THREE OPTIONS FOR THE EU

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ASSESSING THE EU'S POWERS IN A TRUE ECONOMIC AND POLITICAL UNION

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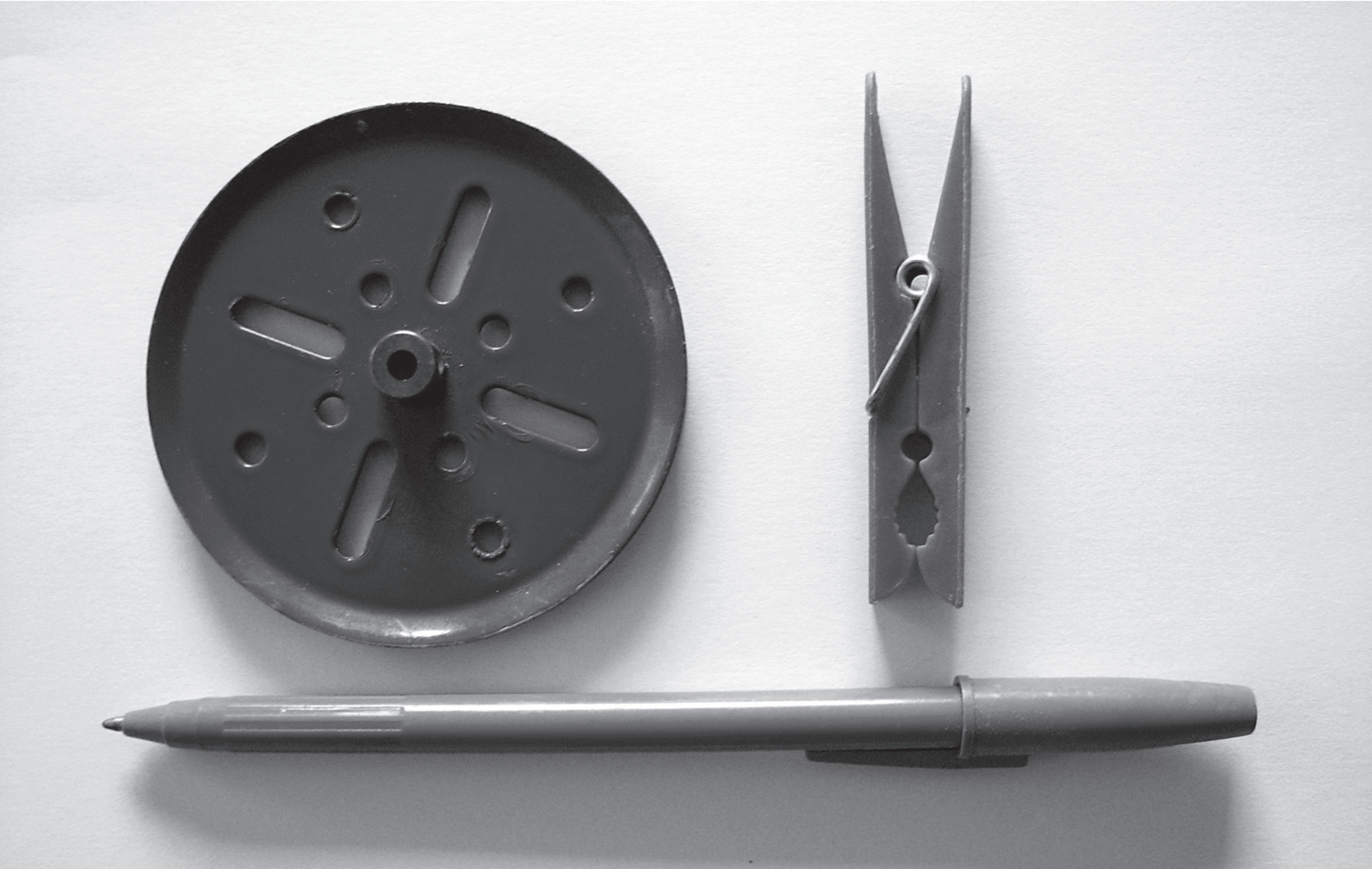

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THREE OPTIONS FOR THE EU

ASSESSING THE EU'S POWERS IN A TRUE ECONOMIC AND POLITICAL UNION

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- Safeguarding the EU's unity in the long-term development of the EMU is currently one of the major challenges for the Union.

- The de facto adjustments made to the EU's economic and fiscal powers due to the economic and financial crisis, including the completion of the Banking Union, create pressures to address the treaty-based division of powers and to strengthen the democratic control of the powers executed by the Union.

- The need to back the EU's macroeconomic goals with fiscal instruments has been made evident by the economic crisis; the position of these instruments outside the common budget might become increasingly controversial.

- A further increase in economic solidarity (jointly guaranteed debt, taxation power) might jeopardize the EU's stability and democratic legitimacy if carried out in the current political and institutional framework.

- A system of constitutional and fiscal federalism would produce a more stable outcome, but would require major changes in the EU's democratic system and system of policy implementation, in its external policies and the way its constitutional powers are arranged.

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For the time being there is no consensus in the EU about the details of the long-term development of the Economic and Monetary Union (EMU). There are, however, a number of political plans introduced by the EU institutions as well as groups of member states proposing major amendments to various aspects of the current EMU system to repair weaknesses identified in the context of the economic crisis. The most far-reaching of these is the Communication from the Commission proposing a deepening of the EMU in three stages.

The most far-reaching of these is the Communication from the Commission proposing a deepening of the EMU in three stages. Forming a major part of the post-2012 agenda of the European Council as well, the long-term development of the EMU has been approached through four policy-fields: an integrated fiscal framework, an integrated budgetary framework, an integrated economic policy framework and the democratic legitimacy and accountability of the EMU.[1]

Since the onset of the economic and financial crisis, it has become obvious that the policies and instruments adopted by the EU to manage the crisis have considerable implications for the whole Union and its future political directions. One major question in this respect is whether it will be possible to safeguard the unity of the Union in the process of the long-term development of the EMU.

One obvious dividing line runs between the eurozone countries and the rest of the EU members, as through participation in the common currency tighter ties have been created for the eurozone countries towards a common policy. Another dividing line is more transnational and divides European societies on the basis of the legitimacy of the EU.

1 See Communication from the Commission; *A blueprint for a deep and genuine economic and monetary union* (COM (2012) 777 final/2; 30.11.2012); *Towards a Genuine Economic and Monetary Union* (EC, the President, various versions of the document have been introduced to the European Council); Final Report of the Future of Europe Group 17.9.2012; *Towards a Genuine Economic and Monetary Union*, EP resolution P7.TA 0430/20.11.2012. There are also several think tank reports, such as *Completing the Euro; A Road Map towards Fiscal Union in Europe*. Notre Europe: Studies and Reports 92, 2012.

The EU's crisis management policy has nurtured a further polarization of public opinion throughout the EU in this respect, due in part to the deficient public anchoring of the Union's measures.

This briefing paper is an outcome of a joint research project carried out by the Finnish Institute of International Affairs (FIIA) and the Research Institute for the Finnish Economy (ETLA)[2], focusing on the long-term development of the EU in the aftermath of the economic and financial crisis. In the project, the main scenarios for the Union's development are outlined and their political and economic implications for Europe, and later more specifically for Finland, are analyzed.

The scenarios reflect the political plans introduced during the past few years concerning the long-term development of the EMU, although they are not directly based upon any of them. The scenarios roughly outline three main alternatives for the EMU's future, referred to henceforth as EU plus, Fed-EU minus and Fed-EU.

In the first (EU plus), the EU is assumed to maintain the form and powers it will have along with the conclusion of the current ongoing reforms, particularly the three stages of the Banking Union. In the second (Fed-EU minus) scenario, the EMU's development would be taken several steps further in the direction of enhanced economic solidarity, taking place, however, within the EU's current legal and political framework. In the third and final form to be analyzed (Fed-EU), the EU would clearly change its character towards a more federal entity, which would be reflected in the overall system of powers as well as in its legal and political character.

A series of briefing papers will be published where these alternative scenarios for the EU's future will be analyzed in respect of their political implications. In this context, a more heterogeneous scenario, namely that of a partial disintegration will also be discussed. Due to its non-unitary character it cannot be outlined as a possible fourth scenario, but various modes of disintegration will be analyzed in the context of the three main scenarios. It should be stressed that an analysis of the political likelihood

2 The research project is funded by the Jane and Aatos Erkko Foundation.

with which each of the scenarios may materialize is not included in the main tasks of the research project, as such a question would demand a different approach to the issue.

The paper at hand will focus on the three scenarios from the point of view of the division of powers between the EU and the member states. How have the measures that have already been taken in the context of the Union's crisis management policy affected the initial division of powers in the EMU, and what will the implications of the Banking Union be in this respect? How far can one go with an increase in the forms of economic solidarity (Eurobonds, debt redemption fund, etc.) in the framework of the current division of fiscal powers, and how would a need to transform the current EU budget into a genuinely federal budget be likely to emerge?

Questions related to the stability and functioning of the three scenarios will thus be one crucial aspect to be addressed. How lasting would the planned forms of the Economic and Monetary Union be, and what kinds of spill-over effects would they be likely to give rise to? The corresponding institutional and democratic appropriateness of the various divisions of power will be addressed separately in briefing papers to be published at a later date.

EU plus – how many new powers are at stake for the EU?

The EU has been characterized as a political and legal hybrid, implying that the structures of the intergovernmental and federal modes of power are combined in various ways in various policy fields. Once established, the EMU matched this description well, as it combined a common monetary policy for the eurozone countries under the supranational powers of the European Central Bank with economic and fiscal policies remaining primarily in the hands of the member states. This combination was initially complemented with a relatively modest role taken by the EU in financial sector control and regulation.

As the economic and financial crisis has made the vulnerabilities of this system clearly visible, the division of powers has been reconsidered in relation to most of its components. A more stringent system of control and surveillance has now been launched, not only with respect to national budgets and public finances but gradually also with respect to national economic policies[3] in support of sound public finances and harmonious macroeconomic development.

The Banking Union – which is meant to decrease interdependences between public finances and the banks – not only provides a new function for the European Central Bank but is also planned to be supported by a funding instrument (a common resolution fund and a common deposit guarantee scheme). The same also applies to the new mechanism of coordinating national economic policies (convergence and competitiveness instrument[4]). In their current form, both the amended economic policy coordination and the Banking Union create pressures to address the current division of powers in fiscal and budgetary policies. The establishment of the European Stability Mechanism (ESM), even if devised as a special arrangement outside the normal budgetary framework, was a first step in the direction of a transfer of powers. It proved that the management of economic and financial interdependences that the EMU comprised requires access to joint fiscal instruments.

The changes taking place in the system of economic policy coordination emphasize its hard law characteristics and increase its similarities to a true common EU policy.[5] The initial mechanism, according to which the member states were supposed to coordinate their economic policies within the Union (TFEU, Article 5), with the Council assisting by providing broad guidelines for these policies, was broadened

3 The European Semester currently provides the common framework for this control, which on the part of national fiscal policies is based on the Stability and Growth Pact (SGP) and amendments to it through the recent six-pack legislation. For the coordination of economic policies, the six-pack introduced a Macroeconomic Imbalances Procedure (MIP).

4 This instrument was initiated in the Commission's Communication (COM 2013, 165), and in its June 2013 meeting the European Council decided to continue discussions on it aiming at the adoption of the instrument in its December meeting 2013 (EUCO 104/2/2013).

5 See e.g. Bekker, Sonja: *The EU's stricter economic governance: a step towards more binding coordination of social policies?* Social Sciences Research Center Berlin: Discussion Paper SP 2013-501.

in December 2011 with the Macroeconomic Imbalances Procedure (MIP).

The system is meant to correct macroeconomic imbalances on the basis of ten indicators (including net international investment position, change in nominal unit labour cost and private and governmental sector debt) and alert thresholds established for each of them. A corrective arm, an Excessive Imbalances Procedure (EIP), will be opened for member states experiencing serious imbalances, including the possibility to fine eurozone members if they fail to comply with the rules. The powers of surveillance granted to the Commission and Council are in line with those exerted within the framework of the coordination of economic policies, but the scope of coordination is more extensive. A further extension of its scope is likely to take place as there is a basic agreement about adding social indicators to the list and making the MIP more comprehensive.[6]

It seems likely that another two principled extensions will take place in the MIP, which will further challenge its character as policy *coordination*. First, there is a firm *ex ante* dimension emerging to this policy coordination according to which at least all the eurozone members would be obliged to acquire EU consent for all major economic policy reforms with EU- or eurozone-wide implications.[7] Second, a new financial instrument will be created in support of the EU's role in this process. This new convergence and competitiveness instrument (CCI) would essentially facilitate national commitment to, and implementation of, the reforms required. The instrument would be funded as a specific part of the EU's common budget.

The new division of powers – where the EU's role would get closer to a true economic policy competence over the MIP issues – would first of all emphasize the question of the legitimacy and democratic anchoring of this competence. It is obvious that the new role whereby the EU would be empowered to assess major reforms in, for example, product, services or labour market issues or issues related to taxation, and provide suggestions for the member states, changes the conditions for national policy-planning. The democratic mechanisms envisaged by the Commission (dialogue with the EP) seem insufficient with respect to the political and non-technical character of the Union's new powers.

The pressure to move towards an EU-level fiscal capacity will be equally obvious when it comes to the integrated financial framework and the creation of a Banking Union, which is due to materialize during 2014. It has been widely argued that the linkages between the three stages of the Banking Union – the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the Deposit Guarantee Scheme – are obvious, meaning that the credibility of a single normative framework is to a large extent dependent on joint fiscal backing.[8]

One part of this need has already been taken into account by enabling the direct recapitalizing of banks from the European Stability Mechanism (ESM) once the single supervisory mechanism is established. The Commission has proposed a single resolution fund of around 55 billion euros to be established to back the Single Resolution Mechanism, and a system where the single supervision of the banking system combined with a variety of national resolution systems seems transitional at most (COM (2013) 520).

The political attraction of the EU plus scenario stems from its pragmatist approach. It rectifies the main structural deficiencies commonly identified in the EMU in the context of the euro crisis without, however, touching upon the more principled division of powers between the EU and the member states. Its main vulnerabilities stem firstly from the obvious inconsistency between the Union's *de jure* and *de facto* powers and responsibilities both in macroeconomic and fiscal policies. If the EU's *de facto* powers are clearly perceived to exceed its legal competence in a policy field with major importance for national legislatures such as economic policy, the result can seriously challenge the Union's legitimacy.

6 This was among the topics discussed in the European Council meeting in June 2013 (EUCO 104/2/13). The Commission is expected to present a communication on the social dimension of the EMU during autumn 2013.

7 The ex ante coordination mechanism was initiated in the Commission's Communication (COM (2013) 166 final) and the European Council requested a further elaboration of the mechanism in its June 2013 meeting (EUCO 104/2/13).

8 See Véron, Nicolas: *A Realistic Bridge towards European Banking Union*. Bruegel Policy Contribution, issue 2013/09.

A second and related issue deals with the need for joint fiscal instruments, which can be treated as an implication of several reforms executed during the crisis. The extent to which the funding and management of these instruments can take place outside the common budgetary procedure is another vulnerability of the pragmatist approach.

Fed-EU minus – stronger economic solidarity within the current political and legal framework

The following scenario in the analysis envisages an EU where the vulnerabilities of the first scenario would be rectified by enhancing the *de jure* economic and budgetary powers of the EU, and by creating a more extensive fiscal capacity to back them.[9] A new form of funding the costs, for example through direct taxation, would be established and the issuance of a jointly guaranteed debt or a debt redemption fund launched to support the overall financial stability.

This kind of deepening would bring the economic and fiscal policy dimension of the current EMU more in line with the common monetary policy in terms of division of powers. It would move economic and fiscal policies to the category of shared competences and shift the emphasis of macroeconomic and budgetary planning to the EU level. This would, however, be achieved without major changes to the EU's overall political and legal framework. The member states would retain their *de facto* legal sovereignty and the EU would act within the framework of powers assigned to it. The size of the common EU budget wouldn't grow decisively, irrespective of the new financial instruments. The emphasis of public finances would thus stay at the member-state level but would, however, be more strictly steered through joint EU policies.

From the point of view of the division of powers between the EU and its member states, the second scenario can in some respects be considered more stable than the first. By transforming the current forms of coordination and control (of economic and fiscal policies) into a clear competence – possibly linked to legal instruments with direct effect – the powers and responsibilities between the two levels would be clarified and made more accessible for legal and democratic scrutiny. The transparency of macroeconomic policy mechanisms would increase as the need for soft law steering instruments such as the recent Euro-plus pact[10] would diminish.

The new fiscal competences included in this scenario, the EU-level taxation in a limited form and the issuance of jointly guaranteed debt would, however, strongly affect the stability of the system through the joint liabilities they create. The implications of the EU's joint instruments for borrowing would depend on the exact type of bond adopted: in this analysis, their main qualification is, however, the system of several and joint responsibility which they comprise. The implications of a debt-redemption fund are from this point of view comparable with those of a joint bond as its funding is planned to take place equally through joint bonds.

A funding instrument with joint and several responsibilities forms, together with the possibility given to the EU to collect some form of direct taxes, a strong incentive for a comprehensive mandate given to the EU in the control of macroeconomic policies. One key challenge in this respect is whether the legal and institutional prerequisites of this scenario are sufficient with respect to these needs. Can, for instance, such a collective control of national budgets which the mutualization of debts requires be justified in the framework of the general division of powers the scenario is based on, and where the emphasis of public finances stays at the member-state level?

The establishment of an autonomous funding instrument in support of sound macroeconomic development and funded through taxes or borrowing includes another new opening which is apt to raise the question about the targets of such direct public funding, namely the material scope of the

9 The 'Medium-term plan' of the Commission's Communication (COM(2012)777 final/2) comes close to this scenario which is, however, ultimately based on its own logic.

10 The Euro Plus Pact commits its signatories to even stronger economic coordination for competitiveness and convergence, also in areas of national competence, with concrete goals agreed on and reviewed on a yearly basis by the European Council. The Pact is integrated into the European Semester and the Commission monitors implementation of the commitments.

EU's solidarity. The linkage of the EU-level funding instruments to a broader macroeconomic policy agenda comprising items related to employment and social policies would be created through the enlarged indicators for the macroeconomic imbalances procedure (MIP). In the second scenario, the spill-over effects would be directed towards a further deepening of social policy integration in the form of a transfer of powers over certain issues from the member states to the EU level.

By clarifying the division of powers and responsibilities over major economic and fiscal policy issues, the second scenario would provide better opportunities for the democratic control of these policies. Building on the model of the first scenario, it would most likely imply a strengthening of the powers of the European Parliament over those issues of economic and fiscal policies which become more clearly defined as powers of the EU.

The issue of democratic legitimacy that the second scenario would undoubtedly face deals with the democratic legitimacy of those macroeconomic policy guidelines which, in this scenario, become a clearer prerogative of the EU and fall under the executive leadership of the Commission. Along with this power, the current origins and scrutiny of the Commission will become insufficient from the point of view of democratic legitimacy. The two alternative ways of enhancing the Commission's democratic accountability that have surfaced in political debates deal with a further deepening of its parliamentary relationship with the EP or a direct election of the Commission president, which would pull the institutional machinery in the direction of a separation of powers system. As the issues of institutions and decision-making will form the basis of the subsequent briefing paper dealing with the deepening of the EMU, they won't be discussed in this context.

The attraction of the Fed-EU minus scenario is based on the way it strengthens the autonomous capacities of the Union to respond to the vulnerabilities identified in terms of financial instability and lack of convergence in the member states' macroeconomic development and sound public finances. The question of whether such firm economic solidarity in terms of debt mutualization and the possibility of direct taxation is politically manageable through the current framework of competences is, however, crucial.

Fed–EU – fiscal and constitutional federalism

The third scenario evaluated here deals with the transformation of the current EU into a full political and fiscal Union characterized by constitutional and fiscal federalism. The first means that the starting point in the EU's legal system would be the sovereignty of the EU, taking expression in a constitutional document defining the division of powers between the EU and its member states. The main material difference with respect to the current way of defining the division of powers – and with clear implications for the economic and fiscal policies – would emerge through a possibility to touch upon both EU and member-state level duties in a single framework. The current treaties allow only the definition of the EU's competences as they are based upon the idea of assigned competences and the member states' legal sovereignty.

Another essential characteristic of a federal system is the system of fiscal federalism where the system of public finances is more evenly divided between the EU and the member states, and where both levels have their own budgets – and own systems of revenues – to fund the public tasks assigned to them in the sovereign constitutional document. As the more detailed division of powers in economic and fiscal policies could vary decisively in such a system, here it is simply assumed that at least the scope of powers included in the Fed-EU minus scenario would be included here as well.[11]

In the European discussion, the further elements linked to such a system would be a proper central budget providing for a fiscal capacity with a stabilizing function (Commission Communication 2012:777). A competence for macroeconomic stabilization,

11 One main distinction in systems of fiscal federalism can be drawn between a cooperative system such as in Germany (coordinated tax policies, federal responsibility for state-level loans) and competitive federalism as in the US (no coordination of tax policies, no federal responsibility for state-level loans). See Bernhard Seidel & Dieter Vesper: Fiscal Federalism: An International Comparison; German Institute for Economic Research; Discussion Papers 183; 1999. For a thorough analysis of the US system and its lessons for the EU, see C. Randall Henning & Martin Kessler: Fiscal Federalism: US History for Architects of Europe's Fiscal Union. Bruegel Essay and Lecture series, 2012.

namely to support the adjustment to asymmetric shocks, and facilitate stronger economic integration and convergence, would be added to the EU's tasks. The central budget would be funded through a competence to collect taxes or by an issuance of the EU's own sovereign debt. Unlike the Eurobonds appearing in the previous scenario, this debt would be guaranteed by the sovereign EU institutions and not by the member states. The funding of all the other policies through the central budget would depend on the division of powers established in macroeconomic policies including employment and social policy.

Through the shared responsibilities it contains, the system of constitutional and fiscal federalism would require a completion of the EU's democratic system. In narrow terms this would mean an extension of the system of democratic participation and control over the powers exerted at the EU level. As the institutional framework for such democratization will be dealt with in the coming briefing papers, it will only be mentioned in passing here. It is, however, obvious that irrespective of this institutional framework, a system of fiscal federalism would require a system of European public space to be established, which would provide citizens with full possibilities for participation in, and public scrutiny of, European politics.

Another institutional requirement deals with the implementation of the powers – and in particular the new economic and fiscal powers – that fall under the EU's competence in this constitutional division of powers. First, a proper EU Treasury should be established for the execution of all the new powers from macroeconomic planning, issuance and control of debt, and collection of taxes. The detailed institutional position of such a body would again depend on the overall institutional framework, but it is obvious that its democratic control would be a key issue. Another new requirement would be directed at the execution of the EU's competences in the member states – a task which is currently carried out by national authorities under the supervision of the Commission. A federal division of powers would require a more direct implementation of the federal tasks which, however, is not the key focus here.

When accomplished, a system of fiscal and constitutional federalism would represent a stable system from the point of view of the division of powers between the EU and its member states. The accomplishment of such a system would, however, presuppose the revision of the current division of powers in at least three major respects with the end results of all of these revisions affecting the final system achieved.

First, the system of division of powers between the federal level and member-state level is a crucial element of the federal system, whose integrity must be safeguarded. The emphasis of the powers over the system (constitutional powers) must be at the federal level even if the member states retained an important role in the final decision-making. Decision-making in key fields of the division of powers must be subordinated to a majority rule in order to maintain the necessary dynamism of the system.

Second, the Fed-EU is the scenario that would have the clearest implications for the way of arranging the EU's competences over external relations. The transfer of constitutional sovereignty to the EU level and the establishment of a central EU budget would create a need to reconsider the current division of powers over major external policies in order to strengthen the EU's political and fiscal responsibility. As there are currently considerable incoherencies between different fields of external policy in terms of the division of powers (common trade and monetary policy being an exclusive competence of the EU, whereas common defence policy remains largely a prerogative of the member states), the question remains whether the system can be rectified to support the emerging logic in the division of powers over internal policies.

Third, the connection of the citizens will, in terms of the formulation of their rights and liberties, be adjusted to the new federalist constitutional setting. This requires at least an extension of the political, and possibly to some extent the social rights guaranteed at the EU level, as well as the definition of the new obligations of the citizens required by the division of power.

Conclusion

The further steps taken in the development of the EMU are crucial with respect to the more long-term path it will be pushed onto, not only with respect to its economic solidity but also in terms of its legitimacy and political stability. This paper has outlined three rough models which have each appeared in the European debate as possible solutions to the weaknesses identified in the EMU. The paper showed that while the first two models (EU plus and Fed-EU minus) are linked to spill-over pressures and challenges of democratic legitimacy, the third model (Fed-EU) would require far-reaching steps taken at least with respect to the EU's democratic machinery and system of implementation, as well as the means of arranging its external relations.

The institutional challenges and challenges of democratic legitimacy related to the EMU's development will be covered in subsequent papers published in the EMU-related FIIA briefing paper series during autumn 2013. Another major issue they address concerns the challenges of unity the EU faces with respect to a deepening of the economic and monetary union.

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