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A NEW GOVERNANCE FOR THE EUROPEAN UNION AND
THE EURO: DEMOCRACY AND JUSTICE

Miguel Poiares Maduro

EUROPEAN UNIVERSITY INSTITUTE, FLORENCE
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GLOBAL GOVERNANCE PROGRAMME

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Democracy and Justice*

MIGUEL POIARES MADURO

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Abstract

The report provides a democratic explanation for the crisis and the EU's failure in successfully addressing it so far. It argues that the solution to the crisis and the future of EU governance must depart from a renewed justification of the project of European integration which must be founded on its democratic and justice enhancing potential. It criticizes two mainstream models of governance for the Euro area and explains the advantages and political viability of an alternative model based on a new EU budget, new EU policies, more EU politics and a more effective political authority. The financial solidarity necessary for any successful model of governance of the EU must be detached from transfers between states and related, instead, to the wealth generated by the process of Economic integration.

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List of Abbreviations

CAP Common Agricultural Policy

ECB European Central Bank

ESM European Stability Mechanism

EP European Parliament

GDP Gross Domestic Product

IMF International Monetary Fund

VAT Value Added Tax

A New Governance for the European Union and the Euro: Democracy and Justice

Miguel Poiares Maduro*

Executive Summary

The focus is on the democratic challenges raised by the current crisis in the Euro system and the governance proposals to address it and strengthen the EU in general. But the report goes further in the connection it establishes between the crisis and democracy: rather than simply addressing the democratic consequences of the crisis and the alternative solutions being put forward, the report places democracy at the heart of the crisis itself. My thesis is that the origins of the financial and economic crisis of the Euro system are state and market based democratic failures that the original regime of Euro governance did not adequately address. It is only by fully understanding the democratic character of the crisis that we can appropriately understand the extent of the democratic challenges faced by Europe and the role of the European Union in this context.

I argue that the future governance of the EU must depart from a revised justification of the project of European integration: a justification that focuses on the democratic and social challenges faced by the Member States and the EU value in addressing them. The EU should not be constructed as a challenge to national democracy but, instead, as offering renewed possibilities for democracy and social justice where Member States can no longer offer them. In this context, it is fundamental for democracy to be linked to a theory of justice in the EU. Citizens should be able to understand the benefits flowing from the process of European integration but also why those benefits come with certain duties towards others. Rights must be complemented by political empowerment and civic solidarity for the Union to be able to develop a genuinely legitimate form of economic and political governance.

The report starts by providing a democratic explanation for the crisis and the Union's failure in successfully addressing it so far. The origin of the crisis can be found in the democratic failures of some Member States and the externalities they imposed on others but also in the incapacity of national democracies to control excessive cross-border capital flows. The Union's failure to solve the crisis is, instead, imputable to the diffuse character of its political authority and its excessive reliance on national politics. The latter are incapable of internalizing the consequences of the interdependence generated by the Euro and integrated markets. As a consequence the Union cannot, de facto, govern and its policies are prisoner to national politics. The real EU democratic deficit is the absence of European politics.

The second part of the report discusses two models of governance for the Euro area as I review some of the proposals put forward so far. One model has at its core the Stability Compact. The other complements the discipline enshrined in the compact with instruments of financial solidarity and debt mutualisation. For example, either through the ESM or jointly issued bonds Member States insure each other's debt. For reasons detailed below I have serious reservations whether such models can work. Their dependence on a permanent negotiation with national democracies (and the multitude of actors therein) will prevent them from providing the certainty that markets require. As to democracy, they are bound to put national democracies on a collision course. Some states will perceive themselves as shouldering others (and their moral hazard) while the others will feel that they are being governed by the former. A key finding of this report is that financial solidarity in the EU must be detached from

* I would like to thank Jose Tavares for the help he has provided in testing the economic consequences and rationale of some of the proposals put forward in this report. The result is an annex as a separate document to this report but some of the findings have been included in this report. In addition I would like to thank Joao Gama, Michael Graetz and Ana Paula Dourado for useful discussions on some aspects of the proposals on own resources included in this document.

transfers between states and related, instead, to the wealth generated by the process of European economic integration.

My alternative proposal departs from the previous idea. It requires an EU budget capable of providing the Union with the necessary financial muscle to address and prevent future crises. This budget would dispense with the need for national democracies and their citizens to insure each other. Their liability would be limited to contributions to the EU budget resulting from EU own resources. These resources, in turn, are linked to EU generated wealth: economic activities that the EU enables and have mostly benefited from the internal market. The legitimacy of these resources is further enhanced by linking them to forms of revenue that have made use of increased economic mobility to lower their tax burden at national level. The proposal suggests using the enhanced EU budget for two fundamental purposes: a stability fund providing collateral to state issued debt when necessary and subject to an adjustment program; and new EU policies aimed at addressing asymmetries in the economic and monetary union. In addition, I argue that the Union needs more than simply new policies. It needs to change the nature of its policies so as to improve how they “communicate” with citizens and increase their capacity to induce real systemic reforms in Member States. These changes would also allow the Union to complement the increased discipline it can impose on Member States through positive incentives. The final pillar of the model proposed addresses political integration. Rather than on institutions, my focus is on politics. By transforming the character of politics at EU level we will be able to infuse its institutional system with real democratic potential. I try to explain how to do it.

Throughout, the report highlights elements of a possible political strategy to promote these proposals. In my view this is the right path forward and the one more likely to gather the support of EU citizens in the different Member States. I have no doubt that some of what has already been suggested in the previous paragraph might be enough to label my proposal as impossible. But, as explained in more detail below, the question soon to be faced by European politicians is which, among several impossible proposals, may be the easiest to present to their citizens. I believe that this is the proposal put forward here. Not least because it links the developments argued for with a clear and convincing justification for the process of European integration. Furthermore, it does not require amending the Treaties (though it could benefit and be enhanced by Treaty amendments). Most of the suggestions put forward do require unanimity however. But I am also convinced that in all those cases recourse to enhanced cooperation is possible. I am naturally available to provide further clarification.

When the Euro was created it was presented as a big achievement of European integration but the rationale behind it was never fully articulated to European citizens. It was perhaps thought that any attempt to do so would engulf the project of the Economic and Monetary Union in endless political debates about the nature of European integration and the impact of the single currency on national sovereignty. Instead, the Euro seemed an ideal way to deepen European integration in the usual way: as a technocratic regime disciplining (but not replacing) national democracies. The governance regime emphasized this technocratic dimension of the project with a focus on the role of the European Central Bank and its insulation from political pressures. Economic and fiscal politics was left to the Member States which were deprived of their role in monetary policy but, for the rest, were supposed to comply with certain limited rules that proved to be too weak to prevent the current crisis. The hope was that the model could protect both national and EU different legitimacies by a strict separation between the technocratic and political dimensions. The price to be paid was leaving outside Euro governance fundamental dimensions of economic and fiscal policy impacting on a monetary Union. This was necessary so as to preserve space for national politics.

This separation has failed. We have found out that a European Monetary Union cannot be fundamentally dependent on national politics. Yet, though many now recognize the political dimension of the Euro project and call the present crisis a political crisis, we are far from articulating exactly what that means and its consequences. In order to think right about the future democratic

governance of the EU we have to clearly understand the political and democratic dimension of the current crisis.

Understanding the Crisis

Two Narratives and Democracy

Two narratives of the current crisis exist. The first is the dominant narrative. It puts most of the blame for the crisis on some Member States and their irresponsible fiscal policies and lack of economic competitiveness. Capital flight from those Member States is a simple consequence of those irresponsible fiscal policies and underlying economic problems. But, in the meanwhile, the interdependence generated by the Euro resulted in the financial problems of those states becoming a problem for all. This can be presented as a democratic problem since the interests of the latter Member States are not taken into account in the former Member States' democratic process (the EU can, in many respects, be presented precisely as expanding the scope of interests to be taken into account in national democracies). What happened is that no effective mechanisms were available to ensure that the fiscal policies of a Euro-Member State would take into account the interests of the other Member States.

This can be presented as a form of democratic externality that is favored by deeper integration and the interdependence it creates. The crisis makes clear our interdependence but also our failure to internalize its consequences. This failure is a democratic failure. But is a democratic failure of the Member States and one that extends beyond Euro related issues. It is sufficient to remember the circumstances in which a wrong assessment by the health authorities of a Member State on the risk of a particular vegetable led to heavy losses for farmers all over Europe. Many such externalities are also not a product of economic integration but independent from it. Consider, as an example of this type, the fact that 75% of nuclear power plants in Europe were built on a border with other states. This amounts to exporting the risk involved in the production of nuclear energy to states that do not benefit from it. In all these instances national democracies are likely to impose externalities on other democracies whose interests they do not attend to. This correction of inter-state democratic externalities ought to be one of the main functions of EU democratic governance, and, in some areas, it is indeed already the case. The Euro crisis is a product of this type of democratic failure that the Euro governance regime was not well set up to correct.

The second narrative does not see markets punishing the mismanagement of Member States but, instead, as the main causes of the crisis. The crisis is a product of unfettered capital flows. After creation of the Euro an excessive influx of capital occurred from northern banks to several EU Member States, particularly in the south. Those banks benefited from the Euro to inject liquidity into other Member States in search of increased profits. This artificially lowered interest rates in those Member States, creating a credit bubble. This narrative is, in fact, very similar to the dominant narrative of the American financial crisis, presented as a creditor generated problem rather than a debtor responsibility.

When the financial crisis took place in the US and expanded to European financial institutions it was only a matter of time until markets lost confidence and suddenly cut off access to credit in those countries. This increased interest rates on sovereign debt, further undermining confidence in those Member States. A self-fulfilling prophecy followed. Not only did capital no longer accrue to those states but, making use of the free movement of capital, started to leave those states on a massive scale. They became victims of what Dani Rodrik has described as a phenomenon similar to a run on the

banks but at the level of states.¹ Moreover, deprived of the possibility to devalue their currencies or reinstate currency controls, those Member States can no longer address those capital flows and their consequences.

This narrative can (and ought) also to be presented in democratic terms. This is a form of transnational democratic externalities imposed on states. Or, in other words, capital movements can be presented as having a profound impact inside a state without being subject to its democratic control.

This explains why the Bretton Woods consensus on capital controls² seemed so closely associated with democratic reasoning. The core idea was in fact to protect the effectiveness of domestic policies that could be undermined by the unfettered movement of capital to and from states. In other words, preserve the results of domestic democratic deliberation from interference, by exit or entry, of capital movements and their associated interests. However, reintroduction of capital controls at national level is not a solution. Not only is it unfeasible for a state to isolate itself from the world economy but capital controls also have negative effects. They prevent capital from moving to where it may be more efficiently used for the societal good. As the Euro demonstrated, flows of capital can also drastically increase the quality of life of poorer states by giving them easier and faster access to credit since their potential for growth is also bigger.

Whatever our view on capital controls it is impossible to conceive of a European internal market subject to national capital controls. The elimination of national controls on the free movement of capital is both a necessary dimension of the internal market and its benefits and a de facto impossibility for states in the context of the internal market.³

An alternative might be free movement of capital with currencies fluctuating. Something that some argue ought to be reinstated, in the context of a solution for the crisis that would involve the breakup of the Euro. But it is a mistake to conceive of this as being free from democratic problems. The devaluation of a currency in a state results in externalities for other states. It imposes a kind of tax on the exports of those other states. It is simply the form that the externality takes that varies. Moreover, devaluation is not a free pass and imposes harsh social costs within countries undertaking it. Finally, one ought to remember that the existence of different national currencies in the internal market has not necessarily involved currency fluctuation (the internal market requires at least some stability in the monetary system). In a context of fixed exchange rates the costs of adjustment will still be very high and involve multiple externalities. In this way, it becomes clear that the democratic challenges mentioned today as resulting from the Euro would simply assume a different form in the absence of the Euro.

In fact, a stronger normative justification for the Euro might be the opportunity it offers to Europe to address the democratic challenges posed by capital flows. The latter, while, as mentioned, also bringing many advantages, challenge two dimensions of democracy: policy autonomy and distributive justice. They do so because they offer exit and entry possibilities to particular economic actors from deliberative settlements reached in the democratic process. The Euro offers an opportunity to address those risks both by providing a new deliberative space for those issues at the European level and empowering Europe to protect them at the global level. For this, however, the right governance model needs to be adopted.

Understanding this second democratic challenge is also crucial to understanding why it is wrong to present the current crisis as involving a trade-off between democracy and economic catastrophe. Many are assessing this crisis and the different alternatives to address it under this paradigm. But, for the

¹ Dani Rodrik, *The Globalization Paradox - Democracy and The Future of the World Economy*, Norton, New York, 2011, p. 93.

² For a description see Rodrik, *op. cit.* p. 95 and ff.

³ As the failed few past attempts to reintroduce them by some states have quickly demonstrated.

reasons given above, this is simply wrong. Giving up the Euro will not, in itself, protect national democracies. The challenges to national democracy arise from economic integration and, in this particular context, unhindered capital mobility at European and global levels. If the Euro has failed so far it is because it has not been effective in protecting democracy from these challenges, not because it is itself the source of those challenges. The Euro may well be the only effective way to ensure, at European level, the conditions necessary for policy autonomy and distributive justice that any democracy requires.

This point must be forcefully made if one wants to secure the social legitimacy necessary for the deeper integration that many consider necessary to preserve European integration and the Euro. Any move towards deeper political and economic integration should be grounded on a choice by citizens and not presented to them simply as the unavoidable consequence of the Euro. It is fundamental for citizens to understand that the need for further political integration is the democratic answer to interdependence and not a mechanical necessity imposed by the logic of integration. More integration should be a matter of choice, not an inescapable consequence of a process outside their control. Certainly, in making this choice citizens must be informed of the economic and democratic consequences of the alternatives. For the reasons presented above, strong arguments exist to actually say that the EU may enhance democracy instead of challenging it. In place of the debate about more or less Europe we should be having a debate about what kind of Europe is necessary to answer the democratic challenges faced by the Member States.

EU Failings in Addressing the Crisis and Democracy

To fully understand the nature of the democratic challenges facing Europe and what to do to address them it is also important to make sense of EU (in)action in the aftermath of the crisis. The perceived incapacity of the EU political process to solve the crisis is a simple continuation of national democratic failure to internalize the consequences of interdependence. National democracies can neither correct their mutually imposed externalities nor effectively regulate the transnational forms of power that evade their control. But because European regulation of these phenomena is too deeply dependent on national politics it too has proved incapable of effectively addressing them.

In fact, the failure of the EU political process to successfully address the current crisis has, at its core, a political gap: the scope and level of politics has not followed the scope and level of political problems in Europe. This is our most important democratic deficit.

European integration generates a deep interdependence between national policies that has, however, never translated itself into European politics. But if national politics is not able to incorporate existing European interdependence on certain issues then it will not provide the correct political incentives for necessary and democratically legitimate solutions to those issues. This has consequences on what decisions the EU takes but also on how those decisions are interpreted since they are both the product of political incentives originating in national political processes and then, again, appropriated by the latter. In other words, political actors at EU level are predominantly responsive to national constituencies that are not able to internalize the consequences of interdependence. As a consequence, European decisions suffer from the democratic failure which those national political spaces are subject to. But they are furthermore affected by the fact that, when adopted, they are then subject to different (and often opposite) interpretations by those national political spaces.

This failure to internalize interdependence is aggravated by what many perceive as the erosion of solidarity within the EU. In fact, the reverse is rather the case. Rather than being the product of the absence of a European cultural or social identity, lack of European solidarity is the result of that very lack of internalization of the consequences of interdependence: this time, of the benefits it generates.

The bedrock of European solidarity will not be a pre-existing cultural or social identity. It will be an awareness of the benefits of European integration and that those benefits must come with duties too.⁴ In other words, the easier (and more legitimate) path to European solidarity comes by establishing a link between the wealth generated by European integration and the requirement to distribute it fairly.

The EU is both a source of wealth creation, through market integration, and of redistributive effects, by mobility and competition in that market and the increased majoritarian character of its decisions. This requires democracy to be extended as far as the problems and the interests they affect extend. But it also requires some democratic notion of distributive fairness to legitimate the impact of what is done and decided in common.

Finally, the excessive dependence of the EU political process on national politics involves another negative consequence: political authority is too diffuse in Europe. We have often in the past been concerned with the democratic risks involved in concentration of political power. But the opposite may also amount to a democratic problem. When political power is too diffuse then democracy becomes ineffective or dominated by minorities. This is, in fact, what we have been witnessing in the EU. The diffuse character of its political authority in some domains is such that it can easily be rendered ineffective not only by a Member State but also by groups within or beyond a Member State. This is a form of political capture. Europe's difficulty in rising to the challenges posed by the crisis and its claimed ineffectiveness in regulating financial markets and opposing speculation are a consequence of the diffuse and weak character of its political authority.

Europe's answer to this problem has often been to try to side-step democracy itself. The EU's recurring preference for technocratic solutions is, in many instances, a simple consequence of the ineffectiveness of its political process. Since European democracy cannot effectively address some of the current issues, the solution has been to take those issues out of politics. It is true that democracy also needs editing and discipline and that this may require insulating certain questions from the politics of the day.⁵ But this cannot be taken too far, otherwise it becomes a challenge to democracy itself. This highlights a conundrum faced by European integration in its relationship with politics; it seems to be faced with a choice between either too much politics or no politics at all. The answer involves a reorganization of European political spaces, including, as will be argued below, the emergence of a European political space.

Conditions for a Democratic and just EU Governance

Any answer to the current crisis and the form of EU governance adopted to that effect will have to fulfill certain conditions to be both effective and legitimate. What follows is a list of those conditions. The proposals that are later put forward must be understood in light of these conditions. These conditions are also closely related to the proposals.

1) *We need political authority.* Any successful model of governance will have to make clear that political authority stands behind the Euro and the EU. It is the absence of this political authority that undermines the effectiveness and credibility of Union governance of the Euro and its capacity to govern financial markets instead of being governed by them.

2) *We need accountability.* The current crisis is a prime example of the need for accountability. Citizens do not know to whom to assign blame for the current crisis and the failures in addressing it. Who exactly was responsible for the crisis? Markets or Member States? Or again, how should responsibility be allocated between them? And who in the EU was responsible for the failure of the

⁴ This brings to mind the aphorism "[I]f duties without rights make slaves, rights without duties make strangers." Selbourne, D. *The Principle of Duty*. Abacus, 1997, p. 19.

⁵ That is one of the functions of constitutions.

Maastricht instruments of surveillance and coordination of national fiscal policies? Citizens also do not know who to hold accountable for the policies adopted, both at the EU and national level, following the crisis. Who should citizens hold accountable for the results of the adjustment programs “imposed” on some Member States: their national governments or the EU? And if the EU, does that mean the Commission, the ECB, the Council, or some Member States within the Council? The diffuse character of EU political authority makes accountability virtually impossible and favors its manipulation by political actors: national political actors can use the nature of intergovernmental bargaining to transfer political costs to the EU. But, increasingly, the EU institutions might use the fact that its policy choices will have to be enforced by national governments to evade accountability too. Clearer political authority will be a necessary (but not sufficient) condition for accountability in Europe. But we should take steps for such accountability even in its absence.

3) *We need to re-establish mutual trust between states and between citizens.* This has been severely affected by the crisis. Some Member States and their citizens believe they are paying for the mistakes and even cheating of others. These others believe that that it is the former that have not shown sufficient solidarity and are, instead, imposing a form of collective punishment on the latter. Moreover, these discourses are increasingly shaped around national and ethnic lines. The risk is real. In order to prevent it we do not simply need a contract linking solidarity with conditionality. We need both the rules and solidarity to be traced back by all citizens to collective goods shared by all. In other words, they must be linked to the broader purposes of European integration and the fair distribution of its costs and benefits.

4) *We need to render both the benefits and the democratic consequences of interdependence visible to citizens.* This will never be achieved by information campaigns, no matter how well designed. The real source of communication by a political authority with its citizens is through the policies that it enacts and how they impact and are perceived by citizens. The benefits and costs of the European Union are only properly internalized by citizens if they are inherent in the character of EU policies, including its revenues. It is in this way that the Union substantively communicates with citizens. In other words, EU policies must be simultaneously capable of informing citizens about the benefits of European integration and the reasons for their contribution to it.

5) We need to legitimate financial solidarity by relating it to the wealth generated by European integration and not the wealth of some states. The idea that the EU is an instrument to transfer the wealth of some states to other states is a poisonous tree that undermines any form of solidarity within the Union. We must detach financial solidarity and financial transfers between states. Financial solidarity must be a product of the wealth that the process of European integration itself generates and be guided by the goal of a fair distribution of the benefits of integration among all European citizens.

6) *We need political integration to support increased transfer of powers to the Union and its financial solidarity.* The starting point for this political integration must be a European political space. Any form of political integration based only on national political spaces will, for the reasons described above, both lack sufficiently clear political authority and be incapable of internalising the democratic consequences of interdependence. Ideally, this form of political integration would also include a reform of the institutions so as to guarantee that their decision-making processes fit closer ideals of representation and participation in the context of multi-level polities.⁶ The proposals to be put forward are aimed at promoting that political integration even in the absence of the treaty reform involved. I believe a change in the political culture of Europe can have profound democratizing consequences even in the absence of further institutional reforms. It is also important to note that I establish a close link between governance and policies, and democracy and justice. If it is well known that there ought to be no taxation without representation, it is equally true that there can be no representation without

⁶ That are briefly described below.

taxation. These are two sides of the same coin since there is no successful political community without distributive justice.

Some of these conditions are, implicitly, assumed in the emerging consensus around the need for a fiscal union (even if it would be more correct to talk about a genuine economic and monetary union). But what is meant by a fiscal union? Three dimensions can be identified in many of the proposals that have been advanced. More importantly, these dimensions appear to form the cornerstone of the report presented by President Herman Van Rompuy (and prepared in cooperation with the Presidents of the European Commission, the ECB and Eurogroup) at the last European Council:

- greater EU powers over national budgetary and fiscal policies;
- financial solidarity;
- stronger EU democratic legitimacy (presented as a necessary consequence of the two previous pillars).⁷

On the basis of the vision highlighted in that report a roadmap with concrete proposals should, again, be presented to the European Council.

The logic appears straightforward. Enhanced EU control over national fiscal policies will guarantee that all states comply with the rules of the monetary union and, in turn, enable forms of mutualisation of debt. Stronger political integration would serve to legitimate these developments. However, behind this apparent simplicity things are rather more complicated. Is it really possible to effectively control national budgets at EU level? And can this be achieved without fundamentally colliding with the core of national democracy? How and when is the trade-off between discipline and solidarity to take place? What form should this solidarity take (e.g. Euro bonds, ESM, ECB intervention)? And how should political integration be organized so as to effectively enhance democracy instead of risking being perceived simply as one more challenge to national democracy? These and other questions explain part of the difficulty in concretizing the promise of a genuine economic and monetary union. In addition, these tough decisions are still ultimately dependent on national political processes which, as we have seen, are ill equipped to understand the consequences of interdependence and provide the right political incentives. The Union is, in certain respects, in a Catch 22 situation: European politics are required to address some of its current problems but the steps necessary for the emergence of European politics are for now dependent on national politics. What to do is therefore inextricably linked to how to do it. The proposals I will put forward take this into account even if they might, at first sight, appear counter-intuitive from the point of view of their feasibility.

Before presenting my proposals, however, I want to discuss the two alternatives that, in my view, have dominated the terms of the debate so far.

A Union of Rules

The first alternative would limit itself to building upon the Stability Compact and the revised legislative framework on excessive deficits and macro-economic imbalances, as resulting from adoption of the 'six-pack' in 2011. The thesis is that what failed with the Euro was appropriate supervision of Member State fiscal policies. If the EU were in a position to effectively guarantee

⁷ To these we should add the banking union which I will not address in the present short report focused on democratic questions. This is not meant to imply that the latter is of more limited importance. In fact, banking union is a fundamental part of any exit strategy for the crisis in both its financial and economic dimensions. However, it should not be limited to an EU centralized banking supervision and deposit guarantee scheme. It must include a genuine financial services internal market. Important competition distortions in the internal market arise from the fact that companies, no matter how economically and financially solid, have their access to credit dependent on their state of residence and cannot, de facto, obtain credit from banks in other Member States at lower interest rates. In some cases, the compatibility of these situations with internal market rules could even be discussed. This is not, however, the object of this report.

Member State compliance with its fiscal discipline, trust in markets would be restored, the crisis would ultimately be overcome and the credibility of the Euro strengthened. The overwhelming majority of the steps taken so far regarding governance of the Euro have followed this approach. The Stability Compact embodies this approach. It could be incorporated into the Treaties in the context of a broader reform that would further enhance the powers of the Union with respect to Member State fiscal policies. The proposal to create an EU Treasury Minister fits in this model. The same could be said of the suggestion to grant more powers to the Court of Justice, beyond what is already in the Stability Compact.

This approach is also presented as reconcilable with democracy. The Union is not conceived as intruding in national democracies but simply guaranteeing the rule of law in the Euro area. It would be a European constitutionalization of fiscal discipline similar to that already in place in some Member States. Member States have democratically bound themselves to these rules and the Union is simply enforcing them, preventing some from free riding at the expense of others. This thesis endorses only the first of the two narratives on the crisis identified above. In doing so, it underestimates the extent of the democratic challenges faced by Europe. It also underestimates the democratic consequences of powers being transferred to the Union.

This is not the document to discuss the merits and demerits of “constitutionalizing” budget discipline. Very briefly one can say that the most important arguments in favor can, indeed, be presented not only as compatible with democracy but even protecting it. First, as mentioned, the lack of fiscal discipline of some Member States, resulting in externalities being imposed on other Member States, can be presented as a democratic failure since the former states do not take into account the interests of the latter. Second, constitutional limits on budget deficit may also help in correcting an inter-generational democratic problem (the generation that decides on the deficit is not necessarily the same that pays it) and, more broadly, disciplining the risks of political malfunction arising from the pressures of political cycles. It is not uncommon for political communities to insulate certain issues from the pressure of day to day politics in order to attend to long term interests. But, on the other side, the arguments against legally disciplining fiscal policy are also democratic. It is said that such legal instruments restrict the scope of political action and empower a particular economic conception of fiscal policy. Deficits may also produce positive effects either to correct urgent economic problems or if they are linked to productive investments.

Whatever our view on the benefits and costs of constitutionalizing fiscal discipline, two things are clear in the current EU context: this discipline is a necessity, if not to reestablish market trust, surely to reestablish trust between Member States; but this discipline is also insufficient to address the current crisis.

It is insufficient for both economic and democratic reasons. It starts by ignoring that the fiscal situation of a state is closely dependent on its underlying economic situation. Several states that are now in a profound fiscal crisis were until recently fully compliant with the Maastricht criteria. The reasons for their fiscal crisis have to be found in deeper economic problems that rapidly turned into a fiscal crisis. This has two consequences. First, it is a dream to assume that Economic and Monetary Union will magically function so as to ensure all its states enjoy permanent trade surpluses. Financial transfers will always be necessary; the question is how and under what conditions? Second, we need to take seriously the economic part of Economic and Monetary Union. A Fiscal Union requires more than fiscal discipline and coordination of economic policies between states. It requires an EU economic policy, albeit limited to correction of the asymmetries emerging in a monetary union.

But a Union only of rules and discipline would also be democratically unacceptable. Budgetary and fiscal issues have been at the core of democratic political debates for centuries. It is true that, as mentioned, in some states they have been in part insulated from politics and constitutionalized. But even where that is so, this was possible as part of a broader political and social contract and supported by institutions with an established democratic pedigree. The EU, as of now, does not yet offer either.

A regime relying exclusively on fiscal discipline to be enforced by the EU would undermine the already limited political and social legitimacy of the Union: either national political processes would preserve autonomy and the effectiveness of the rules would be put into question or the disciplining of national political processes by a non-political space would put democracy itself into question.

A Union of National Democracies

It is always attractive to talk about a Union or Federation of national democracies. It seems to reconcile the irreconcilable and as a label it works. It also seems to be the path preferentially explored in the report presented by President Rompuy to the Council. It reflects many of the proposals being put forward regarding forms of debt mutualisation and further political integration.

The idea is to complement the fiscal discipline regime embodied in the Fiscal Compact with forms of fiscal solidarity between states and enhanced democratic legitimacy (preferentially through national democracies). Fiscal solidarity would take the form of either a limited mutualisation of debt (in the form of jointly issued EU bonds or some form of ECB intervention) or loans to be provided by the ESM. We could describe this system as one where states provide insurance for other states' debt but such insurance is limited and dependent on a case by case political assessment. Democratic legitimacy would be provided by the participation of a broader set of national political actors in these decisions. National Parliaments and courts would be involved by, for example, reviewing assumption of any new financial liabilities by their state.

I have serious reservations regarding the feasibility and legitimacy of this model. Financially, it is doubtful whether this approach would be sufficient to restore confidence in the common currency and in the political will supporting it. To make governance of the Euro dependent on a permanent "negotiation" with national democracies would leave uncertainty as to the extent of financial and political support underlying the common currency permanently intact. It is this uncertainty that feeds market fears and speculation.

Even if the extent of financial solidarity and debt mutualisation cannot be unlimited, how to exercise it cannot depend on a form of political authority that is too diffuse to be effective. But that should not make us give up on democracy in this area. On the contrary, it should make us look into effective forms of democracy at EU level.

In fact, it can be argued that a model that would make EU democracy wholly or fundamentally dependent on national democracies is destined to fail. It would suffer from the fundamental problem of relying too much on national political processes incapable of internalising the consequences of interdependence and providing the right political incentives in that context. Furthermore, a model requiring constant bargaining on how much some states ought to pay to others and, in turn, how these ought to be subject to the policies imposed by the former, would corrode European integration instead of supporting it. States paying would think they are carrying other states on their shoulders and rewarding moral hazard. Those being "disciplined" would take it as being governed by those loaning the money.

A European democracy will only be feasible if Euro problems are perceived as genuinely collective issues and if the answers to them are part of a broader political contract guaranteeing that all comply with the rules of the game but also that all share a fair distribution of the costs and benefits of European integration. For this to be possible it must be structured around proxy politics and not inter-state politics. We certainly ought to work on improving how national political spaces interact with EU policies and better balance EU imposed discipline on national fiscal policies with the preservation of some deliberative space for national politics. But a real European democracy requires a European political space.

A Genuine Economic and Monetary Union

In light of the dominant discourse on the crisis it may seem to many that our choice is between a Union anchored almost exclusively on discipline and that, sooner or later, will enter into a destructive conflict with national democracies, and a Union prisoner of permanent negotiation between those national democracies. But that is not so. There is an alternative. I have advanced above the necessary conditions for a successful model of governance of the EU and the Euro. It is now time to concretize the forms through which those conditions may be fulfilled and how and why they may be politically feasible.

My proposal is based on three pillars: an increased EU budget supported by real EU revenue sources; new EU policies and a different kind of policies; and more effective political authority supported by a European political space.

I am well aware that the simple mention of these three ideas is bound to generate immediate accusations of delusion. I would urge you, however, to continue reading this report and give me the opportunity to make the case as to why this is not only the right thing to do, but, even if counter-intuitively, the easiest thing to do. All proposals arising from the alternative models mentioned above have already been frequently discussed and labeled impossible. I am certain my proposal will equally be labeled impossible. At some point, however, if we indeed want to save the Euro and the project of European integration, an impossible solution will have to become possible. My argument is that the proposals that follow are the most possible of all the impossible proposals. And they have the added value of being the only ones which seriously engage with the depth of the democratic challenges faced by the Union and its Member States. It is important also to mention that some of these proposals require further development which is incompatible with the nature of this report. Some of its details also require expertise that I do not possess. In this respect, I want to thank to José Tavares who has accepted the task of testing the economic impact of some of the hypotheses put forward here and developing others.

a) A Budget and Resources for Stability and Democracy

Currently the Union budget is 1% of EU GDP. We estimate that an increase of the EU budget to at least 3% of GDP (an amount foreseen at earlier stages of European integration and also when the Euro was created) should provide the Union with the firepower necessary to play two fundamental roles in the context of a Monetary Union. First, introducing policies capable of addressing the asymmetries affecting the well-functioning of the monetary union. Second, using the EU budget to address financial emergencies like the one that the Union is currently living through. The accumulation of a yearly budget surplus could be used for stabilization in case of temporary sovereign debt payment crises. The amount of this yearly surplus should reach about 1 percent of Euro area GDP, which could progressively be used as collateral for borrowing up to 2 trillion Euros. As the reserves in the fund accumulate to provide the necessary collateral for up to 2 trillion Euros, the less of a budget surplus would be necessary to be transferred to this fund and the more of the budget could be developed for other EU policies (which could always be reversed if additional strengthening of the fund by the EU budget were necessary).

This debt would not be issued by the EU (which would be legally complicated, if not impossible, under the current Treaties and, I suspect, difficult to include in any amendment to the Treaties). I am suggesting that the Union fund provide collateral for debt to be issued by states with difficulties in accessing the markets. The collateral provided by the EU fund ought to be sufficient to substantially lower the interest rates at which those states would be able to finance themselves. But for states to have access to this EU fund they would have to agree an adjustment program with the Union.

This proposal would, in fact, replace the current regime of loans provided to states under financial assistance and subject to adjustment programs. It would also replace the European Stability Mechanism. It would do so with three fundamental advantages:

- First, funding of the ESM is limited, for some already insufficient, and increases depend on additional agreements by the participating states in light of their respective national procedures (see Article 10 ESM). This is never easy and it may be further limited by national judicial decisions. Even how existing ESM financial muscle is to be exercised has already raised doubts, including as to what the appropriate decision-making rules will be. In this light, the ESM does not seem sufficient to generate trust in the markets. The mechanism we suggest would have much stronger firepower.
- Second, bringing adjustment programs into the scope of EU policies and institutions would provide them with enhanced legitimacy and transparency (in particular if the political reforms suggested below were also implemented). The current *troika* (involving the IMF, the ECB and the Commission) negotiated programs raise many questions of accountability and transparency. This is a criticism that is equally applicable to how the ESM will operate.
- Third, as mentioned, the ESM depends on funds guaranteed by the participating states. This limits its firepower but also undermines the social and democratic legitimacy of the Union. The citizens of Member States which at a particular moment in time would be net contributors under the ESM (loaning to it but not getting funds from it) would tend to construe it as an unjustified transfer of their funds to cover risks assumed by other Member States. Use of the EU budget would prevent that direct link from being established. It would also signal to citizens in all Member States that their financial solidarity will be limited to their obligations towards the EU budget and is the price to be paid for the general benefits and costs of being part of the EU.

This third advantage also clarifies why this proposal will actually be more feasible than alternatives such as Eurobonds. Not only do the latter share with the ESM the socially corrosive link that is established between financial solidarity and transfers between states, they also create in the mind of citizens the fear of an undetermined assumption of other states' risks. There will always be uncertainty as to how much debt might have to be jointly issued in the future. In other words, one of the problems that renders difficult, if not impossible, any real form of debt mutualisation is uncertainty as to the extent of the risk to be shared. The current proposal eliminates the information and transaction costs associated with that risk. Citizens will know that their obligations are fulfilled by their annual contributions to the EU budget. Their states, as such, will not incur any liability with respect to the actions of other states. Certainly, an indirect form of debt mutualisation exists through the financial solidarity involved in the proposed EU budget stabilization fund. But the way it is legitimated in the eyes of citizens would be different. And, more importantly for its political feasibility, the risks incurred by citizens would decrease substantially.

The legitimacy of this form of financial solidarity would also be made stronger by changing the character and origin of EU revenues. The argument I want to put forward next is that what would make an increased EU budget possible, new own resources, could actually also serve to legitimate the Union. Again, I must articulate clearly and carefully what is another counterintuitive argument.

A polity, including the political authority exercised therein and the necessary solidarity between its members must be made meaningful and intelligible to its citizens not only by how it represents itself but also by what it does. One fundamental aspect is certainly how revenues are collected and taxes organized. These are not simply a source of revenue. They are also a way for the reasons for solidarity to be made clear to the members of the polity. How revenues are collected in a polity, and taxation allocated, also informs citizens of the reasons for that polity and what that it means to be a member of it. EU revenues should not simply be determined on a pragmatic basis of how much is required to fund the Union budget and what is the easiest way to obtain it. Instead, the sources of EU revenues should be determined by what makes the Union more legitimate to its citizens by making visible the reasons

for the Union's existence and linking its revenues to the benefits and costs that different social groups obtain from European integration.

If conceived in this way, the new EU own resources would not only provide the EU with the funds necessary to support the proposed budget increase but would also contribute to a clearer justification of the project of European integration. Furthermore, only in this way will we be able to legitimate solidarity within the Union on any meaningful and lasting basis. It is essential that the Union is seen as redistributing Union wealth and not merely the wealth of some Member States. It is equally important for this solidarity to be related to the different degree to which different social groups benefit from European integration and, particularly, the internal market.

In this light, the choice of EU resources should focus on the following areas: economic activity enabled by the internal market; economic activity that, while taking place in a Member State, has important externalities in other Member States; or economic activity that Member States can no longer individually regulate and tax on their own. In all these domains, the Union would be justified in obtaining revenues from the activity in question either because that activity would not exist without the Union or because the intervention of the Union is the only way to limit the negative effects of that activity in some or all states. In addition, the way those EU resources (in particular taxes) should be designed must take into account who benefits most from European integration.

These principles shape my proposals for new own resources. Most of these proposals have already been discussed (some even proposed by the Commission and the EP), albeit in a different form, in different studies. But it is the link with democracy and a theory of justice that sheds a new light over the choice of some and not other resources and makes them both politically more viable and better capable of reinforcing EU legitimacy.

A financial transactions tax is a paramount example. The justification for a financial transaction tax or even a broader tax on financial or banking activities⁸ is threefold. First, in light of the catastrophic costs that a financial crisis can impose on society the financial system is, de facto, systemically insured by the state. What the Euro crisis tells us is that it will now, in fact, be collectively insured by all Member States of the Euro. The projected banking Union is evidence of this. This collective insurance justifies calling on the financial sector to provide a particular contribution to the EU budget which will help insure the financial system. Second, mobility of capital is protected by the internal market and, albeit it brings many advantages, it also, as described above, may itself be the cause of severe crises in Member States. States can no longer effectively control capital movements and Union taxation could help to limit some of the risks arising from excessive capital flows and financial volatility. The tax ought, in effect, to be designed as much as possible so as to reward or penalize the different forms and degrees of risk involved in different financial activities. Third, capital is not the only economic factor protected by internal market rules, but it is certainly the most mobile. As such, it benefits more from free movement than labor, for example. This includes choosing more favorable tax regimes and, therefore, decreasing the overall tax burden by comparison with other forms of income. It is only fair for the Union to help, at least in part, to correct a distortion that has been furthered by the internal market. The income generated by such a European tax could vary immensely depending on its scope and, in particular, if it were a simple financial transactions tax between institutions or a broader banking or financial activities tax. The Commission proposal, which is relatively narrow and limited, estimates close to 60 billion Euros in revenue.

Another possible own resource would be a European Corporate Tax. This would not replace the national corporate tax.⁹ It would be of a marginal character and preferably linked to harmonization of

⁸ Which arguably not only generates substantially more resources but is also more difficult to evade and less capable of generating competitive distortions.

⁹ Even if many good economic and taxation arguments are available to argue that ought to be so, I do not think full replacement of national corporate tax by a European corporate tax would be politically viable at this stage.

the corporate tax base.¹⁰ I cannot articulate the details of this proposal here but will highlight its possible structure and, more importantly, why it makes sense as an EU own resource.¹¹

Average corporate tax rates have decreased in the European Union in the last few decades. Almost all European Union Member States have lowered their corporate tax rates in recent years. As presented in more detail in the annex, the corporate tax base has also decreased dramatically in some states (particularly southern Europe). This is the product of tax competition. European states now fix their corporate rates so as to attract companies from other states. But the consequence is that a collective action problem is emerging whereby the final outcome may be disadvantageous for all states. There have been frequent calls for a harmonization of corporate taxation in Europe so as to address this collective action problem and reverse the current race to the bottom. However, this has been met with strong opposition from some Member States. Many states believe that they are entitled to compete by using their tax regime. Others think they have no alternative. While some states insist it is necessary to prevent a total race to the bottom, others are afraid that harmonization will preclude any form of tax competition. As a consequence, attempts to harmonize corporation taxation have been unsuccessful so far.

The proposal I am making will have the advantage of allowing tax competition but moderating it and preventing the current rate of tax avoidance by companies. A marginal rate somewhere between 2 to 5% on company profits would not only help to fund the budget increase proposed but would also create a limit to tax competition without preventing it (states could still compete as to their national corporate tax rates and these would continue to be substantially more relevant for companies).

This tax would also make clear that the internal market is not an instrument for some to lower their contribution to society at the expense of others. Companies are among the primary beneficiaries of the internal market. It is only fair that they should pay back some of the advantages (including tax advantages) that they get from the internal market in the form of a rather small tax to the EU. This is further justified by the fact that most economic activity in the EU is now inter-Member State. It makes sense for the EU to get a small percentage of the profits generated by the internal market.

This rationale would be reinforced by my preferred structure for this tax. If possible¹², the revenues from this tax should be distributed between the Member State and the EU in relation to the proportion of the economic activity of the company that is intra-state or inter-state. The reason for this is that the more the economic activity of a company is linked to the internal market the more the taxation of its profits should also benefit the EU. In addition, one might assume that the more a company's economic activity takes place outside its tax residence the more the latter might be a product of tax avoidance and the more justified it would be for the revenue from a marginal European Corporate tax to go to the EU.

It seems paradoxical to be arguing for a European corporate tax, in addition to national taxes, at a time when tax authorities have increasingly given up on corporate taxes for revenue and all national governments are under pressure to lower their existing tax rates on companies. But what this proposal does is to turn that reasoning upside down. Member States are under pressure to lower those tax rates to extremely low levels because of excessive tax competition and not necessarily because those lower rates are more efficient in themselves (in fact, it is well known that excessive tax competition is likely to produce inefficient outcomes). As such, it would not be appropriate to talk about an increase in

¹⁰ To set it up with an autonomous tax base would be more complicated, although not impossible, because the EU would likely have to depend on national tax authorities for collection purposes. However, it may be an indirect way of achieving a long sought harmonization of the corporate tax base.

¹¹ Further developments can be found in the annex report by Professor José Tavares.

¹² What follows would again require a more in depth study on the costs and risks of evasion arising from differentiation between the nature of the economic activity of the companies that I suggest for determining how revenues from the tax would be distributed between the EU and Member States.

corporate taxation in Europe with negative effects on economic activity. Since the tax would serve mainly to prevent excesses of tax avoidance one should not expect a negative impact on the overall economy. On the contrary, it might promote a more efficient distribution of resources in the internal market. The distinction between revenues from intra-state and inter-state activity would also enable some states (those that have been most affected by tax competition) to actually compensate, at least in part, introduction of a European tax by lowering their national tax rate without a severe impact on their corporate tax revenues (which are, in any case, severely under pressure in the current corporate tax competition context). There is a final argument linked to the current economic and social context in Europe. Austerity policies have been adopted in almost all Member States, including those not subject to adjustment programs. But most of these austerity policies have focused on other forms of income precisely by fear of driving companies and capital away, to other EU Member States. This is only reinforcing social opposition to these austerity measures and, indirectly, to Europe. Reinstating some social justice by taxing these forms of income at EU level would increase EU legitimacy and help address this problem. The revenues generated by the tax are difficult to predict but could potentially amount to 0.5% of GDP.¹³

An alternative to a European corporate tax might be a tax on corporate shareholders. This would reduce some of the risks of tax competition from outside Europe but it presents another type of tax administration problems and might actually be more politically controversial at this stage of European integration (because it would be imposed on a form of individual income). I am not developing it here.

I am well aware that the politics of this tax will not be easy. It is bound to receive strong opposition from a significant set of economic actors, an opposition that will resonate particularly well in some states in times of economic recession. States that have opposed harmonization are also likely to oppose this proposal even if with more limited effects on their interest. But I think a viable political strategy could be devised on the basis of the following points:

- The majority of European citizens will certainly favor a tax which is presented as the way to guarantee tax fairness when states can no longer do so. It would help correct some of the increased regressive effects of national taxation systems by ensuring that those that are able to avoid national taxes are made to pay, at least in part, at the EU level.
- Member States which have opposed tax harmonization are also well aware that their opposition will sooner or later be overcome. The pressure to decide by majority in some of these areas is strong and they are aware of it. The present proposal might be a compromise acceptable to them because, while limiting the effects of tax competition, it will be far from eliminating it. Differences between national corporate taxes will continue to be relevant.
- Corporate interests might be the source of stronger opposition. But even these might be “bought in” by a grand bargaining that could involve the type of measures suggested by José Tavares in the annex and a furthering of the internal market in areas such as energy and financial services. If part of the resources of the new EU budget were used for a package of growth policies this would mitigate the opposition of such interests. In addition, it should not be excluded that some companies feel themselves the victims of tax competition. Finally, it cannot be ignored that nothing has created more difficulties for European companies than the current situation in the Euro area. If this small rate were the price to pay for a stable currency and re-establishing access to financing, companies would certainly be ready to accept it.

Other own resources must also be considered. A carbon emissions tax is one such example that again fits the rationale that I have put forward. Most environmental taxes could be justified at EU level both because of externalities imposed in other Member States and because their share has also decreased in Europe as a percentage of GDP and tax revenues. One might also consider introducing some fees in

¹³ Total corporate tax revenues in Member States amount to more than 2.5% GDP.

the EU.¹⁴ This could be the case with respect to projects to be funded through EU project bonds (such as high speed railroads). Once a project is completed a usage fee could be imposed allowing repayment of bonds or funding new projects, or both. A final suggestion might involve a reform of VAT also aimed at reducing carousel fraud that some studies estimate could amount to close to 30 billion Euros yearly. This reform could be used to introduce a modulated VAT as already proposed several years ago in a European Parliamentary Report.¹⁵ That proposal focused on two separate tax rates (one national and another EU). But it might be possible, and more in line with the link I advocate between revenues and EU generated wealth, to relate the EU VAT rate to certain types of transaction (online sales or, if the VAT reform were to incorporate them, cross-border transactions).

A mix of these different forms of revenue should be enough to fund the budget proposed. It would be fundamental for them to be chosen and designed in light of the general principles mentioned above. That would provide them with strong justification in terms of justice for the EU. It would also make them politically more viable. In this respect, an additional political move to tackle foreseeable opposition to these new resources would be to link them to a reduction (or even replacement) of the current GNI contribution of Member States.

These proposals should be presented in light of a narrative stressing two points: decreased contributions from national budgets to the EU in exchange for taxation of those that have benefited most from the internal market; and reinstating at EU level some of the tax fairness that has been lost at national level.

In democratic terms, such a budget and the new resources would make the Union accountable not only for what it spends but also for the wealth it generates. It would distribute ‘its’ money and not that of the Member States. This would have a profound impact on how the EU would be conceived by its citizens.

b) New and Reformed EU Policies

Union policies also need to be rethought in light of what justifies European integration. The European Union can increase its democratic legitimacy by more closely aligning its policy priorities to the problems that, given the ineffectiveness of Member State solutions, it should address.

The problem with current policies is visible in the clear gap between what EU citizens expect from the Union (as expressed in Eurobarometer surveys) and what the more important policy areas of the Union actually are. But it is not simply a problem of managing citizens’ expectations. EU policies have not really adapted to what the EU is today and what its functions ought to be. Fritz Scharpf has famously described a gap between negative integration (economic integration through deregulation of national markets: elimination of national measures restrictive of free movement) and positive integration (economic integration through Community wide re-regulation: adoption of harmonized legislative measures by the EU political process). As a consequence, the Union shapes the economic and social model of Europe without the corresponding policy instruments or political debate, something the current crisis is aggravating.

The Euro has become an even more dramatic example of the EU policy gap. One of the most important instruments of correcting economic and fiscal asymmetries in a monetary union is mobility of the workforce. But the free movement of persons remains the most underdeveloped of all free movement provisions. Nor does the Union have any active policies regarding training, employment or social security. The same could be said of the financial services market. How can we correct

¹⁴ I thank Michael Graetz for having brought this possibility to my attention.

¹⁵ The Langes Report.

underlying economic asymmetries in the Euro area when companies compete under profoundly different conditions in accessing credit depending on their state of origin?

This requires new policies. Among those to be considered, two priorities must be a European employment agency (that could coordinate and facilitate exchange of job offers and demand among the different Member States) and a job training and mobility program that could focus on structural unemployment. The Union could also replace the Erasmus program by Union granted loans to effectively study abroad (i.e. take a degree in another Member State).

But the problem with EU policies concerns more than having the right policies. The structure and character of EU policies also needs to be rethought. Politics remains intergovernmental at the decisive level of EU policy-making. Policy decisions continue, in spite of the enhanced role of the European Parliament, to be a product of intergovernmental bargaining. More importantly, they continue to be often framed in intergovernmental terms. National governments aggregate the preferences of their citizens and EU policies strike a balance between those aggregated preferences. But EU rules are then applied as such to EU citizens. This is in tension with many aspects of constitutionalism and democracy. First of all, it interferes with the mechanisms for political accountability of both national governments and the European Union. It is well known that national governments sometimes transfer unpopular decisions from the national to the European level as a way of transferring the political costs of those decisions. In the second place, the inter-governmental character of EU policies enters into tension with a conception of the EU as a polity that does not discriminate between its citizens. When Member States negotiate national quotas for certain products, often trading the interests of some of their producers for the interests of others (as in any international negotiation), can producers from a particular Member State claim that they are being discriminated against because they are less well treated than those in another Member State as a product of the trade-off made by their own state?¹⁶ In other words, some EU policies are still predominantly a result of inter-Member State bargaining and framed as such. Under this logic, it is not important to assess whether such policies treat all EU citizens alike. What is relevant is the legitimacy of the bargaining between Member States. Since, however, EU rules often affect individuals directly they can, in fact, be constructed as discriminating on the basis of nationality. This affects citizens' understanding of what determines the redistributive effects of EU policies and the idea of justice that guides them.

It is unrealistic (and also wrong) to eliminate inter-governmental bargaining from EU policy-making. But one should require EU decisions, whatever the bargaining underlying them, to be designed along EU citizenship and not nationality lines and conform to universality criteria. This would require a higher percentage of Union expenditure to be allocated to policies structured around citizen benefits and rights instead of funds allocated along national quotas.

This reform of EU policies should also transform how the EU interacts with national polities and policies and its role in reforming them. Though EU legislation generally produces direct effects in the Member States¹⁷, its effective implementation is made by national administrations. The same occurs with EU funds. This dependence on the state can have an important legitimating effect but can equally affect positive and negative accountability with respect to those policies. Moreover, EU structural

¹⁶ Consider the famous litigation by German importers on the banana CAP regime. Were the negative consequences to that set of economic actors a form of unjustified discrimination or a simple function of the bargaining between national governments in the EU decision-making process? The Court of Justice has showed great deference to all these type of decisions in the CAP regime, accepting the argument raised by the EU institutions that any other approach would unsettle the balance among Member State interests involving trade-offs with other areas of the CAP. But this is not without problems regarding how these decisions are then perceived by affected citizens in different Member States. It requires in reality a reflection on the extent to which nationality can still be an acceptable criterion in designing and applying EU law to EU citizens.

¹⁷ I leave aside the difference in the extent and nature of these legal effects between Directives and Regulations even if this could also be of relevance for the present discussion.

funds are, for the most part, focused on identifying certain priorities for investment in the Member States. Specific implementation and selection of the projects to be funded is left to the Member States. These funds, as such, have limited, if any, impact at the level of structural reforms and institutional impact in the Member States.

EU structural policies, in particular, should be more closely linked to domestic institutional reforms. In other words, the EU should use its purse to promote deeper institutional reforms at the national level. One example will, hopefully, make this idea more concrete: in the area of education and research, instead of defining themes of research on the basis of which the Union selects research projects deemed worth of funding, the EU could easily use those funds to have a real systemic impact on higher education and research in Europe. It could, for example, make the award of those funds conditional on certain institutional criteria defined so as to reform national higher education and research in a more meritocratic and international direction (in order to access these funds, institutions would have to fulfill or commit to criteria regarding, for example, academic mobility, internationalization of faculty and student bodies).

Increasing the power of the purse and linking it with institutional reforms is also essential in light of the number of regulatory and supervisory powers that the EU exercises with respect to the Member States and that have expanded further with ongoing Euro reforms. In the context of extended powers being attributed to the EU in national economies the Union cannot be limited to using a “stick”. It must also provide positive incentives. This comes in the form of new policies but also by rethinking how EU policies may be adjusted to further national reforms with systemic impact.

c) A European Political Space

One hears endlessly about the European democracy deficit, real and imagined. But, as I tried to explain at the start of this report, Europe’s real democratic deficit is to be found in its excessive reliance on national politics that have not internalized the consequences of European and global interdependence. Europe can certainly improve its forms of democratic representation and participation but without European politics other democratic developments will either be ineffective or even harmful in legitimacy terms. For example, without proxy politics (organized around transnational and not national lines) any further moves towards a more majoritarian and proportional representation in the Union will simply be perceived as larger states imposing their will on smaller states.

The democratic problem of the Union is also one of effectiveness. A democracy that cannot effectively govern is no democracy. There is no self-government without government. Europe needs a strengthened political authority if it is to become a legitimate and accountable democratic authority.

All this is only made more urgent by the powers being transferred to the Union. A fiscal Union does require a political Union. This problem is particularly acute with respect to the Commission’s position. On the one hand, the Commission has lost part of its powers of political leadership to the Council. But, on the other hand, it has acquired significantly more powers with respect to the Member States under the Fiscal Compact and other fiscal crisis related legislation such as the six-pack. To be effective and legitimate, the Commission must be able to rely on the kind of legitimacy that comes with a direct link to the outcome of European elections.

The need for European politics also rises by the increased redistributive effects of its policies. The expanded scope of EU policies and the predominantly majoritarian character of EU decision-making no longer allow conceiving of the Union simply as a regulatory authority. Its policies and forms of decision-making produce redistributive effects that require more than technocratic legitimacy and a different kind of politics from inter-governmental politics. The deliberative and institutional system of the EU should favor proxy politics (where majorities constructed along national lines are progressively replaced by cross-national ideological majorities). Any future institutional amendments should also prevent the emergence of permanent and insulated minorities (*net losers*), the development of rigid

and insulated majorities or minorities and creation of pivotal players. It is this that will be capable of securing loyalty from citizens to Union decisions. It assures them that their voice is not limited to the voice of their Member State and that, even if one day you may be in the minority, another day you may be part of the majority. Securing these conditions might require additional institutional reforms. But, as stated at the start of this report, my proposals focus on what can be done even in the absence of Treaty amendments. In any case, any institutional reforms, to be effective in enhancing the Union's legitimacy, must be implemented together with or preceded by changes in the nature of EU politics.

My fundamental proposal for this is "transforming" elections to the European Parliament into an electoral competition for the government of Europe. The most important step in this direction would be for the different European political groups to present competing candidates for the role of President of the Commission before the next election to the EP.¹⁸ The Treaties attribute to the European Council the power to propose the President of the European Commission but its subjection to approval by the European Parliament, and the electoral focus on the choice of a President, will ensure that the "winner" of the elections would be the selected President. This is similar to the situation in several Member States where the head of government is appointed by the head of state but following the result of parliamentary elections.

The cohesion of the Commission would also be reinforced by the fact that the President elect would have much stronger bargaining power *vis à vis* the Member States in selection of the other members of the Commission. One may even consider whether the Commission should not fully reflect the political majority in the EP following the elections. Even if the Treaty states that the list of other members of the Commission to be proposed by the Council to the Parliament is based on suggestions by national governments (Article 17, para. 7, second subparagraph TEU), nothing in the Treaties requires or even suggests that they have to be affiliated or related to the political parties in power at national level. It would be possible, under the Treaties, for all members of the Commission to be suggested by national governments to have to be persons supporting the political program under which the President of the Commission has run for election. If anything, we can say that the link that is now established in the Treaties between the Commission and the Parliament requires that to be the case. This does not put into question the obligation of independence to which the Commissioners are also subject under the Treaties (Article 17 para. 3 TEU). This independence must be interpreted as referring to independence from national governments and any other particular interests. The accountability of the Commission to the European Parliament, imposed by Article 17, para. 8 TEU, makes clear that the Commission is no longer supposed to be an independent technocratic body but a politically accountable one.

I am well aware of the risks this approach involves. The politicization of the Commission is bound to affect its perceived neutrality and the authority it derives from being conceived as a semi-technocratic body. But the reality is that the latter authority is already under attack. The expansion of EU and Commission powers into the core of social and economic policy issues is bound to immerse the Commission in politics. The only question is the nature of this politics. As what is happening in some Member States is already making clear, the Commission will not succeed in preserving an appearance of technocratic neutrality in the face of deeply contested political issues. It will simply come across as a limit on democracy and politics. It will no longer be perceived as bringing reason into the passions of national politics but as passion without politics. In order for the Commission effectively and legitimately to exercise the role required by the new EU governance it will have to embed itself in a political space where the legitimacy of the reason that it will impose on Member States will gain the authority of political deliberation.

A first consequence of transformation of EP elections into an electoral competition for the government of Europe would be promotion of transnational politics. Once each European political

¹⁸ This proposal has notably been developed in a book by Simon Hix: *What's Wrong With the European Union and How to Fix It*, Polity, 2008.

group selects a candidate for President of the Commission they must also come up with a political platform or government program. Clearly, these political platforms, in order to be agreed within that political group and to be successful in all Member States, would have to focus on genuinely European issues: issues where citizens are not divided along national lines but across them. The simple need to come up with these European political platforms is bound to generate European politics. The election itself would finally be focused on European issues framed by the competing candidates and their alternative political platforms. Electoral participation is bound to increase in elections since, rather than increasing the powers of the parliament or information campaigns, it is the possibility to choose a government and who would be heading it that is capable of mobilizing people.

The Commission and its President would not simply gain stronger legitimacy. They would gain political capital. EU political authority would also be reinforced. The link established between the election and a specific political platform would provide the Commission and Parliament with a strong political claim in pursuit of the proposals contained in that platform. Just imagine how different the current discussion on the Euro crisis might be if many of the proposals that the Commission has put forward had been at the centre of an engaged and participated debate during the previous election and would, in fact, have been endorsed by the electoral outcome. I am not arguing that national governments and the Council would become irrelevant in the politics of EU decision-making. Far from it, and they should not. But the current proposal would balance the terms of the debate and would put European politics at the centre of the European debate, on at least an equal footing with national politics.

In this respect, it would also be important to promote a closer relationship between national politics and European politics and improve the way European issues are immersed in national politics. As promised above I advance two proposals with this purpose:

1 - The state of the State in the EU

In the same way that we now have the state of the Union debate in the EP we should organize, in each national parliament, a debate on the state of the State in the Union with the presence of either the President or one of the Vice-Presidents of the European Commission. The debate should have two purposes: first, to allow national parliamentarians to discuss with the Commission the different reports and recommendations regarding the State that it must produce; second, to give them an opportunity also to engage the Commission in its broader policies for the Union. At the same time, it would provide the Commission with access to national political space and help make the latter more sensitive to European issues.

2 - A “state aids regime” for certain budgetary measures

One could consider introducing in the new Euro governance a regime similar to the rules currently regulating State aids under EU law. This regime could be applied, in particular, to investment expenditures of states subject to adjustment programs. A state subject to such a program might request the Commission to authorize certain expenditures exceeding the agreed limits if they have a clear higher future return, might serve to counteract a negative economic cycle and no other viable budgetary alternative exists. It would be for the Commission to determine if such conditions were met. This regime might also be considered as an alternative (or complement) to the budgetary limits imposed by the Fiscal Compact. The advantage is that such a regime preserves a margin for politics at the national level while at the same time disciplining it under a clear democratic rationale: controlling risks of capture in national political processes and possible democratic externalities for other states.

The effects of the change of paradigm that I propose with respect to EU politics would be profound. In a democratic Europe citizens can disagree about the right policies to respond to the current economic and financial crisis. If they are not presented with alternative EU policies then the

only alternative that remains for them is to be for or against Europe. Disagreement on the right European response must take place and be arbitrated in a European political space. The extent to which European citizens from different Member States increasingly feel engaged in national elections in other Member States, particularly those understood as playing a key role in EU policies, is revealing. This signals the extent to which European citizens perceive the EU as shaping their lives. But it also highlights the risk that they will see those lives being determined by national politics in which they have no voice. The only viable alternative is to offer such politics at European level.

A Final Comment on Political Viability

At the start of this report I mentioned that much of what I was going to propose would be considered impossible by many. But I also stressed that the question soon to be faced by national and EU politicians will be which, among competing impossible proposals, is the least impossible of all. I believe the model of governance sketched in this report is both the most politically viable and the only one capable of legitimating the process of European integration in the medium and long term. At a certain point, national politicians will be confronted (are confronted?) with the choice between some sort of fiscal and political Union or letting the Euro collapse. The latter would have incalculable economic and social costs, very likely putting into question much of what we take for granted in European integration. If the choice favors a political and fiscal Union, the question becomes what is easier for a national politician to explain to their citizens: that they will have to share, to an extent that will never be clearly determined, the risk of other states' debt? Or that the EU budget will have to be increased by taxing forms of revenue avoiding national taxes so that it can have the financial "muscle" to guarantee financial stability in the Euro area and relieve Member States (and their citizens) from providing financial insurance to other Member States?

Throughout this report, I have highlighted how the political dynamics might be explored to favor the solutions being proposed. It is also the case that many of the proposals put forward have been conceived so as to be embedded in an overall narrative that allows citizens to make sense of the EU. As such, they have a self-reinforcing effect in that, once in place, they have the capacity to generate a stronger understanding and adhesion to the EU. This results from the links established between democracy and a theory of justice for the EU and the latter two with a renewed justification for European integration, one that focuses on its added value in terms of democracy and justice with respect to what Member States can no longer guarantee. A Union that empowers citizens at the global level, regulates and arbitrates externalities between states, and protects social justice both by reforming the Member States and supplementing them.

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