers whose exercise would be inimical to internal justice and plenty, will be denied them; in everything else they will be free. In contradistinction from local government authorities within a unitary state, which have initiative only within the limits delegated to them by the central authority, they will have initiative in every respect which is not explicitly surrendered to the federal authority. The powers of the federal government, however, must be expressly defined by statute and will consist chiefly in the discharge of those functions which cannot be discharged by the states without giving rise to disunity. There must be certain additional powers of a more positive nature. But the essence of the federal function is the taking over of powers whose exercise by the states has been found to be productive of conflict. What these are, however, can best be discovered by the examination of particular functions.

Migration within the federation

Let us start with the problem of inter-state migration.

Now here we have a case where the second of our general rules is particularly relevant. If the richer areas in the federation have the power to prevent migration from the poorer areas, they are clearly using the immunity from war conferred by the pooling of armaments to preserve for themselves a position of local privilege. This would be so whatever the industrial structure. If the inhabitants of a collectivist state, where the productivity of effort was high, were to close their borders to migration from collectivist states where the productivity of effort was low, the effect as regards inter-state relations would be no less fissiparous than the effect of similar restrictions under capitalism.[1] The poorer peoples would feel that if the area of their state had been greater – if their *lebensraum* had been more extensive – they would have been better off. If it were a question of entering a federation on these terms, they might well feel that they would do better to remain outside. Somehow, someday, they might hope, there might arise the opportunity of a combination of powers which would bring about the redistribution they desired. These are not considerations which usually present themselves with especial force to Englishmen who, in the twentieth century at least, are not conscious of any particular lack of living space and whose motives for going to war are consequently more likely to be a wish to defend their existing territories rather than any wish to enlarge them. But it is notorious that it is otherwise elsewhere.

It is sometimes thought that this difficulty could be surmounted by some preliminary redistribution of territories. If there could take place some readjustment of boundaries which would remedy the disparity of *lebensraum*, then the constituent states might be permitted to retain their right to regulate entry into their areas and the vexed question of migration would be settled. Let the richer states consecrate the formation of federation by a gesture of altruism appropriate to the occasion and all will then go happily.

Unfortunately such suggestions rest upon a total failure to perceive the essentially dynamic nature of the *lebensraum* problem. We need not pause to enquire into the prospects of such a gesture; for, even if it took place, it would be no solution of the problem. The advantages of position and area are necessarily continually changing; the conditions of supply and demand which determine the height of real incomes obtainable by the inhabitants of any particular region, shift from year to year; and a settlement which secured rough equality of opportunity at one time, might involve gross inequality at another time. If Great Britain were divided into half a dozen sovereign states with rights of limitation of migration, fifty or a hundred years ago it would have been those states containing export coal fields which would have had to be classified among the "haves", southern

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[1] There is indeed some reason to suppose that it would be more so. For an extensive discussion of this point see my *Economic Causes of War*, London: Jonathan Cape, 1939, pp. 94-98.

England among the “have-nots”; a limitation of migration into south wales or the manufacturing districts of the north would have been felt as a severe disability elsewhere. In the period before the present war, however, these roles would have been reversed. Those states containing the depressed areas would have been the “have-nots” a limitation of migration south would have involved disabilities on the citizens elsewhere. Surely it would not be thought to be a sensible solution of this kind of problem that there should be alterations of administrative areas every time there occurred important relative shifts in the values of the products of the inhabitants of the different constituent states. Quite apart from its political impracticability, it would be a grotesquely cumbersome solution of a problem whose natural solution would be some shifting of population.

But what does this imply for our federal constitution? Does it imply that there should be written into it provisions securing complete freedom of movement? Must *laissez passer* be the inviolable rule?

At first sight this might seem to follow. And indeed it is difficult to believe that very much harm would be done if liberty to go where one wills were to be made a fundamental right of the federal citizen. For, if we survey the various arguments which are commonly advanced against freedom of movement, it is difficult to find many which are not either pure nonsense or pure selfishness. It is not easy to think of cases where the establishment of free migration would be any but an advantage to the majority of the citizens.

Nevertheless it is undesirable to commit the constitution once and for all to any particular policy other than that of securing the safety and solidarity of the federation. And if it were found that very rapid shifts of population from one part to another were productive of intolerable strain, it is conceivable that some regulation of the rate of flow might be thought to be desirable.[2] Hence the right policy seems to be to secure, not that no regulation should be allowed, but that what regulation there is should be a federal and not a state function. This is

[2] It is possible that for a short period after the formation of the federation, it might be desirable to regulate the rate of inflow into certain areas. It is, I think, highly improbable that this would be necessary in any European federation which is at all likely for some time to come. But if migration has long been dammed up and wide disparities of levels created, it is at least possible that it may be better to release the flood by degrees.

the fundamental point. If the right of restricting migration is left to the constituent states, it is nearly certain that it will be exercised by some so as to leave the others with a sense of grievance. If it is left to be decided by a conference of the states in their sovereign capacity there seems little prospect of harmonious conclusion. But if it is in the hands of the federation, then, if it is decided to exercise it, it will be decided, in the last analysis, by the citizens of the federation as a whole; and although no doubt, even so, there will be strong conflicts of sectional interests, it will not be open to the losers to argue that they did not have their say. In a world in which it is seldom possible to satisfy everybody, that surely is the optimal solution.[3]

Interstate trade

Much the same sort of solution is applicable to the problems of interstate trade.

Here, too, there is much to be said in favour of complete freedom. Indeed it is very hard to find anywhere, even in the vulgar polemics of restrictionism, any serious argument against it. Even the most rabid protectionist hesitates to denounce a general freeing of markets. "if only other countries were free-trade too, my dear fellow, then of course the argument would be different..." and whatever may be thought of the arguments whereby it is attempted to show that, in certain cases, advantage may be secured by restriction to the inhabitants of the restrictionist area, it has seldom, if ever, been

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[3] It is perhaps worth adding that, in practice, in any federation of European states which it is possible to contemplate in the near future, the actual dislocation likely to be caused by the institution of free migration within the federation, is not likely to be at all serious. The belief that migration from poorer to richer areas must actually depress the average standard of life of the former, is based upon a grossly oversimplified analysis. Even if we assume that the migrants are directly competitive with the existing inhabitants, the most that is likely to happen in an advancing society is that the rate of increase of real income per head may be retarded. But in fact it is improbable that they will be competitive with the majority. Small specialized groups may suffer. But there is no reason to suppose that their case would be at all typical. I should hesitate to rely completely on this argument, for it is obviously contingent on the existence of special circumstances. The main argument for permitting migration is that it is the only way of eliminating inequalities which are due to position. But it happens to be true that those faint souls who are only prepared to do right if no important sectional interest is much embarrassed, may comfort themselves with the reflection that, in Europe at any rate, given the probable magnitude of the rate of movement which would actually take place, this fortunate conjuncture of circumstances is likely for some time to persist.

seriously argued that such measures are not harmful to others. Even if – which is highly dubious – they succeed in doing more than create monopolistic privileges for certain minorities at home, they are essentially *beggar-my-neighbour* policies. To allow to the constituent states the right to interfere thus with interstate trade, would not only tend to lower productivity within the federation as a whole, it would also be a standing cause of disunity. Suppose that the constituent states of the United States of America had been allowed to retain this power. Is it likely that they would not have used it in ways deleterious to the general prosperity of the union; is it probable indeed that the union would have survived; enough disunity has been caused by the unequal incidence of the federal tariff. If there had been interstate tariffs and quotas as well, is it not almost certain that the federation would have been disrupted?

But here again as in the case of migration, there is no need to write into the constitution an absolute prohibition of such restrictions. We may think that the occasions on which their use in any form would be justified would be so rare as to make such a prohibition no obstacle to sound policy. But we cannot be quite sure. Moreover it may be that some schools of thought may desire to make experiments involving internal regulations of trade; we should not wish that adherents of such views should feel that in creating the federation they were being compelled to abandon all such ambitions. All that is necessary is that, if interstate trade is to be restricted, the restriction should be imposed by the federal authority. We need not prescribe in advance the type of policy as regards internal trade which will be pursued by the federation. But we must make sure that individual states have not an arbitrary power to inflict damage on fellow-members of the union. It may be that their members, as citizens of the union, may succeed by persuasion or by political manoeuvre in working the federal mechanism in a direction hostile to the interests of others. Short of a constitution which is eternally rigid, we cannot altogether guard against that. But we can provide that, if it happens, it will happen as the result of majority decisions in the appropriate federal assemblies, not as a result of the exercise of sovereign state rights about which the other members of the federation have no say.

The principle is thus clear. But its working out has more ramifications than at first sight might appear. It is not sufficient to rule out any state law involving important export duties. It is necessary to render inoperative any state law involving restriction or discrimination. The ingenuities of the restrictionist mind are endless; and it is possible to use what are apparently quite innocent forms of local regulation to discriminate against trade from elsewhere. In the United States of America, where, nominally, interstate trade is completely free, the most formidable body of restrictions has been built up under the shelter of regulations ostensibly designed to safeguard health and to provide protection against animal and plant diseases. It is probably not possible to legislate in advance against all such abuses. But at least provision should be made whereby special federal courts should be empowered to make due investigation and to disallow regulations which prove to have this effect.

Perhaps the most important danger of this kind lies in the field of transport. A government resolved to bias interstate trade in favour of its own citizens can do almost anything by discrimination in transport rates and conditions of transport service. Bismarck is reported to have said that if he could control the railways he would not worry about protective tariffs. The problem of the best mechanism for preventing this sort of thing is a subject in itself involving highly technical considerations which obviously cannot be dealt with here. But it is clear that, from the outset, any discrimination which is allowed must be a matter of federal control.[4]

[4] It may be asked whether the general prohibition of state discrimination includes a prohibition of straightforward state subsidies to particular branches of industry. This is a matter about which reasonable people may take two views. There is no doubt that state subsidies can cause considerable confusion – witness the chaos in international shipping which has resulted from this cause – and this might be held to be an argument for complete prohibition. On the other hand, provided the subsidies are straightforward – that is to say, provided they figure to their full extent in the state budgets – it is arguable that they are not likely to go very far without encountering stiff resistance at home and that, since to bar them absolutely would involve a complete prohibition of assistance to local “infants” and “invalid industries”, this would involve too great a restriction of local initiative. I myself have an open mind on this subject. I am sure that ninety-nine per cent of the talk about “infant” and “invalid” industries is either rubbish or paid propaganda. But I am also convinced that the real danger is, not the open but the concealed subsidy. The dangerous feature of discrimination via railway rates, etc., is just that it can go on indefinitely without the local citizens ever becoming aware that they are being made to foot the bill. Provided there were immunity from all other forms of local protectionism, I should not very fervently resist the liberty to give subsidies out of the state finances. But I should be inclined to couple with it the proviso that they should be paid out of special budgets financed exclusively by direct taxation of all incomes.

Money and banking

So far the problems we have had to tackle have not presented any very great difficulty. The objections to sectional control within a political organism of the movements of men or goods are so obvious that it is improbable that, given the objective of stability of the federation, expert opinion would be seriously divided concerning the appropriate means of securing it.

When we come to the problem of money and banking, however, the situation becomes more complicated; and it would be wrong to suggest that there would be anything like the same weight of expert opinion behind any particular solution which might be suggested. There are real divisions of opinion here which make any final decision a matter of great hesitation. Nevertheless it is possible that, here too, the kind of solution which we have proposed in regard to trade and migration, may be found to afford a satisfactory compromise.

At first sight it might seem that the argument was all in favour of a common currency and a common banking system for the whole of the federation. The convenience of a system which would eliminate all the tedious business of turning one currency into another, the superiority of a state of affairs in which the disturbances arising from the lack of co-ordination of the monetary policies of different states would be automatically eliminated by a general unification, seem so obvious that, to the lay mind, it must be difficult to conceive that any other policy could be favoured. And the writer of this essay must himself confess that, on this point, he believes that the lay mind is thoroughly justified. The advantages of a single money are so great that it seems difficult to believe that, once they were firmly established, they would ever seriously be called in question. Would it be seriously suggested that it would be better for England and Scotland to have different currencies or for the different districts of the federal reserve system of the United States to have special dollars of their own and independent powers of varying the rate of exchange with other kinds of dollars?

Nevertheless it must be realized that there is a school of thought, especially strong in Great Britain and Scandinavia, which, far from regarding the existence of different monetary systems for existing national areas with disfavour, looks upon it as a positive advantage.

The reasons for this attitude are various. But the reason which is relevant here is that it is thought that variations of the rate of exchange are an easier way of maintaining equilibrium with the rest of the world than internal expansions or contractions of credit.

This may sound highly technical. But a simple example should make it clear. Let us suppose that, owing to some invention or some change of taste, there occurs a relative fall of demand for the products of a certain national area. If the currency of that area is linked at a fixed rate to the currencies of other areas, this may mean a contraction of power to spend on the part of the local citizens – in the last analysis a reduction of incomes or unemployment.[5] If, however, the currency is independent, then the disequilibrium can sometimes be remedied by a fall of the rate of exchange. In each, case there is a reduction, or a tendency to a reduction, of real incomes. This is inevitable since the value of the local products has fallen. But, in the latter case, it is argued, it is brought about comparatively painlessly by the foreign exchange market; in the former by general deflation. It is for reasons of this sort that national rather than international money is recommended.

Now it would be possible at this point to investigate at length whether this argument gives a really fair account of the relative merits of the two types of adjustment. We might enquire why, if things are as simple as all that, it is not proposed completely to generalize the proposal, and to institute independent currencies not merely for national areas but also for the administrative areas within them. We might push the thing to its logical conclusion and ask why each different industry should not have its own money so that, when the value of its products changed, money incomes could be kept constant and the rate of exchange varied. And, if that proposal was rejected, we might ask for a more precise definition of the "best" area of monetary independence, and scrutinize the answer carefully to see if, in the last resort, it did not depend upon highly questionable assumptions concerning the inability of the economic subjects to distinguish between money and real incomes.[6]

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[5] This need not happen; if incomes elsewhere are increasing, all that may occur is a diminution of the local rate of interest. In practice this is the more probable event.

[6] I have analysed these questions at some length in my *Economic Planning and International Order*, London: Macmillan, 1937, chapter x. See also Friedrich von Hayek, *Monetary Nationalism and International Stability*, London: Longmans, Green

For our purposes, however, it is not necessary to enter into these complications. What is chiefly relevant here is that, so long as the power to vary the rate of exchange rests ultimately with the sovereign state, variations designed to achieve international equilibrium are not the only kind of variation which is possible. It is also possible that there may occur variations which are deliberately designed to snatch trade from competitors. It is possible that, as a result of internal policies, it may be thought necessary to make adjustments of the rate which, though not deliberately predatory, are yet such as to cause considerable embarrassment elsewhere. And while it is perhaps possible to argue that the adjustments which are designed to meet changed conditions of supply and demand might be beneficial all round, it is not possible to argue that these other kinds of adjustment are anything but detrimental to others. There is nothing more disturbing to trade in general than unwarranted fluctuations of the exchanges. There is no field in which the devices of economic nationnalism are more devastating than in the field of monetary policy.

It might seem, therefore, that there was a complete impasse. We cannot allow the federation to be endangered by the vagaries of monetary independence. We cannot hope that sufficient harmony will be reached by voluntary agreement between independent monetary authorities. Agreements of this sort are, of course, conceivable; and might work quite smoothly for a time. But if one state were recalcitrant it might upset the whole arrangement. The monetary history of the last decade affords no warrant for the belief that harmony can always be secured by monetary conferences of representatives of sovereign states. Yet here is a body of expert opinion, often with sincerely international sympathies, which urges that under modern conditions, different monetary systems are desirable in the different national areas.

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and co, 1937. My own view is that the academic advocates of independent national money have based their case upon over-simplified assumptions and that the extreme inconveniences which they profess to discover in international money are associated chiefly with certain varieties of the gold standard which are not truly international. The only definition of an optimal currency area short of the whole world which I have been able to construct for myself rests upon assumptions concerning labour mobility which I hope would be completely irrelevant to the internal affairs of a European federation. But it is not necessary to fight out the issue in this context. I hope the solution I propose below will satisfy all schools of thought in so far as they are not completely in the bondage of the ideology of state sovereignty.

Fortunately there is a way out. It is improbable that in the near future the opposing schools of thought will resolve their differences in this matter. But, for the formation of the federation, it is not necessary that this should take place. All that is necessary is that it should he agreed that the control of money and capital movements within the federation is essentially a federal function. The federal authority may decide that it is better that there should be a single money and a unified banking system – in that case none of the difficulties we have been discussing need arise. It may, however, decide that separate systems are desirable; in that case, however, it will retain control of the variations of the rates of exchange and any other regulations which are necessary; there will be the safeguard that what variations take place take place by federal authority and not by the arbitrary decision of independent sovereign states. The present writer will not conceal his belief that this last would be a radically inferior solution. A common monetary system would be a unifying factor – the sign and symbol of a common market and a common welfare. A congeries of state systems, however carefully co-ordinated, would constitute a standing breeding ground for interstate dispute.[7] But, provided that the federal authority has the last word, it is not a system which is completely incompatible with the idea of federation.

Other powers of the federation

There are certain other powers which must be given to the federal authority if it is to discharge its duties efficiently.

Thus it must be given powers of taxation. Without finance it is impossible for it to undertake either defence or any other task which is allotted to it. Moreover it does not seem desirable in any way to limit the form in which this taxation may be imposed. It is probable that, at first, customs duties will play a large part in financing the federal budget. But customs duties are not necessarily the best form of taxation; and it is easy to think of occasions when to finance the

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[7] I wonder if the advocates of this kind of solution have fully realized that it would necessitate state laws rendering void any contract in terms of the currency of any other constituent state. If it were not so, then of course contracts would tend to be made in terms of the currency expected to be most stable. I would like to add that if the area of union will be limited to Great Britain and continental Europe, excluding Russia, which is perhaps the most probable and certainly the most essential solution, there seems little to be said from any point of view against a completely unified monetary system.

whole of the federal budget by such means would be an intolerable inconvenience. It is unnecessary to linger on this topic. On the necessity for allowing to the federal authority a free hand as regards taxation, the arguments of Hamilton in the federalist have never encountered serious objection; and it is not easy to believe that serious objection is possible.

For the same reason the federal authority must be empowered to borrow. Much as we may dislike public debt, it would be absurd to limit federal borrowing powers by statute.

Moreover it must have the power to carry out public works. No doubt most of the public works within the federation will be initiated by the state authorities; and it is right and proper that this should be so. The federal authority should not be burdened with administrative duties which are best carried out by those with better knowledge of local circumstances. But it is quite conceivable that there may be public enterprises whose efficient operation involves an area of administration transcending the boundaries of particular states – a channel tunnel for example – and we must be careful to see that state rights do not impede the efficient performance of these functions. Moreover it is not excluded that to mitigate the incidence of periods of economic depression, it may be thought desirable that the federal authority should initiate special expenditure. Here again probably most of the work necessary could be done by state action, co-ordinated perhaps by federal subsidies. But direct federal action may be thought necessary and it is desirable that the way should not be barred by constitutional obstacles.

Finally it is necessary that the federation should have sufficient powers to deal adequately with any forms of monopoly which prove a menace to interstate trade. It will, no doubt, be felt desirable in many states that steps should be taken to limit and control monopolistic extortion. But if the operations of the monopolies involve more than one state, then in the absence of an adequate federal law, these attempts are likely to be frustrated. Provision must therefore be made that the slackness of particular states in this respect involves no danger to the welfare of the citizens of the rest of the federation. It must not be possible for predatory trusts and combines, operating elsewhere in the union, to find sanctuary in some state whose legislature is indifferent to the welfare of the consumers. To devise adequate instruments of regulation and control in this sphere involves problems of the utmost legal and technical complexity. But the broad economic principle involved is not a matter of serious doubt.

Local differences of industrial structure

We have now sketched very roughly the necessary powers of the federal authority as regards internal economic activity. There are, of course, many details which remain to be filled in. But the outlines seem fairly clear, and the broad principles which have guided us thus far seem adequate to determine any questions which may be left over.

As regards the powers of the states, it is fortunately not necessary to be so lengthy. For as we have seen already, the powers of the states are only limited by what is necessary to transfer to the federation; and it is no more necessary to make a detailed catalogue of them than it is necessary to make a catalogue of all the things which may be done by a free citizen living under a law which restrains him only from doing that which is harmful to others. Any economic function which can be discharged without injury to other parts of the federation will be open to the constituent states – public operation of industry, control of local public utilities, labour legislation,[8] social services, research and education – all these and many others will be within the competence of the state legislatures, if the electors so desire.

There is, however, one question which it is desirable to deal with explicitly. To what extent will the states be free to make experiments in general economic organization? In particular to what extent will it be possible for the states to initiate collectivist experiments;

The answer is surely obvious. The states are completely free to set up collectivist undertakings. They may nationalize the means of

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[8] It ought perhaps, to be noted that there is a school of thought which favours the transfer of labour legislation to the federal authority. The problems involved are highly technical; and I will only say here that in my judgment this is not desirable. Uniformity of labour legislation throughout the federation might well involve substantial injustices to the poorer workers. (the reasons for this are set out *in extenso* in my *Economic Planning and International Order*, *supra*, n. 6, chapter vii). If disparities, which are thought to be undesirable, develop between the different state laws, I think that there are indirect ways, via federal grants-in-aid, whereby adequate remedy is possible.

production within their own borders or they may impose collectivist controls on private undertakings. They are not free, however, to restrict the economic opportunities of other members of the federation without receiving federal sanction. In so far, therefore, and only so far as local collectivist experiments involve restriction or discrimination as regards the rest of the federation, it should be necessary for permission to be obtained from the federal authority.

A simple example should make this quite clear. Let us suppose that the citizens of a particular state become convinced that the coal resources within their area would be better worked by state undertakings than under private ownership. There is nothing whatever to prevent them carrying through the most comprehensive nationalization without any reference whatever to the federal authority. But they must not restrict the import of coal from other parts of the federation without obtaining federal sanction; and if it should happen that they possessed a monopoly of coal *vis-à-vis* the other members of the federation, or were in a strategic position to influence its price monopolistically, they should then in that respect come under federal law and their operations should be subject to whatever controls and regulations the federal authorities saw fit to impose. There is surely nothing in this which is incompatible with the aspirations of genuine collectivism. Collectivists who are genuine in their beliefs and not the secret or unconscious agents of sectional interests, will wish that their states should be free to institute forms of industrial organization which in their judgment have superior productivity. But they will not wish that they should be free to curtail the markets of their neighbours or to make extortionate gains through manipulating federal markets.

External economic relations

Finally a word may be said concerning the economic policy of the federation in its relations with the outside world.[9]

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[9] Perhaps I ought to state explicitly that, in all that has been written above, although the treatment is formal and abstract, I have had clearly in mind the formation of such a federation as seems possible in parts of Europe and certain associated regions. I do not believe that the formation of a world federation is at present remotely possible. Federation necessarily involves some degree of like-mindedness and like educational levels; and the sort of political reorganization which will provide security for the main values of western civilization is much more likely to come from the small beginnings of a federation of like-minded Europeans, than from more grandiose

It should go almost without saying that the treaty-making power which must necessarily be vested in the federal government must carry with it the power of regulating external economic relations. It would clearly be dangerous to the unity of the federation if the constituent states were in a position to make external agreements regarding economic affairs, independently of the central authority. Regulation of international trade and communications, international financial relations and immigration must therefore be federal functions.

Now it is not the object of this paper to examine how the various functions of the states and of the federal authority should actually be exercised in practice. Its object has been to establish how powers should be divided, not how they should be used. The question of the proper policy to be adopted in the exercise of different powers will be the continuous preoccupation of the political life of the states and the federation; and it is no part of our present business to attempt to anticipate the various decisions which will from time to time be reached.

But in regard to external economic relations perhaps it is permissible to lay down one generalization. It is probable that relations with the outside world will be subject to some degree of restriction. In particular, whatever degree of freedom of internal trade is permitted, it is likely that, for many years to come, there will be some limitation, via customs tariffs, on trade with the outside world. The prospects of superior market advantages within the federal area may indeed be one of the main attractions to new adherents. It is most improbable that the external policy of the federation would be one of completely free trade and free migration.

Nevertheless the same reasons that suggest the desirability of eliminating sectional interest within the federation, suggest also the undesirability of an external federal policy which consolidates positions of local privilege. We cannot hope in our day to build a federation so wide that it embraces even a majority of the world's inhabitants; and although our most pressing task is to eliminate the chaos of independent sovereignties among the closely juxtaposed states of Europe, yet when that is done there will still exist the

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structures which, because of the lack of these essentials, would not stand the strains of so close a unity.

possibility of clashes between the interests of the inhabitants of that area and the interests of the inhabitants of other political units. A European federation would be a supreme example of a "have" state; and if its economic policy *vis-à-vis* the "have-nots" in other parts of the world were markedly illiberal, it might raise up against itself formidable combinations. Quite apart, therefore, from the undesirability of giving rise to the internal disunities and maladjustments which almost always accompany the policies of restrictionism, there are solid reasons of international politics, why such policies should be reduced to a minimum. The formation of the federation is essentially an affirmation of the principles of justice and freedom as regards internal relations. It is desirable that its external policy should be based upon similar principles.

Final note

In the above paper, nothing has been said concerning the problems which would arise during the transition to federation or during the first few years of its existence. This omission has been deliberate; it would have been impossible to deal with these questions without intolerable complications of exposition. But it ought to be pointed out that it is in this sphere that some of the greatest difficulties arise and it is in this sphere that there is probably most scope for fruitful realistic research.

Appendix II

Federal Constitutional Court of Germany's ruling on the Greek rescue package

Headnotes
to the judgment of the Second Senate of 7 September 2011

– 2 BvR 987/10 –
– 2 BvR 1485/10 –
– 2 BvR 1099/10 –

1. Article 38 of the Basic Law protects the citizens with a right to elect the *Bundestag* from a loss of substance of their power to rule, which is fundamental to the structure of a constitutional state, by far-reaching or even comprehensive transfers of duties and powers of the *Bundestag*, above all to supranational institutions (BVerfGE 89, 155 <172>; 123, 267 <330>). The defensive dimension of Article 38.1 of the Basic Law takes effect in configurations in which the danger clearly exists that the competences of the present or future *Bundestag* will be eroded in a manner that legally or de facto makes parliamentary representation of the popular will, directed to the realisation of the political will of the citizens, impossible.

2. a) The decision on public revenue and public expenditure is a fundamental part of the ability of a constitutional state to democratically shape itself (see BVerfGE 123, 267 <359>).

The German *Bundestag* must make decisions on revenue and expenditure with responsibility to the people. In this connection, the right to decide on the budget is a central element of the democratic development of informed opinion (see BVerfGE 70, 324 <355-356>; 79, 311 <329>).

b) As representatives of the people, the elected Members of the German *Bundestag* must retain control of fundamental budgetary decisions even in a system of intergovernmental administration.

3. a) The German *Bundestag* may not transfer its budgetary responsibility to other actors by means of imprecise budgetary authorisations. In particular it may not, even by statute, deliver itself up to any mechanisms with financial effect which – whether by reason of their overall conception or by reason of an overall evaluation of the individual measures – may result in incalculable burdens with budget relevance without prior mandatory consent.

b) No permanent mechanisms may be created under international treaties which are tantamount to accepting liability for decisions by free will of other states, above all if they entail consequences which are hard to calculate. Every large-scale measure of aid of the Federal Government taken in a spirit of solidarity and involving public expenditure on the international or European Union level must be specifically approved by the *Bundestag*.

c) In addition it must be ensured that there is sufficient parliamentary influence on the manner in which the funds made available are dealt with.

4. The provisions of the European treaties do not conflict with the understanding of national budget autonomy as an essential competence, which cannot be relinquished, of the parliaments of the Member States, which enjoy direct democratic legitimation, but instead they presuppose this. Strict compliance with them guarantees that the acts of the bodies of the European Union in and for Germany have sufficient

democratic legitimation (BVerfGE 89, 155 <199 ff.>; 97, 350 <373>). The treaty conception of the monetary union as a stability community is the basis and subject of the German Consent Act (BVerfGE 89, 155 <205>).

5. With regard to the probability of having to pay out on guarantees, the legislature has a latitude of assessment which the Federal Constitutional Court must respect. The same applies to the assessment of the future soundness of the federal budget and the economic performance capacity of the Federal Republic of Germany.

[…]

Judgment

holds as follows:
1. The proceedings are dealt with together for a joint decision.
2. The constitutional complaints are rejected as unfounded.

Grounds

A.

The constitutional complaints challenge German and European legal instruments and further measures which are related to attempts to solve the current financial and sovereign debt crisis in the area of the European monetary union.

I.

1. The Treaty on European Union (Maastricht Treaty) of 7 February 1992 (OJ C 191/1; Federal Law Gazette II p. 1253) provided for a common monetary policy of the Member States, which was in stages to create a European monetary union and finally to communitarise the monetary policy in the hands of a European System of Central Banks (ESCB) (for an earlier decision on the following facts, see Decisions of the Federal Constitutional Court (*Entscheidungen des Bundesverfassungsgerichts* – BVerfGE) 125, 385 ff.). In the third stage, the euro was introduced in 2002 as the single currency. In order to

guarantee financial discipline to support the uniform monetary policy, at the same time the Stability and Growth Pact (Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997, OJ C 236/1) entered into force; in the interest of the stability of the euro, this provides for new borrowing at a maximum rate of 3% of the gross domestic product (GDP) and a maximum level of indebtedness of 60% of the GDP.

2. The Hellenic Republic (hereinafter Greece) has since 2001 been a member of the group of 16 (since January 2011: 17) of the 27 Member States of the European Union (Council Decision 2000/427/EC of 19 June 2000 in accordance with Article 122(2) of the Treaty on the adoption by Greece of the single currency on 1 January 2001, OJ L 167/19) whose single currency is the euro (Eurogroup). The details of the size of the Greek budget deficit in the year 2009 had to be corrected from 5% to almost 13% of the GDP, for 2010, an increase of the national debt to 125% of the GDP and thus more than twice the reference level of 60% of the GDP was expected (see press release of the Economic and Financial Affairs Council <ECOFIN Council>, 16 February 2010).

3. Against this background, the European Council of the heads of state and government met in Brussels on 11 February 2010 in order to deliberate on possible measures relating to Greece. On this occasion, the European Council announced that it would take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole (see Statement by the Heads of State or Government of the European Union, 11 February 2010). On 16 February 2010 the ECOFIN Council tightened the excessive deficit procedure against Greece which had been introduced in April 2009 and called for the deficit to be reduced by 4 percentage points within one year (from 12.7% in the year 2009 to 8.7% in the year 2010) and to further reduce it by 2012 to a maximum of 3% of the GDP (see press release of the ECOFIN Council, 16 February 2010). Following growing unrest on the financial markets, on 25 March 2010 the heads of state and government of the euro countries declared that they were prepared to support Greece in addition to financing by the International Monetary Fund (IMF) with their own bilateral loans (see Statement by the Heads of State and Government of the Euro Area, 25 March 2010). Evidently this statement also failed to convince

the financial markets with lasting effect. After the Fitch Ratings Agency downgraded its rating for Greece to BBB- on 9 April 2010 and the risk surcharges on Greek government bonds rapidly reached record levels, on 11 April 2010 the Euro area finance ministers reached agreement on the structure of the aid for Greece, to be granted in the form of bilateral loans from states in the euro area, and on its extent and the interest rate. In order set incentives for Greece to return to market financing, the lMF's pricing formula, with certain adjustments, was to be used as the reference rate to determine the conditions of the bilateral state loans. On 12 April 2010, the EU Commission, in consultation with the European Central Bank (ECB), entered into negotiations with the IMF and Greece, in which the conditions of the Greek rescue package were specified. The support was to be activated at the moment when it was actually needed, and needed above all to satisfy its liabilities on the bond markets. The participating states were then to decide on the disbursements (see Statement on the support to Greece by Euro area Member States, 11 April 2010).

4. On 23 April 2010, Greece applied for financial aid from the EU and the IMF (see Joint statement by European Commission, European Central Bank and Presidency of the Eurogroup on Greece, IP/10/446, 23 April 2010). Thereupon, on 2 May 2010, the states of the Eurogroup declared that they were ready, in the context of a three-year IMF programme with an estimated total financing requirement in the amount of 110 billion euros, to provide up to 80 billion euros as financial aid to Greece in the form of coordinated bilateral loans, up to 30 billion euros of which would be provided in the first year (see Statement by the Eurogroup, 2 May 2010). The shares of the individual states in the loans are based on the respective shares of the euro area Member States in the capital of the ECB. Germany's share as one of the 15 states which formed the Eurogroup at the time (without Greece) was to be 27.92% (see draft bill of the CDU/CSU and FDP parliamentary groups, *Bundestag* printed paper (*Bundestagsdrucksache*, BTDrucks) 17/1544, p. 4). The German share of the credits was therefore, if all Eurogroup states (apart from Greece) participated, approximately 22.4 billion euros, up to 8.4 billion euros of which was payable in the first year. The IMF was to take a share of 30 billion euros (see draft bill of the CDU/CSU and FDP parliamentary groups, BTDrucks 17/1544, p. 1). The financial aid

from the Eurogroup is provided subject to strict conditionality which was agreed between the IMF and the EU Commission (in consultation with the ECB) and Greece. The arrangements between the states of the Eurogroup with Greece and between themselves consist of two agreements. On the one hand there is the Loan Facility Agreement between the states of the euro area and Greece, which essentially establishes the loan conditions and requirements for granting the loan, and on the other hand the Intercreditor Agreement, an agreement between the Member States of the euro area which lays down the rights and duties of the Member States between themselves. Both agreements, with regard to Greece's measures of financial and economic policy, relate to the Memorandum of Understanding entered into with Greece (see Greece: Memorandum of Understanding on Specific Economic Policy Conditionality, 2 May 2010), which lays down the conditions for granting loans and in particular makes the disbursement of the financial aid conditional on strict requirements with regard to budget consolidation. The disbursement of the individual tranches is therefore coupled to compliance with quantitative performance criteria. Thus, detailed savings goals are laid down for each quarter; these must be achieved by means of measures such as tax increases or the cancellation of bonuses in the civil service (see Greece: Memorandum of Understanding on Specific Economic Policy Conditionality, 2 May 2010, p. 1). The Intercreditor Agreement also provides for internal balancing of interest and disbursements for financially ailing lender countries. As a result, a lender which has higher refinancing costs than the borrower's interest under the loan agreement may require that it is granted an adjustment of interest which is financed pro rata from the interest revenue of the other lenders. In addition, if it has higher refinancing costs than the borrower's interest under the loan agreement, a lender may apply not to take part in the disbursement of the next tranche. The other lenders decide on this application by a two-thirds majority of their capital shares. As soon as this lender again has lower refinancing costs than the borrower's interest, it is provided that its share of the loan should again be adjusted to the share provided in the loan agreement. No lender is responsible for the commitments of another lender.

5. In order to take the necessary measures on a national level, on 7 May 2010 the German *Bundestag* passed the challenged Act on the

assumption of guarantees to preserve the solvency of the Hellenic Republic necessary for financial stability within the Monetary Union (Act on Financial Stability within the Monetary Union – WFStG, Federal Law Gazette I p. 537). The provisions of the Act on Financial Stability within the Monetary Union are as follows:

§ 1
Guarantee authorisation

(1) The Federal Ministry of Finance is authorised to give guarantees up to the total amount of 22.4 billion euros to the Hellenic Republic; these are necessary as emergency measures to preserve the solvency of the Hellenic Republic in order to ensure financial stability in the monetary union. The guarantee serves to safeguard loans of the Kreditanstalt für Wiederaufbau to the Hellenic Republic, which are to be disbursed together with the loans of the other Member States of the European Union whose currency is the euro and of the International Monetary Fund. It is based on the measures agreed between the International Monetary Fund, the European Commission on behalf of the Member States of the European Union and the Hellenic Republic, with the cooperation of the European Central Bank. The loans from the Kreditanstalt für Wiederaufbau are to be disbursed in the first year up to the amount of 8.4 billion euros.

(2) A guarantee is to be applied against the maximum amount thus authorised in the amount in which the Federal Government can be called upon under the guarantee. Interest and costs are not to be charged on the amount authorised.

(3) Before guarantees are given under subsection 1, the German *Bundestag*'s budget committee must be informed, unless for compelling reasons an exception is advisable. In addition, the German *Bundestag*'s budget committee is to be informed quarterly on the guarantees given and their correct use.

§ 2
Entry into force

This Act shall enter into force on the day after it is promulgated.

6. The share of the aid measures assumed by Germany will be lent by the *Kreditanstalt für Wiederaufbau* (KfW), which requires a Federal Government guarantee for this. § 1.1 of the Act on Financial Stability within the Monetary Union authorises the Federal Ministry of Finance to give guarantees of this nature, which secure the granting of the guarantee by the KfW.

7. On the same day, 7 May 2010, the heads of state and government of the Eurogroup met again in Brussels and inter alia stated that they were in favour of strengthening economic governance in the euro area and regulating the financial markets more intensively and combating speculation (for an earlier decision on the following facts, see BVerfGE 126, 158 <160 ff.>). They reaffirmed their determination to exploit all means to preserve the stability of the euro area. For this purpose they agreed inter alia that the EU Commission should propose a European stabilisation mechanism to preserve the stability of the financial markets in Europe (euro rescue package). Thereupon, on 9 May 2010, the ECOFIN Council passed a resolution to create a European stabilisation mechanism, which consists of two parts: the European Financial Stabilisation Mechanism (EFSM), based on an EU regulation, on the one hand and the European Financial Stability Facility (EFSF), a special purpose vehicle based on an inter-state agreement between the Member States of the Eurogroup to grant loans and credit lines, on the other hand. These instruments are intended to give financial assistance to Member States which are in difficulties caused by exceptional occurrences beyond their control (see the "Agreement on Conditions" on the "central structural elements of the EFSF"). The ECB also agreed to be involved in the new approach by resolving on a "securities markets programme". Inter alia, the ECB Governing Council in this connection authorised the national central banks of the Eurosystem to purchase on the secondary market debt instruments issued by central governments or public entities of the Member States (OJ L 124/8).

8. Council Regulation No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (OJ L 118/1) is based on Article 122.2 of the Treaty on the Functioning of the European Union (TFEU). This provides that where a Member State is in difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control, it may be granted European Union

financial assistance. The Council is of the opinion that the exceptional situation consists in the fact that the intensification of the global financial crisis has led to a grave deterioration for more than one Member State of the Eurogroup, which exceeds what can be explained by fundamental economic data. The European Financial Stabilisation Mechanism is to remain in effect for as long as is necessary to preserve the stability of the financial markets and is to have a total financial volume of up to 60 billion euros, which makes it necessary for the EU to borrow. The Regulation lays down the details of the conditions and procedures under which a Member State may be granted financial assistance by the EU. The decision on the grant of financial assistance is made by the Council on a proposal of the EU Commission, by a qualified majority.

9. In addition to the introduction of the EFSM, the heads of state and government of the Eurogroup agreed to support each other financially through a special purpose vehicle, the EFSF. A special purpose vehicle is a legal person or an entity equivalent to a legal person which is usually founded for a quite specific purpose and is dissolved after this purpose has been achieved. It was resolved that the participating Member States, paying due regard to their constitutional provisions, guarantee the special purpose vehicle in proportion to their share of the paid-in capital of the ECB (see Decision of the Representatives of the Governments of the Euro Area Member States Meeting within the Council of the European Union, of 9 May 2010, Council Document 9614/10). The EU Commission may, through the EFSF, be tasked by the Member States of the Eurogroup (see Decision of the Representatives of the Governments of the 27 EU Member States of 9 May 2010, Council Document 9614/10).

10. With regard to this special purpose vehicle, which at this date had not yet been founded, first of all framework conditions were agreed ("Agreement on Conditions"): The shareholders are all Member States of the Eurogroup; every Member State of the Eurogroup delegates one director to the board of the company, and in addition the EU Commission delegates an observer. The special purpose vehicle is to be founded under Luxembourg law. Its purpose is to issue bonds and to grant loans and credit lines to cover the financing requirements, subject to conditions, of Member States of the Euro-group who are in difficulties. The guarantees for the special purpose

vehicle in the amount of 440 billion euros will be shared among the Member States of the Eurogroup in proportion to their share of the capital of the ECB; the liabilities of the Member States under the guarantee are limited to their share plus 20% for each bond issue. The increase of up to 20% results from the fact that not all Eurogroup Member States will be involved in all bond issues. The decisions will be made unanimously; the life of the special purpose vehicle is limited to three years from its foundation, irrespective of the date of maturity of loans granted or bonds issued by the special purpose vehicle and of guarantees given by Eurogroup Member States.

11. In addition, a framework agreement is to be entered into between the Eurogroup participating states and the proposed special purpose vehicle; this will govern the details of the issue of bonds on the capital market by the special purpose vehicle, of the declaration of guarantee of the Eurogroup states and of the terms of the loan extension (see EFSF Framework Agreement, draft of 20 May 2010). On the basis of Germany's share in the ECB capital, the German share of the guarantee volume was to be 123 billion euros; in cases of unforeseen and absolute need, it was anticipated that the amount might be exceeded by 20% (see draft bill of the CDU/CSU and FDP parliamentary groups, BTDrucks 17/1685, p. 1). The total volume of the stabilisation instruments in the amount of 750 billion euros is calculated on the basis of the volume of the EFSM in the amount of 60 billion euros, the volume of the EFSF in the amount of 440 billion euros and the (expected) participation of the IMF in the amount of half of the sums named, that is a further 250 billion euros (see Conclusions of the ECOFIN Council of 9 May 2010, Rat-Dok. SN 2564/1/10 REV 1).

12. In order to create the conditions on a national level to give financial support through the special purpose vehicle (EFSF), on 21 May 2010 the German *Bundestag* passed the challenged Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism (hereinafter: Euro Stabilisation Mechanism Act, Federal Law Gazette I p. 627). After the *Bundesrat* had resolved on the same day not to refer the bill to the Mediation Committee, the Act was promulgated on 22 May 2010. The provisions of the Euro Stabilisation Mechanism Act are as follows:

§ 1

Guarantee authorisation

(1) The Federal Ministry of Finance is authorised to give guarantees up to a total amount of 123 billion euros for loans which are raised by a special purpose vehicle founded or commissioned by the euro area Member States to finance emergency measures to preserve the solvency of a euro area Member State, provided these emergency measures for the preservation of the solvency of the affected Member State are necessary to ensure financial stability in the monetary union. The condition is that the affected Member State has agreed an economic and financial policy programme with the International Monetary Fund and the European Commission with the cooperation of the European Central Bank and that this is approved by mutual agreement of the euro area Member States. Prior to this, the risk to the solvency of a euro area Member State must be established by mutual agreement of the euro area Member States, without the participation of the Member State involved, together with the International Monetary Fund and the European Central Bank. Guarantees under sentence 1 may only be given by 30 June 2013 at the latest.

(2) The giving of guarantees under subsection 1 is subject to the condition that the euro area Member, without the participation of the Member State involved and with the cooperation of the European Central Bank and in consultation with the International Monetary Fund, mutually agree that emergency measures under the Council Regulation to create a European financial stabilisation mechanism are not or not in full sufficient to avert the risk to the solvency of the euro area Member State in question.

(3) A guarantee is to be applied against the maximum amount thus authorised in the amount in which the Federal Government can be called upon under the guarantee. Interest and costs are not to be charged on the amount authorised.

(4) Before giving the guarantees under subsection 1, the Federal Government will endeavour to reach agreement with the German *Bundestag* budget committee. The budget committee has the right to submit an opinion. If for compelling reasons a

guarantee has to be given before agreement has been reached, the budget committee must be subsequently informed without delay; the absolute necessity of giving the guarantee before agreement is reached must be justified in detail. In addition, the German *Bundestag*'s budget committee is to be informed quarterly on the guarantees given and their correct use.

(5) Before the guarantees are given by the Federal Ministry of Finance, the agreement on the special purpose vehicle must be submitted to the German *Bundestag*'s budget committee.

(6) The scope of the guarantees under subsection 1 may, if the requirements of § 37.1 sentence 2 of the Federal Budget Code are satisfied, with the consent of the German *Bundestag*'s budget committee be exceeded by up to 20 per cent of the sum stated in subsection 1.

§ 2

Entry into force

This Act shall enter into force on the day after it is promulgated.

13. On 7 June 2010, the Grand Duchy of Luxembourg founded the special purpose vehicle, initially alone (see European Financial Stability Facility, Société Anonyme, 7 June 2010). On the same day, the finance ministers of the Eurogroup and a representative of the special purpose vehicle accepted the Framework Agreement (see EFSF Framework Agreement, Execution Version of 7 June 2010). Article 13.8 of this Framework Agreement gives the other Member States the right to assume their shares of the special purpose vehicle.

II.

In their constitutional complaints, the complainants challenge German and European legal instruments and further measures which are related to attempts to solve the current financial and sovereign debt crisis in the area of the European monetary union. All complainants assert that there is a violation of their fundamental rights under Article 38.1, Article 14.1 and Article 2.1 of the Basic Law.

1. The first complainants are of the opinion that Article 38.1 sentence 2 of the Basic Law gives every citizen a right that the principles of the

structure of the state in the Basic Law are at least in essence safeguarded. They submit that fundamental principles of the Basic Law have been disregarded, in particular the principle of the social welfare state, and that the principles of the constitutional rules governing public finances have been disregarded and in particular there has been a violation of borrowing limits (Article 115 of the Basic Law). Germany has largely abandoned its budgetary sovereignty. They state that the measures are contrary to convergence and thus to stability, and that they also violate the fundamental right to property of Article 14.1 of the Basic Law, and they submit as follows:

a) aa) Article 38 of the Basic Law grants an individual right that every instance of European integration policy must be supported by sufficiently specific decisions of the German *Bundestag* and of the *Bundesrat*. Legal instruments which depart from the concept of the European Union monetary union would be ineffective in Germany, for if they took effect, this would lack parliamentary accountability and would therefore violate Article 38.1 of the Basic Law. The German *Bundestag* has assumed responsibility for the monetary union, but only subject to particular basic conditions to ensure the stability of the European Union currency. The stability criteria are binding not only as the limit of the sovereign powers transferred, because the *Bundestag* and the *Bundesrat* were not prepared or entitled to be accountable for a development of the monetary union independent of these stability criteria, but also because a stability community strictly bound by the convergence criteria is a subject agreed on by European Union treaty. Parliament bears responsibility for and legitimises European Union policy only within the limits of the sovereign powers transferred. Just as the policy of a monetary union cannot take effect in Germany without a German Consent Act, such a policy can also not assert itself under the Basic Law contrary to the Consent Act, whose basis is in the treaty. It would also violate the right equivalent to a fundamental right under Article 38.1 of the Basic Law.

bb) If there is a departure from the stability principle of the Maastricht Treaty, the German *Bundestag* and the *Bundesrat* are not responsible or accountable for this policy, and this violates the citizen’s constitutional rights. Measures which are resolved upon by the European Council and the Council of the Finance Ministers and implemented by the Act on Financial Stability within the Monetary

Union disregard the limits of the powers of the European Union and can have no effect in Germany. The measures do not only violate the convergence principle of financial stability law in the narrow sense, but also ignore the requirement of convergence in currency law, that is, the budgetary independence of the members of the monetary union. Decisions of the German *Bundestag* passed by a simple majority cannot democratically assume responsibility for the aid measures of the European Union and Germany. Whether the monetary union following the stability concept of the Treaty may be expected to result in the European currency being stable depends on whether convergence is realised in such a way that the monetary union can be a community which guarantees stability and in particular monetary stability in the long term (BVerfGE 89, 155 <204>).

b) In the commitment to grant financial aid to other members of the Eurogroup in order to avert their budgetary hardships, Germany has largely abandoned its budgetary sovereignty, which is an essential part of economic sovereignty. In this way, Parliament's right to decide on the budget, which defines democratic parliamentarianism (Article 110.2 sentence 1 of the Basic Law), is restricted in a way which surrenders existential statehood in an anti-democratic manner. Limits to permissible loan guarantees can be found in the fundamental budgetary principle of Article 110.1 sentence 2 of the Basic Law. It is impossible for Germany to satisfy its commitments under the guarantees without borrowing.

c) The measures are contrary to convergence and thus to stability, and they also violate the fundamental right to property of Article 14.1 of the Basic Law. This fundamental right guarantees the "citizen's fundamental right to price stability". It also receives its substance from the principle of the social welfare state. This guarantee of property is violated by a policy of money instability. Together with the value of money, inflation materially reduces monetary claims. As a result of inflation, monetary wealth loses value to a greater or lesser extent. It is true that the guarantee of property does not generally guarantee the value of assets, but it does afford protection against a state policy which encourages inflation. It also follows from Article 14.1 of the Basic Law that the state has a duty to protect the stability of value of property. The policy of the European Union and of

Germany is contrary to convergence and thus to stability and it gives rise to fears of a present and immediate loss of value of the complainants' personal assets. The legal protection of property calls for inflation to be averted in an early stage. For if one waits until inflation has developed, the damage has already occurred. The constitutional complaint proceedings must examine whether the monetary policy of the European Union and of Germany creates a risk of inflation.

d) The federal bodies have no powers to undertake acts which are contrary to the Basic Law; at all events, all powers end where they violate the core of constitutional identity, which under Article 79.3 of the Basic Law is not at the disposal of the policies of the federal bodies. The core of constitutional identity also restricts the powers of the European Union bodies. Both the European Union policy and the national policy of the euro rescue package violate not only the principle of conferral, but in the form of inflation policy also violate the core of Germany's constitutional identity, in particular the principle of the social welfare state. They even hold the danger of creating a currency reform which is contrary to the social welfare state. The European Union is attempting to develop Article 122.2 TFEU into a form of federal emergency constitution. This is an arrogation of power which has the quality of a *coup d'état*. The European Financial Stabilisation Mechanism creates the "financial union", which is at the same time a "social union". It creates the "transfer union" and the liability community. Financial aid for ailing state budgets is a form of financial compensation which departs from the concept of the monetary union.

2. The second complainant also submits that his fundamental rights and rights equivalent to fundamental rights under Article 38.1, Article 14.1 and Article 2.1 of the Basic Law have been violated. He states that the euro stabilisation mechanism is incompatible with the Treaty on the Functioning of the European Union and has the effect of altering the Treaty (a). Both these elements are significant with regard to more than one violation of a fundamental right ((b) and (c)). He submits as follows:

a) The euro stabilisation mechanism – in the same way as the earlier aid to Greece – violates the bailout prohibition of Article 125.1 TFEU, which rules out European Union liability for commitments of the Member States and liability of the Member States for commitments of other Member States. It is the purpose of this provision to ensure comprehensive legal responsibility of the Member States for their own public-revenue conduct. Only if it is clear to every Member State that neither the European Union nor other Member States are liable for or guarantee that state's own commitments and therefore there is a risk of state insolvency in certain circumstances is there sufficient incentive to satisfy the requirements of stability in the long term and not to engage in an irresponsible debt policy at the cost of the others – who admittedly have no legal obligation, but might see themselves, as a result of the pressure of economic circumstances, de facto forced to be responsible for the commitments of the Member State with unsound economic activity – and to enjoy prosperity on credit in the hope that ultimately the others will pay for this.

A justification of this violation by a state of emergency under Article 122.2 TFEU is out of the question. In particular, the overindebtedness of Greece and other states is not an event comparable to a natural disaster, but the result of a financial policy for which, according to the Treaty, the states in question are solely responsible. In the case of overindebtedness, state bankruptcy is an economic consequence of the state's own conduct, for which the state in question must take responsibility under the meaning and purpose of Article 125 TFEU. If the impending insolvency of a Member State were to be understood as an exceptional occurrence within the meaning of Article 122.2 TFEU, scarcely an area of application for the bailout prohibition would remain.

The contravention of the bailout prohibition by the euro stabilisation mechanism is not an isolated infringement of the Treaty; on the contrary, the concept of the stability union provided for by the Treaty is permanently destroyed, and replaced by the completely different concept of a liability and transfer union. In addition, the euro stabilisation mechanism as such represents the institutionalisation of ongoing failure to fulfil Treaty obligations. In the Maastricht Treaty, the Federal Republic of Germany only consented to monetary union subject to the proviso that the provisions guaranteeing stability should be in force and be strictly applied. Every time it disregards these provisions, the European Union leaves the Treaty foundation of monetary policy and oversteps the scope of competence defined in the Member States' Acts to ratify the Treaty. Politically, there may be differing opinions as to whether such a turning away from the previous conception is desirable or not. But legally, at all events, such a fundamental change of design is possible only by a formal amendment of the Treaty. The participation of the Federal Government and the *Bundestag* in the de facto alteration, sanctioned by custom, of the Treaty on the Functioning of the European Union is incompatible with the principle of democracy.

b) In its Lisbon judgment, the Federal Constitutional Court recognised a comprehensive right of the individual to participate in the democratic legitimation of state authority – a "right to democracy" – which is not restricted to legitimation in connection with the transfer of sovereign powers. In substance, admittedly, this right equivalent to a fundamental right does not entail a comprehensive review of the lawfulness of the whole of the state's activity, but it does entail a "review of democracy". This right of the individual under Article 38.1 of the Basic Law has been violated in several ways by the challenged acts and omissions.

aa) *Ultra vires* acts of the European Union bodies contravene the principle of democracy and infringe the complainant's right equivalent to a fundamental right under Article 38.1 of the Basic Law because they involve the exercise of sovereignty in Germany which is not democratically legitimised. From Article 38.1 of the Basic Law there follows in general the right of every citizen that state authority and European sovereign power is democratically legitimised, unless the constitution itself – within the limits of Article 79.3 of the Basic Law – permits restrictions or modifications of the democratic principle of legitimation. The challenged acts and omissions of the European Union bodies, as *ultra vires* acts, contravene Article 38.1 of the Basic Law. This applies to the decision of the Council of 9 May 2010 to introduce a euro stabilisation mechanism (violation of the bailout prohibition of Article 125.1 TFEU), to Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (violation of the bailout prohibition of Article 125.1 TFEU), to the purchase of government bonds of Greece and of other euro area Member States by the European Central Bank (violation of Article 123.1 TFEU) and to the coordination of the rescue packages, that is, of the aid to Greece and the euro stabilisation mechanism, by the Council and the EU Commission (violation of the bailout prohibition of Article 125.1 TFEU). These are manifest and serious cases of overstepping of competence within the meaning of the Federal Constitutional Court's Honeywell case-law.

Unlike in the case of the review against fundamental rights, the Federal Constitutional Court has not retracted its authority for *ultra vires* review of European Union acts. The focus is not on a constant, regular overstepping of European Union competences; instead, the Federal Constitutional Court reviews every individual overstepping of the limited individual competences. Since European Union acts which are not covered by the limited individual competences can have no legal effect in the Member States, they are subject in full to review by the Federal Constitutional Court. Consequently, the complainant can also challenge the fact that the European Union acts violate Article 14.1 or Article 2.1 of the Basic Law; in this case, the Solange II case-law is not pertinent. From the perspective of German constitutional law, *ultra vires* acts of the European Union bodies are to be disregarded by German state authority because they are not covered by the German Consent Act ratifying the Treaty and thus are not based on an effective transfer of sovereign powers. Every overstepping of their competence by European Union bodies also severs the democratic legitimation connection which is based on the Consent Act.

bb) Article 38.1 of the Basic Law has also been violated by the Federal Government's cooperation in the *ultra vires* acts of the European Union bodies.

cc) The same applies to the acts of the Federal Government, which in cooperation with the European Union bodies and with the governments of the other Member States led to a fundamental change of the stability conception of the European monetary union. Not only the Federal Government was involved in this de facto alteration of the Treaty outside the legal Treaty amendment procedure, but also the *Bundestag* and the *Bundesrat*, by passing the Act on Financial Stability within the Monetary Union of 7 May 2010 and the Euro Stabilisation Mechanism Act of 22 May 2010. Admittedly, as a rule measures for which Parliament as legislature gives authorisation by statute do not lack democratic legitimation. But it must be noted that the Basic Law makes differing requirements of the democratic legitimation conveyed by the Act of parliament. An amendment of primary European Union law, except where it is a case of a simplified treaty amendment procedure provided for in EU law, requires an international-law treaty and a Consent Act ratifying the treaty within the meaning of Article 23.1 of the Basic Law to be entered into. Treaty amendments without such a ratifying Act do not satisfy the constitutional requirements for democratic legitimation.

dd) In addition, the complainant finds his rights under Article 38.1 of the Basic Law violated in that the de facto abolition of the bailout prohibition encroaches upon the people's constituent power. A liability community and a European centralisation of budget policy may not even be introduced by a Treaty amendment unless the Member States are given other competences by the European Union by way of compensation. For with this impetus to centralisation the limit of what the Federal Constitutional Court, in the Lisbon decision, regarded as constitutional by way of transfer of sovereign powers would be clearly exceeded. In this decision, the Court emphasised the importance of the budgetary sovereignty of the national parliaments as the most important element of state sovereignty.

ee) There is also a violation of the principle of democracy guaranteed by Article 38.1 of the Basic Law because the guarantee authorisation and the institutional embodiment of the special purpose vehicle in the Euro Stabilisation Mechanism Act is too imprecise and possibilities of parliamentary monitoring and influence were lacking when the Act was implemented. What standards are to be imposed before guarantees are given on the economic and financial policy programme of the Member State which is to benefit and in what way the performance of this programme in practice is monitored and safeguarded cannot be understood from the challenged statute. It is true that the Federal Government has a right of veto, because the programme has to be approved by mutual agreement of the Member States. However, this veto position is relativised in view of the immense political pressure. In addition, the institutional structure of this special purpose vehicle is not defined in the Act. Nor did the delegates have access to articles of association of the special purpose vehicle when the Act was passed. The "Agreement on Conditions", which sketches the "central structural elements of the EFSF" in a few words, was by no means sufficient to enable the *Bundestag* to make an accountable decision.

In addition, under § 1.4 of the Euro Stabilisation Mechanism Act, the Federal Government is merely obliged to attempt to reach agreement with the *Bundestag* budget committee before giving guarantees. This is not enough, since in the case of conflict the obligation to attempt to reach agreement leaves the decision on a financial volume of half of the federal budget to the Federal Government.

ff) With regard to the German *Bundestag*'s budget responsibility, the second complainant finds a violation of Article 38.1 of the Basic Law in particular in the fact that responsibility for the guarantee authorisation given in § 1 of the Euro Stabilisation Mechanism Act in the amount of 147.6 billion euros (123 billion euros plus 20%) exceeds what is possible in a parliamentary democracy. If one adds to this the guarantee authorisation in favour of Greece in the amount of 22.4 billion euros agreed in the Act on Financial Stability within the Monetary Union, this is a total amount which is much larger than the largest federal budget item and which greatly exceeds half of the federal budget. Admittedly, it is not likely that the Federal Government will have to assume liability for all guarantees in full, but it is also not unrealistic to prepare for this possibility. The *Bundestag* renounces its budget responsibility and its responsibility for the public interest if it ties itself down in this volume in advance for future budget years. With good reason, the Basic Law provides that decisions on revenue and expenditure are to be made in annual budgets or in budgets relating to years, which are adopted as Budget Acts. Admittedly, Article 115.1 of the Basic Law permits the *Bundestag* to authorise by statute guarantees of various kinds which may result in expenditure in future financial years. But this presupposes that these are obligations which remain on the scale of customary individual budget items. If, however, half the federal budget is potentially spent in advance in this way, this is a quantum leap. In drafting Article 115 of the Basic Law, the legislature creating the constitution was not thinking of such exorbitant orders of magnitude. It contradicts the principle of parliamentary budget responsibility that the whole or – as in the present case – half of the budget is disposed of in advance and thus room to manoeuvre in order to perform the state's many duties is abandoned.

gg) Moreover, Article 38.1 of the Basic Law is also violated by the fact that the Decision of the Representatives of the Governments of the Euro Area Member States Meeting within the Council of the European Union of 9 May 2010 is a treaty under international law and under Article 59.2 in conjunction with Article 115.1 of the Basic Law it required the consent of Parliament in the form of a Consent Act. In the absence of a Consent Act, the democratic legitimation necessary under Article 59.2 of the Basic Law is lacking.

hh) Finally, the second complainant finds a violation of Article 38.1 of the Basic Law in the fact that Parliament was compelled by the Federal Government to pass the Act on Financial Stability within the Monetary Union and the Euro Stabilisation Mechanism Act, in that the Federal Government claimed that there was a state of emergency with threatening catastrophic consequences or actually caused this state of emergency by a number of omissions. A characteristic of parliamentary democracy is that Parliament debates on various possible decisions and the majority decides in favour of one of the alternatives. If parliament is forced to decide in favour of one alternative because otherwise an absolutely intolerable evil threatens, a democratic choice between alternatives on the basis of competing political conceptions is impossible. However, it is debatable whether there really is only one way out of the Greek crisis and the "euro crisis". Respected economists think that a far better solution could be achieved if the creditors take a "haircut". But if there are realistic alternatives, it is undemocratic to put Parliament under such pressure.

c) In addition to Article 38.1 of the Basic Law, Article 14.1 of the Basic Law is also violated by the challenged acts and omissions. They lead to the collapse of the legal stability structure of the currency system. Admittedly, in its decision on the introduction of the euro, the Federal Constitutional Court stated clearly that by law the currency policy must orient itself towards the objective of price stability, which follows from Article 14.1 in conjunction with Article 88 of the Basic Law, but that there is no individual right to demand that this obligation is fulfilled. This is also correct, because and to the extent that the law of economic, financial, currency and social policy allows tolerance for structuring and prognosis. But where there are strict legal commitments with regard to the structuring of the economic regulatory framework for the development of monetary value, no reason is apparent to restrict the individual right under Article 14.1 of the Basic Law. This is precisely the nature of the legal position in the present case. For the policy violates Article 125.1 and Article 123.1 TFEU and thus fails to observe the limits established by treaty of provisions determining the content and limits of property. It would be a one-sided and impermissibly restrictive point of view if one were always to understand provisions determining the content and limits of property only as restrictions of the rights of owners. They are at the same time constitutive elements of the owner's rights. Since the legal scope of owners' rights follows from the totality of the statutory provisions determining the content and limits of property, the individual also has a claim for state authority to observe the provisions determining the content and limits of property.

III.

The German *Bundestag* (1) and the Federal Government (2) submitted written opinions on the constitutional complaints.

1. The German *Bundestag* is of the opinion that the constitutional complaints are inadmissible (a) and unfounded (b) and submitted as follows:

a) The complainants disregard the limits of constitutional complaint proceedings and also of the judicial decisions of the Federal Constitutional Court. The constitutional complaint, which is designed to give an individual recourse to justice, is completely pushed into the background and the complainants conduct themselves as if they were champions of the public. The decisions made by the Council of the European Union and the acts and omissions of the ECB and the EU Commission are outside the scope of a constitutional complaint under Article 93.1 no. 4a of the Basic Law and § 90 of the Federal Constitutional Court Act (*Bundesverfassungsgerichtsgesetz* – BVerfGG). Nor do the Solange II case-law of the Federal Constitutional Court and the statements on European *ultra vires* acts made in the Lisbon judgment lead to a different result. Independently of this, there is no entitlement to file a specific constitutional complaint, for the complainants are exposed to mere reflex effects, and this is not sufficient to assume a direct effect on them.

aa) The possibility of a violation of Article 14 of the Basic Law has not been shown. It is true that specific property rights are protected, and consequently so is property in the form of money and the basic possibility of being able to exchange money for material assets. However, Article 14 of the Basic Law contains no guarantee of value; the exchange value of property rights is not covered by the guarantee of property, provided that the possibility of exchange is not completely ruled out. The area of protection of Article 14.1 of the Basic Law does not include monetary stability, and therefore there is no fundamental right to a stable currency. Furthermore, the challenged measures serve to ensure the monetary stability of the euro and for this reason too they do not contravene Article 14 of the Basic Law.

bb) An infringement of Article 2.1 of the Basic Law is out of the question. Only if an infringement of Article 14.1 of the Basic Law were to be assumed would there at the same time be an infringement of Article 2.1 of the Basic Law, but by reason of its subsidiarity this would then be overridden as a fall-back fundamental right.

cc) Where the argument is based on objective constitutional law (the principle of the social welfare state), this is outside the area of application of a constitutional complaint. The principle of the social welfare state alone does not give rise to any individual rights. The principle of the social welfare state includes the requirement for the state to create the minimum requirements for an existence inline with human dignity. This does not include the guarantee of a stable currency, because the principle of the social welfare state does not relate to the general economic conditions of environment and existence.

dd) Nor has the possibility of a violation of Article 38 of the Basic Law been shown. State power and the influence on the exercise thereof are legitimised by election, and in the area of application of Article 23 of the Basic Law, Article 38.1 of the Basic Law precludes emptying this of meaning by relocating duties and powers of the *Bundestag* in such a way that the principle of democracy, insofar as Article 79.3 in conjunction with Article 20.1 and 20.2 of the Basic Law declares it to be inviolable, is violated (BVerfGE 89, 155 <171>). This guarantee is not relevant, because duties and powers of the German *Bundestag* are not relocated. The Federal Republic of Germany does not abandon its statehood. The challenged statutes are statements of the German legislature and as such an expression of continuing statehood. In the present context, Article 38.1 of the Basic Law gives no protection against the democratically legitimised legislature.

b) The constitutional complaints are also unfounded. Fundamental rights have not been violated. Nor does an argument which places an alleged contravention of provisions of European primary law in centre stage carry weight. Insofar as the constitutional complaints assert that there have been violations of law and place these violations in the context of *ultra vires* review, they overlook the fact that the concept of *ultra vires* acts does not imply a general review, encroaching upon areas of discretion, by Member State courts of the lawfulness of all European physical acts or legal instruments.

aa) Apart from the fact that violations of the European treaties by the federal legislature cannot be challenged by way of a constitutional complaint, the accusations are also substantively incorrect with regard to European Union acts.

(1) In Article 122 TFEU, there was a legal basis for European Union acts. Under Article 122.2 TFEU, the Council may under certain conditions grant a Member State financial assistance from the European Union if this Member State, by reason of natural disasters or exceptional occurrences beyond its control, is in difficulties or is seriously threatened with severe difficulties. It is true that there is no natural disaster in the present case. However, the financial crisis and the developments on the financial markets are exceptional occurrences within the meaning of Article 122.2 TFEU. They are also beyond the control of the Member States considered, that is Greece, Portugal, Spain, Italy and Ireland. The difficulties within the meaning of Article 122.2 TFEU need not in their entirety arise without fault. Even if Greece and other euro area Member States had themselves actuated their strained budget situations, it would only have been the financial crisis, contagious tendencies entailed by it and the developments on the financial markets which would have led to difficulties or to the threat of severe difficulties. These difficulties

within the meaning of Article 122.2 TFEU consist in a substantial deterioration of loan conditions of some euro area Member States, which could have resulted in these Member States being insolvent, and in the danger that these tensions would spread from the government bonds market to other markets and would adversely affect the functioning of the international financial markets.

(2) The purchase of government bonds of Greece and of other euro area Member States by the European Central Bank is not a violation of Article 123 TFEU. This provision only prohibits the ECB from directly purchasing debt instruments of public-sector bodies and institutions. Consequently, only the purchase of government bonds direct from state issuers, that is, the euro area Member States, is prohibited. The direct purchase of government bonds by the ECB from the secondary market is not prohibited.

(3) There is no violation of Article 125 TFEU and the bailout prohibition contained therein. There is no aspiration to achieve a completely different conception of the monetary union, away from the stability community and towards the liability and transfer community. Article 125 TFEU is open to interpretation to the extent that it may simply contain a "prohibition of a commitment to give financial aid", with the result that voluntary financial aid is not affected. Under Article 125 TFEU, neither the European Union nor individual Member States are liable for the obligations of sovereign agencies of other Member States and they do not take responsibility for such obligations. In this way the bailout prohibition prevents creditors of Member States or these Member States themselves from being able automatically to call upon the European Union or other Member States as if they were guarantors of the debts of these Member States. However, this does not mean that Article 125 TFEU contains a general prohibition of financial assistance for Member States. There is no obligation to give assistance, but this is not forbidden. The aid from the Member States does not contravene the bailout prohibition for another reason too. Under the wording of Article 125.1 TFEU – "… A Member State shall not be liable for or assume the commitments …" – a Member State is only forbidden to enter into the debt relationship between another Member State and its creditor, with the result that the bailout prohibition specifically does not contain a general prohibition of voluntary assistance

between the Member States. For this voluntary assistance creates a new, independent commitment and is therefore not conceptually an entry into an old commitment.

In addition, a further reason why the financial assistance of the European Union does not violate Article 125 TFEU is that Article 122.2 TFEU authorises the European Union to grant financial assistance and at the same time can be regarded as the ground of justification for deviating from the prohibition of Article 125 TFEU. Even if one were to infer from the provision a prohibition of assistance, it would still be the case that when choosing between the loss of currency stability and giving assistance, in the last resort European Union law could not stand in the way of giving assistance. On the contrary, it would have to be objectively interpreted following the purposive approach. In the political process, reference has repeatedly been made to the last-resort nature of the present measure. It appears absurd to hold fast to a narrowly interpreted bailout clause if assistance is the last means to preserve the stability of the currency, which is precisely what a narrowly interpreted bailout clause is intended to achieve.

bb) Finally, in all considerations of lawfulness it must be taken into account that this is an area in which considerable latitude must be given to economic and political assessment and prognosis. The *Bundestag* and the Federal Government are responsible for the stability of the currency. The Federal Constitutional Court cannot release the politically responsible actors of this responsibility by interpretation of constitutional law. If parts of the euro rescue package were invalidated, this would lead to considerable uncertainty on the financial markets and might completely call into question the stabilisation of the financial markets now achieved. Doubt could be cast on Germany's willingness and ability to defend the European integration achieved and the joint currency. Trade-offs on the stabilisation package would directly entail substantial risks to the functioning of the financial system in the euro area. As a consequence, a substantial devaluation of the euro could be expected. The probable effects would be a new acute financial and economic crisis in the euro area and beyond it, high welfare loss in Germany and Europe and further political dangers and distortions, which would extend far beyond the economic area.

2. The Federal Government also regards the constitutional complaints as inadmissible (a), but at all events as unfounded (b). It submitted as follows:

a) With regard to the secondary-law measures and other practices to be regarded as equivalent to these of the bodies of the European Union, the constitutional complaints are at minimum inadmissible because the conditions under which such acts may be the subject of a constitutional complaint are not satisfied. Nor is it sufficiently shown that the protection of fundamental rights regarded as essential in each case is not generally guaranteed on the European Union level. In addition, the complainants are not affected by the challenged measures in an individual manner. The constitutional complaint proceedings give them no right to challenge provisions which could have only indirect effects on them as part of the general public. In other respects too, there is no possibility that a fundamental right or a right equivalent to a fundamental right has been violated.

aa) Article 38.1 of the Basic Law only protects against an erosion of the *Bundestag*'s competences by the transfer of sovereign powers or by *ultra vires* acts of the European Union. On the basis of Article 38.1 of the Basic Law, losses of substance of democratic freedom of action may be challenged; this also includes encroachments upon the principles laid down in Article 79.3 of the Basic Law as the identity of the constitution. But such a case is not applicable in the present matter. Nor can the alleged violations of Articles 123 and 125 TFEU be seen as *ultra vires* acts in the sense of manifestly wrongful recourse to competences not transferred and therefore reserved to the Member States. Consequently, the challenged European Union measures are also incapable of being violations of Article 38.1 of the Basic Law. Insofar as the second complainant asserts that there has been a violation of Article 38.1 of the Basic Law because there is no statute under Article 59.2 of the Basic Law, it is plain that no violation of this right equivalent to a fundamental right is possible. This follows from the mere fact that an alleged violation of Article 59.2 of the Basic Law cannot be challenged by way of a constitutional complaint.

bb) Nor is there a violation of the fundamental right to property under Article 14.1 of the Basic Law. The "civil right to price stability" alleged by the first complainants does not exist. Even if a state duty under objective law to protect monetary value resulted from the principle of the social welfare state or other provisions of the Basic Law, this does not entail a fundamental right of the individual. The second complainant may not rely on the argument that violations of strict legal commitments in shaping economic framework conditions for the development of monetary value could be challenged by constitutional complaint with reference to Article 14.1 of the Basic Law. It is true that the fundamental right to property protects concrete legal interests with the value of assets and thus also property in the form of money, but it does not protect monetary value. The area of protection of Article 14.1 of the Basic Law does not include the purchasing power of money. The subject of protection of the fundamental right is essentially only the substance of specific legal positions which have the value of assets and their use. With regard to money too, only its existence and the possibility of using it as a means of payment are guaranteed, but not its exchange value. In addition, the challenged measures – even if a fundamental right to monetary stability existed – could not violate such a fundamental right, because they would serve to guarantee the euro as currency and thus also the monetary stability of the euro.

b) At all events, the constitutional complaints are unfounded. The practices of German constitutional bodies and bodies of the European Union that are challenged do not adversely affect the fundamental rights or rights equivalent to fundamental rights of the complainants (aa). Even if other German constitutional law (bb) and the law of the European Union (cc) could be matters open to review by a constitutional complaint, there would be no violation of prior-ranking law.

aa) (1) Article 38.1 of the Basic Law has not been violated, for there has been no transfer of sovereign powers on the basis of Article 23.1 of the Basic Law which could have resulted in an erosion of the *Bundestag*'s competences. The German *Bundestag*'s scope of action has in no way been restricted by law. In the Act on Financial Stability within the Monetary Union and the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism, the *Bundestag* exercised its competences. The challenged acts of cooperation of the Federal Government in the circle of the representatives of the governments of the Member States meeting within the Council of the European Union and in the passing of decisions in the Council and these decisions themselves also do not violate the right equivalent to a fundamental right under Article 38 of the Basic Law. Political agreement on bilateral measures was made expressly subject to the states' domestic constitutional provisions. The same applies to the decision of the Council of the European Union (Economic and Financial Affairs) of 9 May 2010. The decision of the Council to introduce a European financial stabilisation mechanism, by which it passed Regulation (EU) no. 407/2010, was made on the basis of Article 122.2 TFEU and is not a measure extending competence which could erode the rights of the *Bundestag*. The acts of cooperation of the current German representative from time to time therefore cannot have been violations of Article 38 of the Basic Law.

(2) Article 14.1 of the Basic Law has also not been violated; its area of protection has not even been touched on. The measures decided on serve to protect financial stability in the euro area, the euro currency as such and thus also monetary stability. For this reason they cannot violate the fundamental right to property. Even if one presumes that the challenged measures carry dangers for the stability of the euro, consideration should be given to the legislature's economic and political latitude for assessment and prognosis, which should at all events be recognised.

bb) (1) The measures of assistance in the form of loan guarantees to threatened Member States do not violate Article 115 of the Basic Law, nor do they contravene other constitutional law relating to the budget. The principle of budgetary equilibrium (Article 110.1 sentence 2 of the Basic Law) requires only a formal balancing of revenue and expenditure, but it forbids neither guarantees nor borrowing. Under Article 115.1 sentence 1 of the Basic Law, guarantees, like borrowing, require authorisation by federal statute in an amount which is either determined or determinable. The legislature exercised the responsibility to safeguard Parliament's right to decide on the budget which was assigned it by the Basic Law. In addition, the budget committee was given extensive rights of participation and monitoring under § 1.4 and § 1.5 of the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism which exceeded the mere right of information which is otherwise customary when guarantees are given (see § 3.8 and § 3.9 of the Budget Act 2010).

Article 115 of the Basic Law provides for no upper limit in figures for guarantees. There is no basis in the Basic Law for limiting the amount of a guarantee to the magnitude of "customary" individual budget items.

(2) Nor do the measures disregard the core of constitutional identity in the form of the principle of the social welfare state. It is true that constitutional identity, which is laid down in Article 79.3 of the Basic Law, includes the core of the principle of the social welfare state. However, monetary stability is not one of the elements which constitute this core based on the concept of the social welfare state.

(3) There is no violation of Article 59.2 of the Basic Law. Even violations of Article 59.2 of the Basic Law are not permitted to be challenged by a constitutional complaint, and there is no violation either with regard to the matters agreed by the government representatives meeting within the Council or with regard to the EFSF Framework Agreement. This follows firstly from the mere fact that these are not agreements under international law. Secondly, even if one were to assume that they were agreements under international law, the requirements in Article 59.2 of the Basic Law which make a Consent Act necessary would not be satisfied.

cc) Nor can Article 38. 1 of the Basic Law have been violated under the aspect that the challenged measures contravene European Union law or lead to an alteration or even destruction of the concept of the monetary union as a stability community. On the contrary, it is precisely their objective to preserve the monetary union as a stability community.

(1) Regulation (EU) No 407/2010 is permissibly based on Article 122.2 TFEU. Under this provision, the Council may under certain conditions grant a Member State financial assistance from the European Union if this Member State, by reason of natural disasters or exceptional occurrences beyond its control, is in difficulties or is seriously threatened with severe difficulties. The global financial crisis and the negative developments on the financial markets, which cannot be explained solely by the basic economic data, constitute such exceptional occurrences. Article122.2 TFEU authorises only emergency measures. This proves that the Financial Stabilisation

Mechanism is only an emergency measure, not a permanent institution which could result in the "liability and transfer community" feared by the complainants. An argument against assuming a permanent institution is the general restriction to measures subject to a time-limit and the obligation of review, which is intended to ensure that the Regulation applies only as long as the exceptional occurrences which threaten the financial stability of the European Union as a whole continue to exist (Article 9 of Regulation <EU> no. 407/2010).

(2) Article 125 TFEU does not conflict with the grant of aid through the Financial Stabilisation Mechanism, for Article 122.2 and Article 125 TFEU are part of a uniform system of provisions introduced at the same time. It is true that Article 125 TFEU is intended to preserve the budgetary discipline of the Member States by obliging them to take out loans on market conditions. For this reason, a narrow interpretation of Article 125 TFEU may suggest forgoing measures of assistance even where there are imminent dangers to financial stability. However, if the Member States had forgone the measures challenged by the constitutional complaint, serious consequences would have had to be feared, not only for the euro area. Every mechanical application of Article 125 TFEU would have considerably endangered the economy and also the currency in the euro area and beyond. The provision is not tailored to the case of an already existing acute danger to the financial stability of the euro system. The Member States were permitted to act to avert this danger because in Article 125 TFEU there is a gap relating to the case of burdens on Member States in the euro area resulting from a financial crisis, at all events insofar as there is an imminent danger to the whole economic and monetary union. This gap, in the sense of the lack of a necessary restriction, can be closed if it is interpreted purposively with the result that Article 125 TFEU does not apply if the monetary union would otherwise be endangered. In the decision on the emergency measures, in the opinion of the Federal Government the federal legislature has latitude of decision and judgment. At all events, the fact that the legislature, on the basis of consultations in the circle of the finance ministers and of opinions of the European Central Bank, decided in favour of this protective mechanism in order to prevent the feared far-reaching market reactions does not overstep the latitude for judgment to which it is entitled. In this connection it is

essential that the measures are merely situation-related emergency reactions, which are therefore subject to a time-limit.

(3) In other respects too, the Federal Government did not cooperate in an extra-treaty supplementation of the concept, laid down in the Treaty on the Functioning of the European Union, to ensure the price stability of the euro. The challenged measures were not a de facto amendment of the European Union treaties. The European Union does not arrogate to itself any sovereign powers not yet transferred to it which erode the competences of the German *Bundestag* and thus may violate Article 38 of the Basic Law.

The bilateral aid and the German emergency measures provided by the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism are not elements of an overall strategy aimed at creating a liability and transfer community. Nor do they establish an arrangement for permanent financial compensation. The fact that these are emergency measures and not a long-term financial transfer is shown on the one hand by the strict requirements laid down in the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism, and on the other hand by the time-limit both for the Act and for the measures of the special purpose vehicle which coordinates the national aid (Article 2.5.b, Article 10, Article 11 of the EFSF Framework Agreement). If the existing extraordinary situation should take a positive course with the result that the emergency measures are no longer needed, there would be nothing to prevent them being terminated prematurely. For this very reason, Regulation (EU) No 407/2010 establishing a European financial stabilisation mechanism, which governs the European Union measures preceding the bilateral aid, includes a commitment to a half-yearly review of the need for its continuance. The Federal Government will continue its commitment to the preservation of price stability in the monetary union and also to an improvement of the associated procedures to protect the stability of the euro as a currency. In this connection, the Council, not least as the result of a German initiative, affirmed its complete determination to ensure the sustainability of public finances in all Member States and to accelerate plans for budget consolidation and structural reforms. The Council also affirmed its determination to bring forward reforms with great urgency to reinforce the monetary union framework in order to ensure the sustainability of public finances. The Federal Government supports these measures because they serve the stability of the euro. It would oppose endeavours to develop the stabilisation mechanism into a permanent institution in the form of a transfer union, which would be inconsistent with the concept of the monetary union as a stability community, and would not permit de facto amendments to the treaty.

(4) Finally, the purchase of government bonds by the ECB does not contravene European Union law, for Article 123 TFEU prohibits only the direct acquisition of debt instruments of state issuers, but not purchase on the secondary market.

IV.

As expert third parties (§ 27a of the Federal Constitutional Court Act), the German Bundesbank (1) and the European Central Bank (2) submitted opinions.

1. In the opinion of the German Bundesbank, the decisions of May 2010 are defensible, all in all, from an economic point of view (a). However, they do put quite considerable strain on the foundations of the monetary union (b). Additional reform steps are necessary to safeguard the monetary union as a stability community in future in order to be prepared for financial crises of Member States too (c). The Bundesbank submits as follows:

a) The latest developments have revealed fundamental weaknesses in the current financial policy provisions and have shown the economic consequences where competitive positions in the monetary union diverge in the long term. In view of the risks to the stability of the European monetary union, the decisions made by the European Union finance ministers in May 2010 are defensible, all in all, from an economic point of view. It is true that they do not remove the deeper causes of the intensification of the crisis, that is, the dangerous situation of state finances and the past undesirable macroeconomic developments in some states of the monetary union which entail a continuing high need for capital imports. Countering these undesirable developments calls instead for comprehensive financial and economic corrections, the implementation of which takes time and which often only reach their full effect in the medium term. But in view of the situation of the strongly networked financial sector in the euro area, which as a whole is still fragile, a correction at short notice was not possible in May 2010 without the risk of massive economic distortions throughout the euro area. In order to gain the necessary time and against the background of the dangerous situation, the creation of a possibility of support subject to strict conditions and a time-limit is a suitable means.

b) However, the decisions put quite considerable strain on the foundations of monetary union. Against the background of the gaps and weaknesses in the existing set of provisions, which became plain to see at the latest in the course of the crisis, it is now important to create a framework for the monetary union which in future will better guarantee policies encouraging stability and in particular solid public finances in the Member States. The current financial provisions of the monetary union have to date not been adequate to prevent the escalation of the situation in May 2010, and they have also been additionally weakened by the rescue measures. It is therefore now necessary to combine these rescue measures, as intended, with a toughening of the fiscal rules and an improvement of the statistical foundations. The Bundesbank has repeatedly pointed out that the criterion of indebtedness has particular importance for a stability-oriented monetary policy. It should be given more weight in future. For indebtedness levels of over 60% it should be laid down how quickly they should be reduced and what sanctions will apply if this is not achieved. The deficit criterion could be strengthened if extraordinary provisions which were relaxed in the reform of the Stability and Growth Pact were once again drafted more narrowly and above all greater pressure were created in the precautionary part of the Pact if the conditions were not complied with. Altogether, there is a need for a quicker reaction to undesirable developments and thus an acceleration of the current procedure. The central concern is to improve the inadequate implementation of the provisions. Thus the imposition of sanctions should be less subject to the political negotiation process and more strongly comply with the rules. A commitment to firmer entrenchment of the European fiscal provisions – and in particular of the medium-term budget objectives – in national budget law, as for example in the German brake on debt, would also be effective. In the case of manifest serious undesirable developments, strengthened macroeconomic monitoring on the

European level is also necessary. However, in this connection both the independence of monetary policy within the existing framework and the subsidiarity principle must also be taken into account; a basic tendency to centralisation of economic policy and to fine-tuning of the economic process does not make sense.

c) The future safeguarding of the monetary union as a stability community demands additional reform steps over and above the toughening of the existing set of provisions in order to be prepared for a financial crisis of Member States which nevertheless occurs. In this connection, a variety of instruments have been suggested for discussion. Thus, for example, the introduction of a state insolvency code has been suggested as an essential element of a reformed set of framework provisions. Especially against the background of the latest experience, such a procedure would take account of the no-bailout principle. Thus, the creditors of state debt instruments would also be called upon to solve the debt crisis. They would then have a greater incentive even in advance to demand interest rates appropriate to the risk, and they would have a tendency also to allow for undesirable developments which had not yet become directly observable in fiscal policy figures, for example non-sustainable economic structures or future burdens on government budgets. Using the disciplining function of the financial markets in this way would have the advantage that interest in sound public finances in individual Member States would at least not solely depend on the political decision process on the European level, which in the past has often been shown to be insufficient. Such proposals or further-reaching proposals to supplement the existing framework must be examined if the existing sanction mechanism proves to be inadequate. A critical view must be taken if the present European Financial Stability Facility, which is subject to a time-limit, were to become a long-term support facility. From the view point of the advocates of such a proposal, this would take better account of the fact that the interconnection of the capital markets has greatly increased since the Maastricht Treaty was passed and thus the effects of economic contagion which the payment default of one state in the monetary union has on the other Member States have increased. But at the same time such a course of action would additionally weaken the personal responsibility of the national financial policies, and it would be a further step in the direction of a liability and transfer community. The risk of default on government bonds of individual Member States would be distributed among all states in the monetary union and thus the disciplining effect of the financial markets would be largely removed. The probability that with such an unsound financial policy the creditors of the state in question would call for adequate risk premiums would be reduced and thus the incentive for a cautious budgetary policy would be weakened. In addition, the intended participation of the International Monetary Fund in the present financing facility, which is subject to a time-limit, plays an important role in the credibility of the consolidation packages from the point of view of the markets, and if there were a long-term European stabilisation facility this participation would probably be extremely difficult to ensure. As part of the collective monetary policy, the euro system is committed to the objective of guaranteeing stable prices in the monetary union. In a monetary union based on stability, however, it is a central duty of financial policy to ensure that sound state finances and a suitable institutional framework appropriately support monetary policy. For the long-term stability of the monetary union, the crucial factor will be not allowing the window of opportunity for reforms to strengthen the financial framework and the capacity for growth in the Member States to pass unused.

2. The European Central Bank points out that the current financial situation and the economic and currency decisions based on it are linked to the global economic and financial crisis. It submits as follows: The crisis began with turbulences on the financial markets in August 2007 and drastically intensified in September 2008 when the collapse of Lehman Brothers led to the financial markets virtually drying up in the industrial countries; this had considerable effects on the real economy in the countries affected. The turbulences on the financial markets and the intensification of the crisis required decisive and energetic measures by the political decision-makers, including the ECB, at that time, in order to guarantee price stability in the euro area. In the weeks and months following this, there was again a drastic and abrupt aggravation of the situation on the financial markets. The epicentre of the tensions was in the European bond markets, in particular in the government bonds markets. These extremely serious tensions on the financial markets affected the whole euro area including the interbank market, the stock market and the foreign exchange market, and it threatened to spread to the

global financial markets. The development on the government bonds markets quickly affected the money markets and resulted in a marked increase of uncertainty in connection with the risk of counter-party default. Quotations which reflect this risk of default rose to twelve-month maximums. There was also a liquidity squeeze on the interbank markets. The liquidity position in the area of unsecured loans deteriorated, not only for term money, but also for overnight money. On the European overnight money market, liquidity fell to the lowest level since the beginning of the economic and monetary union in January 1999. The global economic and financial crisis led to unprecedented challenges for political decision-makers, in particular in the industrial countries, which were most severely affected. The latest developments with regard to the increasingly more difficult situation on the government bond markets had the potential to considerably increase the total risk to the financial stability of the euro area, and it should be noted that financial stability is a basic condition of the guarantee of price stability.

V.

Applications by the complainants for the issue of temporary injunctions were rejected by the Federal Constitutional Court in orders of 7 May and 9 June 2010 (BVerfGE 125, 385; 126, 158).

VI.

On 5 July 2011, the Federal Constitutional Court held an oral hearing in which the parties explained and expanded upon their legal viewpoints.

B.

The constitutional complaints against the Act on Financial Stability within the Monetary Union and against the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism are admissible insofar as they challenge an injury to the permanent budgetary autonomy of the German *Bundestag* on the basis of Article 38.1 sentence 1, Article 20.1 and 20.2 in conjunction with Article 79.3 of the Basic Law (I). Apart from this, the constitutional complaints are inadmissible (II).

I.

1. The Act on Financial Stability within the Monetary Union and the Act on the Assumption of Guarantees in Connection with a European

Stabilisation Mechanism may be the subject matter of a constitutional complaint in constitutional complaint proceedings as measures by German state authority.

2. The complainants submit with sufficient substantiation that they themselves may be presently and directly affected by violation of a fundamental right or right equivalent to a fundamental right which is challengeable under Article 93.1 no. 4a of the Basic Law and § 90.1 of the Federal Constitutional Court Act (§ 23.1 sentence 2, § 92 of the Federal Constitutional Court Act).

a) Insofar as the complainants assert a violation of their right equivalent to a fundamental right under Article 38.1 sentence 1 of the Basic Law by the Act on Financial Stability within the Monetary Union and the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism, the entitlement to file a constitutional complaint depends on the contents of the individual challenges (see BVerfGE 123, 267 <329>). The constitutional complaints are admissible with regard to the alleged erosion of the budgetary autonomy of the German *Bundestag*.

aa) In their submission that the sustained (long-term) budgetary autonomy of the German *Bundestag* is violated in the sense of the erosion of its competences, the complainants set out with sufficient substantiation the possibility of a violation of their right equivalent to a fundamental right under Article 38.1 sentence 1, Article 20.1 and 20.2 in conjunction with Article 79.3 of the Basic Law.

(1) Article 38.1 and 38.2 of the Basic Law guarantees the individual right to take part, in compliance with the constitutional election principles, in the election of the Members of the German *Bundestag* (see BVerfGE 47, 253 <269>; 89, 155 <171>; 123, 267 <330>). Here, the act of election does not consist solely in a formal legitimation of state power on the federal level under Article 20.1 and 20.2 of the Basic Law. The right to vote also comprises the fundamental democratic content of the right to vote, that is, the guarantee of effective popular government. Article 38 of the Basic Law protects the citizens with a right to elect the *Bundestag* from a loss of substance of their power to rule, which is fundamental to the structure of a constitutional state, by far-reaching or even comprehensive transfers of duties and

powers of the *Bundestag*, above all to supranational institutions (BVerfGE 89, 155 <172>; 123, 267 <330>). The same applies, at all events, to comparable commitments entered into by treaty, which are connected institutionally to the supranational European Union, if the result of this is that the people's democratic self-government is permanently restricted in such a way that central political decisions can no longer be made independently.

(2) This substantive extent of protection of Article 38 of the Basic Law does not in general give rise to any right of the citizens to have the lawfulness of democratic majority decisions reviewed by the Federal Constitutional Court. The right to vote does not serve to monitor the content of democratic processes, but is intended to facilitate them. Article 38.1 of the Basic Law, as the fundamental right to participate in the democratic self-government of the people, therefore in principle grants no entitlement to file a specific constitutional complaint against decisions of Parliament, in particular enactments.

(a) Since the judgment on the Maastricht Treaty on European Union, the Federal Constitutional Court has recognised an exception to this principle if, by reason of relocations of duties and powers of the *Bundestag* under international agreements, an erosion of Parliament's political legislative possibilities guaranteed by the constitutional system of competences is to be feared (see BVerfGE 89, 155 <172>). This view holds that the principle of representative rule of the people protected by the right to vote may be violated if the *Bundestag*'s rights are substantially curtailed and thus a loss of substance occurs of the democratic freedom of action for the constitutional body which has directly come into being according to the principles of free and equal election (see BVerfGE 123, 267 <341>). Such a possibility of challenge is restricted to structural changes in the organisation of government such as may occur when sovereign powers are transferred to the European Union.

This review of state power accessed by every citizen's constitutional complaint was already criticised in connection with the Maastricht judgment (Tomuschat, *Europäische Grundrechte-Zeitschrift* – EuGRZ 1993, p. 489 <491>; Bryde, *Das Maastricht-Urteil des Bundesverfassungsgerichts – Konsequenzen die weitere Entwicklung der europäischen Integration*, 1993, p. 4; König, *Zeitschrift für ausländisches* *öffentliches Recht und Völkerrecht* – ZaöRV 54 <1994>, p. 17 <27-28>; Bieber, *Neue Justiz* – NJ 47 <1993>, p. 241 <242>; Gassner, *Der Staat* 34 <1995>, p. 429 <439-440>; Cremer, NJ 49 1 <1995>, pp. 5 ff.). Similar opinions were also expressed following the Lisbon judgment (Schönberger, *Der Staat* 48 <2009>, pp. 535 <539 ff.>; Nettesheim, *Neue Juristische Wochenschrift* – NJW 2009, p. 2867 <2869>; Pache, EuGRZ 2009, p. 285 <287-288>; Terhechte, *Europäische Zeitschrift für Wirtschaftsrecht* – EuZW 2009, p. 724 <725-726>). However, the Senate adheres to its opinion. The citizen's claim to democracy, ultimately rooted in human dignity (see BVerfGE 123, 267 <341>) would lapse if Parliament abandoned core elements of political self-determination and thus permanently deprived citizens of their democratic possibilities of influence. The Basic Law has provided, in Article 79.3 and Article 20.1 and 20.2 of the Basic Law, that the connection between the right to vote and state power is inviolable (see BVerfGE 89, 155 <182>; 123, 267 <330>). In the revised version of Article 23 of the Basic Law, the constitution-amending legislature made it clear that the mandate to develop the European Union is subject to permanent compliance with particular constitutional structural requirements (Article 23.1 sentence 1 of the Basic Law) and that in this connection an absolute limit is created by Article 79.3 of the Basic Law to protect the identity of the constitution (Article 23.1 sentence 3 of the Basic Law), which at all events in this context requires less than cases of imminent totalitarian seizure of power for it to be exceeded. Citizens must be able to defend themselves in a constitutional court against a relinquishment of competences which is incompatible with Article 79.3 of the Basic Law. The Basic Law provides for no more extensive right of challenge.

The defensive dimension of Article 38.1 of the Basic Law therefore takes effect in configurations in which the danger clearly exists that the competences of the present or future *Bundestag* will be eroded in a manner that legally or de facto makes parliamentary representation of the popular will, directed to the realisation of the political will of the citizens, impossible. The entitlement to make an application is therefore only granted if there is a substantiated submission that the right to vote may be eroded.

(b) The entitlement to file a specific constitutional complaint under Article 38.1 of the Basic Law may also exist if, and this is the only matter at issue in this case, guarantee authorisations under Article 115.1 of the Basic Law which implement matters decided in international agreements may by their nature and extent result in massive adverse effects on budgetary autonomy.

The fundamental decisions on public revenue and public expenditure are part of the core of parliamentary rights in democracy. Article 38.1 sentence 1 of the Basic Law excludes the possibility of depleting the legitimation of state authority and the influence on the exercise of that authority provided by the election by fettering the budget legislature to such an extent that the principle of democracy is violated (see BVerfGE 89, 155 <172>; 123, 267 <330> in each case on the relocation of duties and powers of the *Bundestag* to the European level). By putting the elements into specific terms and objectively tightening the rules for borrowing by Federal and *Länder* governments (in particular Article 109.3 and 109.5, Article 109a, Article 115 of the Basic Law new, Article 143d.1 of the Basic Law, Federal Law Gazette I 2009 p. 2248), the constitution-amending legislature made it clear that a constitutional commitment of the parliaments and thus a palpable restriction of their power to act is necessary in order to preserve the democratic freedom of action for the body politic in the long term. The act of voting would be devalued if the German *Bundestag* no longer disposed of these means of organisation to fulfil state functions resulting in expenditure and to exercise its powers, when its power to act is legitimised by the voters to use these very means of organisation.

Whereas conventional guarantee authorisations within the meaning of Article 115.1 of the Basic Law, as the discussion in the oral hearing showed, entail no extraordinary risks to budgetary autonomy and therefore the Basic Law contains no restrictions in this connection, guarantee authorisations to implement obligations which the Federal Republic of Germany undertakes as part of international agreements to preserve the liquidity of states in the monetary union certainly have the potential to restrict the *Bundestag*'s possibilities of political organisation to a constitutionally impermissible extent. Such a case would have to be feared, for example, if the Federal Government, without the requirement of the *Bundestag*'s consent, were permitted to give guarantees to a substantial extent which contribute to the direct or indirect communitarisation of state debts, that is, guarantees where only the conduct of other states decided when the guarantee would be called upon.

(3) In the circumstances of the present case, the complainants' submissions satisfy the strict requirements for showing the violation of a fundamental right.

The present case concerns statutory authorisations for the giving of a guarantee with effect outside the state and the creation of an international mechanism intended to be temporary to preserve the liquidity of states in the monetary union. With regard to the German *Bundestag*'s right to decide on the budget affected by this, this is a case of the creation of obligations whose effects may be equivalent to a transfer of sovereign powers if the *Bundestag* is no longer able to dispose of its budget on its own responsibility. Since it has not yet been clarified in the case-law of the Federal Constitutional Court subject to what requirements in such a combination of circumstances the right under Article 38.1, Article 20.1 and 20.2, and Article 79.3 of the Basic Law may be violated, in this respect it is sufficient to submit that the challenged statutes are merely first steps towards a historically unprecedented automatic liability which is becoming established and altogether is constantly increasing and which does indeed correspond to the shaping or transformation of transferred sovereign powers within the meaning of Article 23.1 of the Basic Law and at all events is designed to be such a shaping or transformation.

bb) Insofar as the second complainant submits on the basis of Article 38.1 sentence 1 of the Basic Law that there is also an extra-treaty supplementation of the concept provided in the Treaty on the Functioning of the European Union to ensure the price stability of the euro, his constitutional complaint is inadmissible.

It is true that the principle of the Basic Law's openness towards European law (see BVerfGE 123, 267 <354>; 126, 286 <303>) and the constitutionally protected viability of the European Union's legal order (see BVerfGE 37, 271 <284>; 73, 339 <387>; 102, 147 <162 ff.>; 123, 267 <399>) subject German agencies to an obligation when they act functionally for the European Union within its institutional organisation, and at the same time constitutionally bind them to observe European Union law. But this is not relevant in the present case. The second complainant has not submitted with sufficient substantiation to what extent domestic requirements of the particular responsibility of German legislative bodies in the European integration process (responsibility for integration) might not be complied with. It may therefore remain undecided subject to what requirements constitutional complaints against extra-treaty supplementation of primary European Union law may be based on Article 38.1 sentence 1 of the Basic Law (see BVerfGE 123, 267 <351>; with reference to the amendment of treaty law by European Union bodies without ratification procedures). In particular, no decision is necessary as to when measures of German state power which have an extra-treaty effect on primary European Union law or which substantively or institutionally supplement it may be challenged in constitutional complaint proceedings in the same way as a Consent Act to agreements under international law. It may also remain undecided whether contraventions of the principle of democracy – at all events in conjunction with the principle of the rule of law – are in principle also challengeable in this way. For the second complainant has at all events not shown a specific context which suggests an extra-treaty supplementation of primary European Union law in such a way that a violation of the right to vote seems possible. In particular, he has not submitted with sufficient substantiation that an extra-treaty supplementation of primary European Union law might be connected to the Act on Financial Stability within the Monetary Union or the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism.

b) The constitutional complaints against the Act on Financial Stability within the Monetary Union and against the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism are also inadmissible insofar as the complainants submit that there is a violation of their fundamental right under Article 14.1 of the Basic Law.

aa) Whether, and if so in what more detailed circumstances, the purchasing power of money is included in the area of protection of the fundamental right to property of Article 14.1 of the Basic Law (see BVerfGE 97, 350 <370-371>) need not be decided here. The same applies with regard to the constitutional protection against inflationary effects which are clearly induced by the state and which may possibly be desired in economic policy (see Herrmann, *Währungshoheit, Währungsverfassung und subjektive Rechte*, 2010, p. 338 ff.). In particular, it is not necessary to answer the question as to how far the provision on the organisation of government of Article 88 sentence 2 of the Basic Law, as a result of the statutory requirement of independence and as a result of the commitment to price stability, also serves the goal of the individual protection of property (see BVerfGE 89, 155 <174>; 97, 350 <376>).

bb) At all events, the complainants neither show in a substantiated manner an inflationary effect in the sense of such an intentional state economic policy, nor do they submit sufficient facts to show that the purchasing power of the euro is substantially objectively impaired by the challenged measures. The fact that the challenged authorisations to give guarantees – with regard to their volume – entail considerable challenges for the budgetary policy of the Federal Republic of Germany does not alter the fact that the sums which have been involved to date do not as yet display such massive effects on monetary stability that a justiciable violation of the guarantee of property is possible, and in particular the submissions of the complainants do not support this. It is not in general the task of the Federal Constitutional Court in the course of constitutional complaint proceedings to review economic and financial policy measures to identify negative effects on monetary stability. Such a form of review only comes into consideration in marginal cases – which have not sufficiently been shown in the present case – where there is a manifest decrease of monetary value as a result of state measures. With regard to the support measures challenged in the present case too, the result is the general conclusion that monetary value is in a particular way related to and dependent on the Community (see BVerfGE 97, 350 <371>).

II.

With regard to the other subject matters of the constitutional complaints, the constitutional complaints are inadmissible in their entirety.

1. Insofar as the constitutional complaints are directed against the Federal Government's cooperation in the intergovernmental Decisions of the Representatives of the Governments of the Euro Area

Member States Meeting within the Council of the European Union and of the Representatives of the Governments of the 27 EU Member States of 10 May 2010 (Council Document 9614/10) and against the cooperation of the Federal Government in the decision of the Council of the European Union of 9 May 2010 to create a European stabilisation mechanism (Conclusions of the Council [Economic and Financial Affairs] of 9 May 2010, Rat-Dok. SN 2564/1/10 REV 1 of 10 May 2010, p. 3), and against the cooperation of the Federal Government in the decision of the Council on the Council Regulation establishing a European financial stabilisation mechanism of 10 May 2010 (Council Document 9606/10), the complainants are not directly burdened (see BVerfG, Order of the Second Chamber of the Second Senate of 12 May 1989 – 2 BvQ 3/89 –, NJW 1990, p. 974; BVerfG, Order of the Third Chamber of the Second Senate of 9 July 1992 – 2 BvR 1096/92, *Neue Zeitschrift für Verwaltungsrecht* – NVwZ 1993, p. 883; Chamber Decisions of the Federal Constitutional Court (*Kammerentscheidungen des Bundesverfassungsgerichts* – BVerfGK) 2, 75 <76>).

The various acts of cooperation of the Federal Government are not acts of sovereign power against the complainants which are challengeable by constitutional complaint. In this respect, despite the differences between the law of international agreements and supranational law, the same applies as to acts of cooperation of German bodies in agreements under international law (see BVerfGE 77, 170 <209-210>; BVerfG, Order of the Second Chamber of the Second Senate of 12 May 1989 – 2 BvQ 3/89 –, ibid.).

2. The submissions of the complainants that their fundamental rights are directly violated by the intergovernmental decisions of the representatives of the governments of the euro area Member States meeting within the Council of the European Union and of the representatives of the governments of the 27 EU Member States of 10 May 2010 (Council Document 9614/10), the decision of the Council of the European Union of 9 May 2010 to create a European stabilisation mechanism (Conclusions of the Council [Economic and Financial Affairs] of 9 May 2010, Rat-Dok. SN 2564/1/10 REV 1 of 10 May 2010, p. 3), the decision of the Council on the Council Regulation establishing a European Financial Stabilisation Mechanism of 10 May 2010 (Council Document 9606/10) and the purchase of government bonds of Greece and other euro area Member States by the European

Central Bank are inadmissible because they are not based on qualified subject matters of constitutional complaints. The challenged acts – notwithstanding other possibilities of review with regard to the right to apply them in Germany (see BVerfGE 89, 155 <175>; 126, 286 <302 ff.>) – are not sovereign acts of German state authority within the meaning of Article 93.1 no. 4a of the Basic Law and § 90.1 of the Federal Constitutional Court Act which may be challenged by the complainants.

3. Insofar as the second complainant's constitutional complaint challenges an alleged omission of the EU Commission to use the measures against the indebtedness of euro area Member States provided in the Treaty on the Functioning of the European Union and to counteract their disregard of the budgetary discipline laid down in the Treaty and to prevent in this way a state of emergency coming into existence which is now used as the justification of the rescue packages (Greek rescue package and European stabilisation mechanism) which are incompatible with the Treaty, the constitutional complaint is also inadmissible. The same applies insofar as the second complainant submits that the Federal Government omitted to take measures against the speculators who, by the account of the Federal Government, speculate against the euro or against particular euro area Member States so aggressively that the rescue packages are needed to save the stability of the currency.

An omission on the part of the legislature may be the subject of a constitutional complaint if the complainant can rely on an express mandate of the Basic Law which essentially defines the content and scope of the duty to legislate (see BVerfGE 6, 257 <264>; 23, 242 <259>; 56, 54 <70-71>). Fundamental principles which could justify the assumption of such a duty to act on the part of the Federal Government of the EU Commission have neither been submitted with substantiation by the second complainant, nor are they otherwise apparent.

C.

The constitutional complaints are unfounded insofar as they are admissible. There are no well-founded constitutional objections to the Act on Financial Stability within the Monetary Union and the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism.

I.

Article 38.1 sentence 1, Article 20.1 and 20.2 in conjunction with Article 79.3 of the Basic Law determine the basis for judicial review. The right to vote, as a right equivalent to a fundamental right, guarantees the citizens' self-determination and guarantees free and equal participation in the state authority exercised in Germany (see BVerfGE 37, 271 <279>; 73, 339 <375>; 123, 267 <340>, with reference to the respect for the constituent power of the people). The guaranteed content of the right to vote includes the principles of the requirements of democracy within the meaning of Article 20.1 and 20.2 of the Basic Law, which Article 79.3 of the Basic Law guarantees as the identity of the constitution (see BVerfGE 123, 267 <340>).

1. There is a violation of the right to vote if the German *Bundestag* relinquishes its parliamentary budget responsibility with the effect that it or a future *Bundestag* can no longer exercise the right to decide on the budget on its own responsibility.

a) The decision on public revenue and public expenditure is a fundamental part of the ability of a constitutional state to democratically shape itself (see BVerfGE 123, 267 <359>). The German *Bundestag* must make decisions on revenue and expenditure with responsibility to the people. In this connection, the right to decide on the budget is a central element of the democratic development of informed opinion (see BVerfGE 70, 324 <355-356>; 79, 311 <329>). On the one hand, the right to decide on the budget serves as an instrument of comprehensive parliamentary monitoring of the government. On the other hand, the budget brings the fundamental principle of equality of the citizens up to date in the imposition of public charges as an essential manifestation of constitutional democracy (BVerfGE 55, 274 <302-303>). In relation to the other constitutional bodies involved in establishing the budget, the elected parliament has a paramount constitutional position. Article 110.2 of the Basic Law provides that the competence to prepare the budget lies solely with the legislature. This particular position is also expressed by the fact that the *Bundestag* and *Bundesrat* are entitled and obliged under Article 114 of the Basic Law to monitor the Federal Government's execution of the budget (see BVerfGE 45, 1 <32>; 92, 130 <137>).

The budget, which under Article 110.2 sentence 1 of the Basic Law is declared by the Budget Act, is not merely an economic plan, but at the same time a sovereign act of government in the form of a statute (see BVerfGE 45, 1 <32>; 70, 324 <355>; 79, 311 <328>). It is subject to a time-limit and task-related. The state functions are presented in the budget as expenses which must be covered by revenue under the principle of compensation (see BVerfGE 79, 311 <329>; 119, 96 <119>). The extent and structure of the budget thus reflect overall government policy. At the same time, the revenue achievable restricts the latitude to exercise state functions resulting in expenditure (see Article 110.1 sentence 2 of the Basic Law). Budget sovereignty is the place of conceptual political decisions on the correlation of economic burdens and privileges granted by the state. Therefore the parliamentary debate on the budget, including the extent of public debt, is regarded as a general debate on policy (BVerfGE 123, 267 <361>).

b) As representatives of the people, the elected Members of the German *Bundestag* must retain control of fundamental budgetary decisions even in a system of intergovernmental administration. In its openness to international cooperation, systems of collective security and European integration, the Federal Republic of Germany commits itself not only in legally, but also in fiscal policy. Even if such commitments assume a substantial size, parliament's right to decide on the budget has not been infringed in a way that could be challenged with reference to the right to vote. The relevant factor for adherence to the principles of democracy is whether the German *Bundestag* remains the place in which autonomous decisions on revenue and expenditure are made, even with regard to international and European commitments. If decisions were made on essential budgetary questions of revenue and expenditure without the requirement of the *Bundestag*'s consent, or if supranational legal obligations were created without a corresponding decision by free will of the *Bundestag*, Parliament would find itself in the role of merely re-enacting and could no longer exercise overall budgetary responsibility as part of its right to decide on the budget.

2. Against this background, the German *Bundestag* may not transfer its budgetary responsibility to other actors by means of imprecise budgetary authorisations. In particular it may not, even by statute, deliver itself up to any mechanisms with financial effect which – whether by reason of their overall conception or by reason of an overall evaluation of the individual measures – may result in incalculable burdens with budget relevance without prior mandatory consent, whether these are expenses or losses of revenue. This prohibition of the relinquishment of budgetary responsibility does certainly not impermissibly restrict the budgetary competence of the legislature, but is specifically aimed at preserving it.

a) Accordingly, the Federal Constitutional Court has already, in connection with the opening up of the state political regime to the European Union which is intended to realise a unified Europe (see Article 23 of the Basic Law), referred to constitutional limits which the Basic Law creates to prevent Parliament limiting its own right to decide on the budget (see BVerfGE 89, 155 <172>; 97, 350 <368-369>). In this view, a transfer of the right of the *Bundestag* to adopt the budget and control its implementation by the government which would violate the principle of democracy and the right to elect the German *Bundestag* in its essential content would at all events occur if the determination of the type and amount of the levies imposed on the citizen were supranationalised to a considerable extent and thus the *Bundestag* would be deprived of its right of disposal (see BVerfGE 123, 267 <361>).

A necessary condition for the safeguarding of political latitude in the sense of the core of identity of the constitution (Article 20.1 and 20.2, Article 79.3 of the Basic Law) is that the budget legislature makes its decisions on revenue and expenditure free of other-directedness on the part of the bodies and of other Member States of the European Union and remains permanently "the master of its decisions". There is a considerably strained relationship between this principle and guarantee authorisations which are intended to ensure the solvency of other Member States. Admittedly, it is primarily the duty of the *Bundestag* itself to decide, while weighing current needs against the risks of medium- and long-term-guarantees, in what maximum amount guarantee sums are responsible (see BVerfGE 79, 311 <343>; 119, 96 <142-143>). But it follows from the democratic basis of budget autonomy that the *Bundestag* may not consent to an intergovernmentally or supranationally agreed automatic guarantee or performance which is not subject to strict requirements and whose effects are not limited, which – once it has been set in motion – is removed from the *Bundestag*'s control and influence. If the *Bundestag* were to give indiscriminate authorisation in a substantial degree to guarantees, fiscal disposals of other Member States might lead to irreversible, possible massive, restrictions on national political legislative discretions.

For this reason, no permanent mechanisms may be created under international treaties which are tantamount to accepting liability for decisions by free will of other states, above all if they entail consequences which are hard to calculate. The *Bundestag* must specifically approve every large-scale measure of aid of the Federal Government taken in a spirit of solidarity and involving public expenditure on the international or European Union level. Insofar as supranational agreements are entered into which by reason of their magnitude may be of structural significance for Parliament's right to decide on the budget, for example by giving guarantees the honouring of which may endanger budget autonomy, or by participation in equivalent financial safeguarding systems, not only every individual disposal requires the consent of the *Bundestag*; in addition it must be ensured that sufficient parliamentary influence will continue in existence on the manner in which the funds made available are dealt with. The responsibility for integration borne by the German *Bundestag* with regard to the transfer of competences to the European Union (see BVerfGE 123, 267 <356 ff.>) has its counterpart here for budget measures of equal weight.

b) The provisions of the European treaties do not conflict with the understanding of national budget autonomy as an essential competence, which cannot be relinquished, of the parliaments of the Member States which enjoy direct democratic legitimation, but instead they presuppose this. Strict compliance with them guarantees that the acts of the bodies of the European Union in and for Germany have sufficient democratic legitimation (BVerfGE 89, 155 <199 ff.>; 97, 350 <373>). The treaty conception of the monetary union as a stability community is the basis and subject of the German Consent Act (BVerfGE 89, 155 <205>). In this regard, the treaties are parallel, not only with regard to currency stability, to the requirements of Article 88 sentence 2 of the Basic Law, and if appropriate also of Article 14.1 of the Basic Law, which makes compliance with the independence of the European Central Bank and the primary objective of price stability permanent constitutional requirements of a German participation in the monetary union (see Article 127. 1, Article 130 TFEU). Further central provisions on the design of the monetary union also safeguard constitutional requirements of democracy in European Union law. In this connection, particular mention should be made of the prohibition of direct purchase of debt instruments of public institutions by the European Central Bank, the prohibition of accepting liability (bailout clause) and the stability criteria for sound budget management (Articles 123 to 126, Article 136 TFEU). Although in this connection the interpretation of these provisions in detail is not essential, it is nevertheless possible to derive from them the fact that the independence of the national budgets is constituent for the present design of the monetary union, and that the acceptance of liability for decisions of other Member States with financial effect which overstretches the bases of legitimation of the association of sovereign states (*Staatenverbund*) – by direct or indirect communitarisation of state debts – is to be avoided.

3. In establishing that there is a prohibited relinquishment of budget autonomy with regard to the extent of the guarantee given, the Federal Constitutional Court must restrict itself to manifest violations and in particular with regard to the risk of guarantees being called upon it must respect a latitude of assessment of the legislature.

a) The restriction to manifest violations applies to the question as to the maximum amount of a guarantee that can be responsibly given, with regard to the risks of its being called on and the consequences then to be expected for the budget legislature's freedom to act. Whether and how far a justiciable limit of the extent of guarantee authorisations can be derived directly from the principle of democracy is questionable. At all events, unlike in the case of borrowing, Article 115.1 of the Basic Law does not explicitly provide for such a restriction (see Kube, in: Maunz/Dürig, GG, Art. 115, marginal nos. 78, 124, 241-242; Wendt, in: von Mangoldt/Klein/Starck, GG, 6th ed. 2010, Art. 115, marginal no. 26; for a more cautious view on the old legal position, see Siekmann, in: Sachs, GG, 5th ed. 2009, Art. 115, marginal no. 21, according to whom guarantees of various types, at all events in the amount of the payment obligations which experience has shown to be realised, should be included in the figure for borrowing without restriction). How far what is known as the brake on debt, which was incorporated into the Basic Law in the year 2009 by the 57th Act Amending the Basic Law (*57. Gesetz zur Änderung des Grundgesetzes*; Article 109.3, Article 115.2 of the Basic Law), nevertheless imposes an obligation to observe upper limits need not be decided with regard to the challenged statutes. At all events, in the present connection with its general standards based on the principle of democracy, only a manifest overstepping of extreme limits is relevant.

b) With regard to the probability of having to pay out on guarantees, the legislature has a latitude of assessment, which the Federal Constitutional Court must respect. The same applies to the assessment of the future soundness of the federal budget and the economic performance capacity of the Federal Republic of Germany. In this connection, the Federal Constitutional Court may not with its own expertise usurp the decisions of the legislative body which is the institution first and foremost democratically appointed for this task.

II.

The right to elect the *Bundestag* under Article 38.1 of the Basic Law is not violated by the Act on Financial Stability within the Monetary Union and the Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism. The *Bundestag* has not eroded its right to decide on the budget in a constitutionally impermissible manner and thus disregarded the material content of the principle of democracy.

1. Insofar as it is possible to derive from the democratic principles of Article 20.1 and 20.2 of the Basic Law, which are declared unamendable by Article 79.3 of the Basic Law, a prohibition for configurations like the present one to burden present or future federal budgets with disproportionately great commitments, even if

these are only guarantees, it is at all events impossible in the present case to establish that such a limit to burdens has been overstepped.

An upper limit to the giving of guarantees following directly from the principle of democracy could only be overstepped if in the case where the guarantee is called upon the guarantees took effect in such a way that budget autonomy, at least for an appreciable period of time, was not merely restricted but effectively failed. This cannot be established in the present case. The legislature considers that the guarantee authorisation contained in § 1 of the Euro Stabilisation Mechanism Act in the amount of 147.6 billion euros (123 billion euros plus 20%) is acceptable from the point of view of the budget even in addition to the guarantee authorisation in favour of Greece contained in the Act on Financial Stability within the Monetary Union in the amount of 22.4 billion euros; this is constitutionally unobjectionable. The same applies to the expectation that even in the case that the guarantee risk were realised in full, the losses of approximately 170 billion euros could be refinanced by way of increases of revenue, reductions of expenses and long-term government bonds, albeit possibly with the loss of growth possibilities and creditworthiness with corresponding losses of income and risk premiums. In this respect, it is in particular not relevant whether the guarantee sum is potentially far greater than the largest federal budget item and substantially exceeds half of the federal budget, because this alone cannot be the yardstick of a constitutional limit of the legislature's latitude for action.

2. None of the challenged statutes creates or consolidates an automatic effect as a result of which the German *Bundestag* would relinquish its right to decide on the budget. At present there is no occasion to assume that there is an irreversible process with adverse consequences for the German *Bundestag*'s budget autonomy.

a) Even the currently applicable legal basis of the monetary union, which cannot be influenced by the two challenged statutes, does not permit an automatic effect by which the German *Bundestag* could relinquish its budget autonomy. All legal and factual effects of the two challenged statutes, in particular those of the further steps of execution contained in them, are decisively influenced by the treaty conception of the monetary union. The development of this is laid down in a foreseeable manner and subject to parliamentary accountability (see BVerfGE 89, 155 <204>; 97, 350 <372-373>; 123, 267 <356>). The German Consent Act to the Treaty of Maastricht (Federal Law Gazette II 1992 p. 1253; now as amended by the Treaty of Lisbon, Federal Law Gazette II 2008 p. 1038) continues to guarantee with sufficient constitutional detail that the Federal Republic of Germany does not submit to the automatic creation of a liability community which is complex and whose course can no longer be controlled (see BVerfGE 89, 155 <203-204>). De facto changes which might cast question on the binding character of this legal framework cannot at present be established by the Court; the same applies with regard to the current discussion on changes in the incentive system of the monetary union.

b) The challenged statutes contain no normative provisions which could – in the necessary overall consideration – undermine the principle of permanent budget autonomy.

aa) The Act on Financial Stability within the Monetary Union restricts the guarantee authorisation by amount, indicates the purpose of the guarantee, provides to a certain extent for the payment modalities and makes certain agreements with Greece the basis of the giving of guarantees. Thus the content of the guarantee authorisation is largely defined. Against this background it is acceptable that the German *Bundestag* participates in the further execution of the statutes merely in the form of giving information to the budget committee.

bb) The Euro Stabilisation Mechanism Act defines not only the purpose and the basic modalities, but also the volume of possible guarantees, which cannot be altered either by the Federal Government or by the special purpose vehicle without the consent of the *Bundestag*. The giving of guarantees is possible only during a particular period of time and it is made contingent on agreeing an economic and financial programme with the Member State affected. This programme must be consented to by the mutual agreement of the euro area Member States, which gives the Federal Government a determining influence.

However, § 1.4 of the Act merely obliges the Federal Government to endeavour, before giving guarantees, to reach agreement with the

German *Bundestag*'s budget committee, which has the right to state an opinion (sentences 1 and 2). Insofar as compelling reasons mean that a guarantee must be given before agreement is reached, the budget committee must be subsequently informed without delay; the absolute necessity of giving the guarantee before agreement is reached must be justified in detail (sentence 3). In addition, the budget committee is to be informed quarterly on the guarantees given and their correct use (sentence 4). On the basis of these provisions alone, the continuing influence of the *Bundestag* on the guarantee decisions would not be ensured by procedural precautions – over and above the general political supervision of the Federal Government. For these precautions – even together with the objective, the amount of the guarantee limits and the time-limit of the Euro Stabilisation Mechanism Act – would not prevent parliamentary budget autonomy being affected in a manner which would adversely affect the right to vote. It is therefore necessary, in order to avoid unconstitutionality, for § 1.4 sentence 1 of the Euro Stabilisation Mechanism Act to be interpreted to the effect that the Federal Government, subject to the cases named in sentence 3, is obliged to obtain the prior consent of the budget committee.

D.

This decision was passed by seven votes to one insofar as it treats the constitutional complaints as admissible.

Voßkuhle, Di Fabio, Mellinghoff, Lübbe-Wolff, Gerhardt,
Landau, Huber, Hermanns

Epilogue

What is at stake?

Alexander Somek
University of Iowa

Europe has given the world two of the most essential political ideas: the *polis*, on the one hand, and the state, on the other. Indeed, it is difficult to imagine how humans could have ever conceived of themselves as political beings had it not been for either the *polis* or the state.

Polis

For the ancients, the *polis* was the space where a distinctly human life was both possible and sustainable. According to Aristotle's famous observation, only animals or gods are capable of living outside of political space. Life that is human requires communion with others in order to realise itself.

Ideally, the *polis* is a place where those counting as fully human are both free and equal in rank. Taking turns in the governance of common affairs is right for them. Only those whom nature has destined to be slaves or to occupy more lowly stations depend on subordination. Since they are incapable of sustaining the right balance among the intelligent and more unruly parts of their soul,they are unable to conduct themselves without direction from others. But even in their case it is true that a good *polis* helps humans to attain and sustain the right composition of the various parts of their soul. Plato, who was, as is well known, not terribly convinced of the benefits of self-government, believed that the composition of the ideal city would reflect the composition of the ideal human soul. If every faculty is at its proper place and plays its proper role, the *polis* realizes justice. Everyone is doing his or her bit and contributes to a harmonious life.

At any rate, that segment of ancient political thought that had its lasting impact on Europe took it for granted that humans are fully human if they inhabit together a political space; that is, if they perceive their life as situated in a particular place of the world where they rule with, and are being ruled by, their own – and not other – people. They sustain this situated form of life by attending to public affairs. What they do and decide will likely be good if they possess 'civic virtue', that is, have cultivated attitudes that are conducive to pursuing the common weal. What matters, in a political context, are qualities such as honesty, civility, courage and a sense of justice. It is through the synthesis of such virtues that humans, *qua* political beings, possess the virtue of a citizen. Even though life is physically dependent on farming, commerce and industry, political life rises above the burdens of doing business. Commerce and industry tie people to the realm of necessity where they merely respond to needs, however manmade these may be. They also place human life in a position where it is constantly challenged with making adjustment to shifting circumstances. In this realm of experience, choice is an act of adaptation. Once life rises above it, people realize how much they can accomplish when they are acting together. Effective common action, however, presupposes a determinate zone of impact. It is by virtue of boundaries the communities are in the position to experience that whatever they are doing together does make a difference.

State

Space is the key to the other essential idea, which is the idea of the state. In a sense, being a state means to be in full control of a territory. More precisely, the state in a position to do on a territory whatever the ultimate decider sees fit. Only control of the territory guarantees sovereignty. If one merely enjoys functional authority one would have to co-ordinate, before getting what one wants, actions with others who are present at the same place. Sovereigns not have to ask. They have a jurisdiction. Sovereignty is freedom for the modern age.

More important, perhaps, is the effect that sovereignty has on the individual. Sovereignty, according to Hobbes, is not only a *de facto* condition of human existence. It is also *de jure* condition because it creates an obligation to obey. What is more, it is most profoundly reason-generating. Whatever restriction on the pursuit of the self-interest of subjects may contemplate to be plausible, as soon as it is issued by the sovereign they encounter in them also their true practical reason. People may hold various beliefs about what is morally right or wrong, but at the end of the day they are told by the state what indeed is right and what is wrong. Since sovereignty claims common authorship, it also claims to have right reason. What people cannot reach or accomplish on the basis of their subjective reason alone, the state as an institution reaches and accomplishes for them. By virtue of the state they are raised above the level of their self-interested existence. Hegel merely repeated this very basic idea when he suggested that the state overcomes the internally conflicted reciprocity of civil society in order to realize universality.

Commercial empire

The European Union is deeply at odds with both ideas. Obviously, being beyond sovereignty is part of its core ethos. But it has also in no manner wedded the idea of being a space where free and equals join in an effort to sustain a form of life. The European Union is neither a state nor a *polis*.

In its current shape, it clearly appears to be a commercial empire. Arguably, it may never have been planned to become one, but for various accidental turns in the course of its history the Union seems have taken on this form.

Since ancient times, empires have been all about protecting the peace. An empire is commercial if it either uses commerce as a means to sustain peace or sustains peace in order to promote commerce. While the British Empire was a commercial empire of the latter type, the Union started out at least with the idea of using commerce for the sake of peace. Not only the belief in the moderating influence of *doux commerce* may have inspired this conception, but perhaps also the example set by the strategy that made America successful during the second half of the twentieth century: mass-consumption. An ever growing economy with increasing opportunities for consumption instils in people the belief that they ought to feel happy and that, if they donot, it is their individual problem. As long as people have enough money to spend they are not likely to revolt. If they are unhappy, they go to church or consult a shrink.

Commercial empires are not tied to a territory in the manner in which a *polis* and a state are. The polis stands for a form of life that is maintained within a bounded community. The state, in a sense, is a territory. Commercial empires, by contrast, need space merely as a contingent condition for the realization of flows. Indeed, for modern financial markets where transactions are effected over the internet space is not even a necessary condition of their existence. Nevertheless, even within a commercial empire the use of force is indispensable, but merely for securing channels of communication. Space is neither a medium for the realization of collective freedom (sovereignty) nor a condition for locating and sustaining a form of life. Empires are not political spaces. They are spheres were administrative rationality can demonstrate its ability to engage in clever problem-solving.

The bubble has burst

The European Union was supposed to be different from a state, but also, we were told, ‘political’. How was that believed to be possible? There is neither a sovereign nor concern for a common form of life and the place of its realization. The existence of this enormous question mark has not stopped routine and devout demonstrations of exuberance about ‘a market that is a polity’, ‘a polity that disciplines nations’, ‘a polity that recognises constitutional pluralism’, a polity that is ‘meta’ in any conceivable respect, a polity that is, in any event, entirely ‘new’, an ‘innovation’. The growing bubble of idealisations became even more inflated when the constitution project was rolled out and the ‘convention method’ praised as the reinvention of the political wheel while observers tied to pinpoint the unfolding of a ‘constitutional moment’.

Then came the French and Dutch ‘no’, which were followed – not surprisingly – by business as usual. Nothing seems to have changed; the bubble had become merely slightly deflated.

Then came a loan crisis, which was followed by a bank crisis and a sovereign debt crisis.

At first glance, again, nothing appears to have altered either. The well-known international fiscal authoritarianism is implemented, this time, however, to the first world instead of the third.

But all of a sudden, business as usual appears to be different. The woes appear to be far more real, for they no longer concern the developing world.

They have hit home.

Risking the political core

If there is one thing that has been true about the Union, politically understood, then that is has embedded polities of the member states into one transnational economy. The longer the integration process continued, the more vividly states experienced that they have become drowned in a sea of markets.

Three stages can be distinguished.

Firstly, integrating states into a transnational market means that they become vulnerable to regulatory competition. Product prices or capital movement signal to states that their policies may make it harder for their businesses to succeed. For example, states may contemplate 'flexibilising' their labour markets in order to give their businesses a competitive edge.

Secondly, states can lose control over their regulations if the transnational market allows people to import relatively more business friendly regulatory backgrounds into another state in order to constitute an economic activity. When states are no longer in a position to pay the price for their regulations, individuals are empowered to pierce holes into the canvass of their authority by importing laws from other countries. In such case states no longer control their territory and cease to be states in the full sense of the term.

Thirdly, with increasing international competition, economies have to be more productive and hence more rationalised in order to be successful. But both imply that in the long term one needs to expect an ever growing number of less skilled workers who are either employed in low-paying jobs or joining the unemployment line. Assuming that they will not be sent home with the belated advice that they had better learned something before they missed all opportunities, this situation necessarily creates a permanent strain on welfare payments and services. For this reason, a highly competitive transnational economy is systematically at odds with the fiscal discipline necessary to sustain the common currency. Sustaining this discipline not only bestows on European institutions greater authority to supervise and to intervene in macroeconomic policy, the experience of the last few weeks has demonstrated that the calibration of adjustments puts financial markets and rating agencies into the role of a thermostat. Not only was every bit of news – for example, on the potential referendum in Greece or the pending resignation of Berlusconi – immediately reflected in market signals, political choices have become mediated by the concern of how one will be reflected on the credit scores of rating agencies.

Remarkably, we are talking about a necessity here. Regardless of whether one believes that the people have to have a say, *de facto* the people will have no other choice but to do the right thing, that is, to act in anticipation of the reaction by the fiscal thermostat.

Europe is about to reach the point at which the people can no longer afford to care about their form of life. This concern has yielded to pressures of adjustment. The 'political' in the ancient sense of the term is about to be wiped out. But since pleasing financial and debt markets is a matter of knowing what is best and not about deciding what one wants, the state is condemned to inaction.

In a word, Europe is about to retire its most essential political ideas and to replace them with the knowledge-based administration of transnational markets. Financial institutions are taking the seat of political choices.

The choice

What is at stake, hence, is nothing short of the political itself. The commercial empire is about to rob Europe of its political core. The end of the state is consistently followed by the end of politics. It appears as though European countries can no longer be under the control of their citizens. Paradoxically, national citizens would behave irresponsibly if they were to claim control.

This is the triumph of transnational liberalism over liberty. Europe is the first casualty. Other countries and regions will follow.

Would there be a way out? Of course. Controlling rating agencies through an international agency might be a good start. More importantly, however, Europeans need to realize that if they care about the common place they occupy in this world, they need to empower themselves collectively. This means concrete things: A government instead of governance, political controversy instead of the administration of things, responsibility instead of deference, and taxes and transfers instead of shaming and blaming.

This may be the right time to keep faith with the vision of the founders. They chose Europe as market not out of excitement for commodities but in order to overcome a political predicament. The 'finality' of Europe was for them, undoubtedly, a federal system.

The question is, however, whether it is this what the Europeans want. In order to find that out, Europeans need to realize what is stake.

If Europeans say no to the federal vision they do not see Europe as a place where they live in common. Under the supervision of Commission and international financial institution they would consequently abdicate their role as citizens of their national polity.

The only way of avoiding this consequence would be to say to hell with Europe. In order to rescue their political being they would have to sacrifice European integration.

Is that what Europeans want?

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This report analyses the many dimensions of the existential crisis of the political project of European integration unleashed by the financial crisis of 2007-2008. The contributions to this volume consider the nature of the European crisis, and in particular, its manifold character – a crisis of the economic model, of the fiscal structure, of the financial sector and finally and foremostly, a deep political crisis. The causal roles played by the twin projects of the single market and of asymmetric monetary integration leading up to the crisis, and the erosion of the tax capacities of European states at the root of the financial troubles of the *Sozial Rechtsstaat* are also dealt with. The volume moreover contains the reprint of a classical text by Lionel Robbins on the political philosophy of market integration in Europe, which reveals a rather surprising streak in the thought of the LSE professor. It also includes the English translation of the ruling of the German Constitutional Court on the Greek assistance package of September 2011.

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