



The Sinews of European Peace

Reconstituting the Democratic Legitimacy of the
Socio-Economic Constitution
of the European Union

Raúl Letelier and Agustín José Menéndez (eds)

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Cover picture: 'The Nightmare of the Bourgoise' (1932) by Nicanor Piñole, Museo Nicanor Piñole.

Preface

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

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

The present report is on 'The Political Economy of the European Union' – work package 7 of the RECON project. It contains the proceedings from the workshop 'The sinews of peace – democratising the political economy of the European Union', held in Leon in September 2008. The aim of WP 7 is to analyse the relationship between public finance and democracy in the EU's multilevel political system. It analyzes the putative connection between the institutional design of a democratic polity and the design of its tax system. WP 7 spells out institutional designs and policy options with regard to the system of financing and the allocation of taxing powers to the European Union.

Erik O. Eriksen
RECON Scientific Coordinator

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This report contains the edited proceedings of a workshop held in León 19-20 September 2008 under RECON's work package 7, 'The Political Economy of the European Union'. The workshop was rendered possible by the financial support granted by the European Commission to the RECON project; and indeed by the superb administrative support coming from the coordinating institution, ARENA. The Archivo Histórico Provincial de León, and especially the director, Eva Merino, kindly allowed us to stage the event at its magnificent historical building, a former prison turned into a repository of collective memory (a magnificent metaphor of European history). This also allowed us to bring our discussions from the ivory tower of the campus to the core of the city centre. Participation of the León team in RECON has been very much supported by the Law School, especially by its former dean, Miguel Diaz, and by the former director of the Basic Public Law Department, Juan Antonio García.

Finally, it must be said that by sheer chance (or was it?), the workshop took place in the very same week in which Lehmann Brothers fell, and Western financial capitalism seemed to be melting. The powerful message of Piñole's painting now reproduced in the cover of this report, (his splendid representation of the ghost that haunted Europe in 1931) became even more self-imposing as Keynes and Minsky were (again and finally) vindicated. That coincidence was the ultimate causal factor behind the decision to include as an appendix to this report the perhaps forgotten, but more relevant than ever, reflections of one of the founding mothers of the idea of European Union, Barbara Wootton, on the interrelationship between the political and the economic systems. The wave of bank nationalisations that started as we met in León was certainly not the breed of socialism she advocated, but clearly marks the end of the age of triumphant capitalism. What implications this has for the socio-economic constitution of the European Union is what this report tries to figure out.

Raúl Letelier and Agustín José Menéndez

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Chapter 1

Reconing the political economy of the European constitution

Agustín José Menéndez
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On RECON in general

RECON ('Reconstituting Democracy in Europe') is a research project aiming at elucidating the ways and means through which democratic government¹ could be 'reconstituted' in Europe. This requires the

¹ In this chapter, the term 'democratic government' is intentionally used in lieu of 'democratic governance'. A full explanation of this choice is not appropriate here for reasons of space, but suffice to say that I assume that there cannot be proper democratic legitimacy without democratic government, and that, consequently, 'governance' mechanisms, the legitimacy of which stems from a different source than the identity between the authors of and the subjects to common actions norms, are 'parasitic' on an encompassing institutional and decision-making framework which can redeem its claim to democratic legitimacy. Governance mechanisms can be very necessary to exploit in democratic terms specialised knowledge and to render efficient the democratic division of social labour, but they are not and cannot be self-sufficient in democratic terms. When they are transformed into the 'new grammar of law', a new form of authoritarianism emerges. It must also be said that the term 'democratic government' is understood in encompassing terms, comprising not only the legally formalised institutions and decision-making processes, but also the role played by general publics in democratic will-formation. However, the term is not conflated with the idea of democratic social order, which refers to democracy as a form of life. On this, see N. Bobbio, *Il Futuro della Democrazia*, Torino, Einaudi, 1984; P. Allot 'European Governance and the Re-branding of Democracy', (2002) *European Law Review*, 27(1), pp. 60-71 ; C. Möllers, 'European Governance: Meaning and Value of a Term', (2006) *Common Market Law Review*, 43(2), pp. 313-36; A. J. Menéndez, 'The European Union between Constitution-Making and Governance', in P. Birkinshaw

combination of the description, reconstruction and normative assessment of the institutional set up, the decision-making processes, the public policies and the common action norms (mainly legal ones) that frame and define the European political order.

RECON makes some basic assumptions concerning the proper standards of legitimacy (hereafter, the *democratic standards* question), the need of explicitly problematising the nature of the European Union as a political community (hereafter, the *polity* question) and the actual democratic shortcomings of the European Union (hereafter, the *democratic deficits* question). The three questions are closely related, but should be kept analytically distinct.

On what concerns the *democratic standards questions*, RECON departs from three premises: First, that democratic legitimacy is the fundamental source of legitimacy of any modern political order; second, that the operationalisation of the democratic principle calls for the combination of a representative institutional set up ('strong publics') with a properly ordered array of democratic decision-making processes ('institutionalised decision-making') through which the existence of a general will supportive of collective action norms and decisions (mainly legal ones) is to be properly ascertained. In its turn, the agenda and the preferences of 'strong publics' need to be reactive and open to be influenced by communicative processes in the wider civil society (the 'general publics'); and third, that the design of a democratic political order at the regional, national or European level is impossible without considering the way in which the other levels of government are structured and ordered; in brief, democracy in Europe cannot be realized in one level of government without considering the constitution of all levels of government simultaneously.² The latter premise is the

(ed.) *The European Union Beyond the 1992 Order*, Dordrecht, Kluwer Law International, forthcoming.

² This does not necessarily entail that the core legitimacy of all levels of government must go back to democratic legitimacy, however, as we will see *infra*. However, the massive set of common interests which bind Europeans together, not only as collective political communities (that is, in inter-state or inter-polity terms) but also as individuals in a horizontal sense (through economic and non-economic relationships, the latter on the increase due to the easiness and cheapness of travel and due to the very process of Europeanisation) creates the presumption that the democratic legitimacy cannot be understood as a complete question but if one considers the European political system as a whole, that is, including all levels of government, and not only the national or regional ones.

consequence of the close vertical and diagonal interweaving between levels of government, institutional structures and common action norms in Europe, further composed by the experimental and consequently dynamic character of European integration.

On what concerns the polity question, RECON departs from the observation of the interweaving of the different components of the European political order and the inherent dynamic of the process of supranational integration. There is ample evidence that the mass of common interests and the degree of mutual affectation is so high that it is proper to speak of the European political order as encompassing the supranational, the national and the regional levels of government. What concrete type of political order the European order is (and, additionally, should become, if considering the question from a normative perspective) remains a controversial question, which differentiates the three alternative models of the Union which the research is structured around (as commented *infra*). By doing this, RECON avoids falling into the trap of methodological nationalism, methodological statism, or even methodological communitarianism.

On what concerns *the democratic deficits question*, RECON makes four assumptions: First, that the European political order is affected by major democratic shortcomings which are sufficiently ample and transcendental so as to render interesting and urgent the task of conceiving ways of mending them; in particular, given that the incompleteness and relative weakness of the supranational institutional structure renders the process of European integration especially vulnerable to major crises of legitimacy; second, that the democratic shortcomings of the European Union are not the unavoidable consequences of a given degree of cultural or political development, or the inescapable dark side of the development of mature capitalism, but are the direct result of taking or not taking some (political) decisions, and that consequently, insufficient democratic legitimacy can be overcome or at least alleviated (which may be what can be achieved in human affairs); third, that the democratic legitimacy of the European political order cannot be ascertained by exclusive reference to the formal constitution of political power, but has to be determined by reviewing actual constitutional and political practice; and fourth, the democratic shortcomings of the Union have different sources. Some are the direct product of the inadequate design of the institutional setup and decision-making processes of the European Union; others flow from the

assumption that democratic legitimacy can be established through autonomous and self-referential changes in each level of government (when the contrary is the case). Finally, democratic legitimacy is also eroded by the actual distributive consequences of the division of European and national competences (and non-competences). Still, the project departs from the assumption that the core of the legitimacy problem of the European Union results from an inadequate constitution of the institutional setup, the decision-making processes, and the processes of mediation between strong and general publics.

The research is then conducted with the help of three models defined by reference to the understanding of democracy at the supranational level and the democratisation strategy to be followed (respectively, audit democracy, federal democracy and post-national democracy; and *renationalisation*, *state-making* and *cosmopolitanisation*), models which are identified, among other things, by reference to the answer provided to the three abovementioned questions (the democratic standards question, the polity questions and the democratic deficits question). Firstly, democratisation of the European political order can be achieved through the reinforcement of national democracies, resulting in the transfer of democratic legitimacy to the supranational level, to be paired with mechanisms of audit democracy which 'safeguard that they (the member states, and in particular, their national political systems) remain the source of the EU's democratic legitimacy'.³ Alternatively, democratisation may result from the transformation of the Union into a federal multinational democracy, which will 'be institutionally equipped to claim direct legitimation, and entrench this in legally binding form'.⁴ Finally, a third and final model will be characterised by claiming democratisation through the full transformation of the European political order into a post-national political order, which may be characterised by a *polycentric system of directly-deliberative polyarchy*, or what is the same, 'as a multilevel, large-scale and multi-perspectival polity based on the notions of a disaggregated democratic subject and patterns of diverse and dispersed democratic authority'. Their claim is that transnational civil society, networks and committees, NGOs and public forums, all serve as arenas in which EU actors and EU citizens from different contexts – national, organizational and professional –

³ Erik Oddvar Eriksen and John Erik Fossum, *Europe's Challenge: Reconstituting Europe or Reconstituting Democracy?*, available at <http://www.reconproject.eu/main.php/EriksenFossum_Paper_RECONworkshop_Mar09.pdf?fileitem=5423278>, at p. 11.

⁴ *Ibid.*, at p. 15.

come together to solve various types of issues, and where different points of access and open deliberation ensure democratic legitimacy. Local problem-solving, the institutionalisation of links between units, and agencies to monitor decision-making both within and between units make this structure conducive to democratic governance'.⁵

Democracy and the political economy of the EU

There is nothing more political than the modern economy, and thus it is only natural that one of the work packages of RECON is devoted to 'The Political Economy of the European Union'. This term makes quite naturally reference to the activities of production and distribution of goods and services, considering not only their 'autonomous' economic logic and relevance, but also their political dimension (as both influential upon politics and as the object of steering through politics) and legal implications (in particular, attention is paid to the legal norms that constitute and regulate economic activities, the substance of which is partially determined by the socio-economic structure). We thus consider European fiscal, tax, labour and social policies, not only as subjects of specialised knowledge, but as key building blocks of the European political and social constitution. In particular, we study the socio-economic constitution of the European Union with a view to determine the extent to which it limits or facilitates the democratic reconstitution of the European Union; we also put forward concrete reform proposals to increase the democratic legitimacy of the European political order.

WP 7 aims at a crowded research area. Full libraries have been written on the political economy of the member states and of the European integration project. In particular, European integration was propelled by economic integration. The creation of a common market implied redrawing the economic boundaries of member states (more on this in the next section). *Vis-à-vis* third member states, it was clear from the beginning that the Communities aspired to become a single economic unit. In their mutual relationship, the common market programme implied redefining boundaries, by means of making them porous to the economic products and actors of all other member states, while the single market was expected to simply bulldoze all internal economic borders. Such transformations could not but have major direct and indirect effects on the European socio-economic configuration. Not only

⁵ *Ibid.*, at p. 20.

did embryonic supranational policies emerge in many different economic and social subfields, but national policies also became increasingly Europeanised, in the descriptive sense of being highly influenced not only and not mainly by supranational design, but also by the design (or lack of design) of all other national policies. As a consequence, the literature on the fiscal, tax, social and labour policies of the Union is broad and wide-ranging. Especially prominent is the legal literature on the four economic freedoms, the politico-scientific literature on supranational and Europeanised national social policies, and the politico-economic analysis of economic and monetary integration.

Still, RECON aims at filling a major gap in the literature of the political economy of the EU, namely that of a systemic and normatively conscious description and assessment of the socio-economic constitution of the Union. The very fragmentary and progressive dynamics of European integration has fed the latent tendency in socio-economic research, and in research in general, to specialisation. For that matter, literature on the political economy of the European Union tends to be narrowly specialised, resulting in a double disconnection. There is an uncoupling from other subfields dealing with other aspects of the socio-economic structure of the European political order. For example, the Europeanisation of national tax systems is considered as an autonomous problem, and barely any attention is paid to the structural changes brought about by the new interpretation of free movement of capital after the entry into force of the 1988 Directive⁶ and the resulting case law of the European Court of Justice. Still, such changes have severely undermined the effectiveness of the power to tax in the hands of states, and may have affected the shape of tax law more deeply than any direct legislative reform. Economic borders maintained through capital controls were fundamental in ensuring knowledge of income flows to national exchequers; now that such a basis is basically gone, tax evasion is more likely to go undetected. And then there is the second disconnection from the overall discussion on the legitimacy of power in the EU. In national public debates (clearly after the Second World War), it was assumed that the whole set of socio-economic policies did not constitute an autonomous subset of social problems, but were part and parcel of the overall political structure of the polity. However, such an

⁶ Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, OJ L 178, of 08/07/1988, at pp. 5-18.

assumption is rare in European socio-economic debates.⁷ And still, the interconnection is also present at the supranational level. Just consider that the amount of revenue levied through taxation determines the policy choices available when fixing the range of public goods to be delivered and funded at the European level, or to be defined at the European level and funded at the national level. This is so because a higher or lower capacity to implement tax decisions determines the level of funding for public programs (debt is only a short term alternative, as some member states are bound to rediscover pretty soon after the frenzy of expenditure which started in the autumn of 2008). This requires a simultaneous emphasis on the specificities of the constitutional norms governing each sector being studied, and on the analysis of the mutual interactions of such constitutional frameworks.

The key point made in the previous paragraph is, simply stated, that research under RECON is premised on the double reconnection of socio-economic questions. This results in three basic methodological choices (concerning empirical research, the focus on constitutional elements, the ambition to integrate findings in an interdisciplinary framework), which may be proper to spell out briefly in the following paragraph.

First, research in WP 7 is based on concrete and detailed empirical research, which motivates and explains the choice of a research team where different researchers focus on specific sub-projects. The interdisciplinary character of the research project (to which I return *infra*) entails that there are different understandings of what constitutes a proper object of empirical study and what methods are proper to undertake empirical research; lawyers focus on statutes and judicial rulings, and on the surrounding policy discourses, with a view to analyse how they reflect different elements of different models of the socio-economic European model; economists focus on raw statistical data; political scientists combine an analysis of raw data and interviews. But besides these disciplinary divergences lays the common purpose of transcending mere 'formal' analyses of the socio-economic configuration of the European Union in favour of substantively grounded and informed ones. Thus, for example, the analysis of the law governing the four economic freedoms, non-contractual liability of member states for breaches of Community law, or personal income tax is based on a

⁷ Such disconnection is reinforced by the very design of the European constitution, as we will see later in this chapter.

detailed analysis and reconstruction of each and every relevant judgment of the European Court of Justice which is attentive to the actual substantive and distributive implications of the rulings.

Second, research in WP 7 aims at clarifying the fundamental guiding principles of the socio-economic constitution of the European Union, or what is the same, the underlying ideological understanding of what is European socio-economic integration about, the institutional configuration and decision-making processes, and the means of social integration proper of the European socio-economic configuration. Focus on the constitutional dimension implies that the consideration of minute details is undertaken without losing sight of the 'larger' picture, increasing the chances that empirical research will be relevant to all members of WP 7 and of the research project in general.

Third, research in WP 7 takes seriously the political, legal and economic dimensions of the socio-economic configuration of the emerging European political community, and especially the mutual interconnections between these dimensions. Indeed, reconnecting socio-economic issues depends on taking seriously all disciplinary perspectives. In particular, the work package inscribes itself in the long-standing tradition of 'political economy',⁸ in the double sense of

⁸ The phrase 'political economy' is an ancient one, dating back to the seventeenth century, which has been used to design, censure and uphold rather different contents and approaches. Its core meaning refers to the description of the production and distribution of goods and services in a given society which highlights the role played the political, cultural and legal structures of that society. The original body of literature which was associated to the term has been the source of many of the ambivalences of the term. Smith or Ricardo were keen on describing the specific mechanisms which explained how a relatively unregulated and untamed economic structure could bring about generalised social welfare. However, they were not only very interested in the interrelation between philosophy, politics, law and economics, but actually contradicted the viability of a 'pure' approach to economics. Still, the alleged 'possessive individualism' that pervaded their thinking explains why Marx used the term as describing the 'system of bourgeois economy', and thus presented his work as a critique of political economy (and among other reasons, because 'liberal' political economy was too formalistic). On the terms of the debate and on the neo-classical shift of paradigm, it is entertaining to read J. K. Galbraith, *A History of Economics, The Past as Present*, Boston, Houghton and Mifflin, 1987. Not so dissimilar debates have developed more recently concerning the study of international relations, and the property and convenience of tying together political and economic analysis. The very development of International Political Economy as a field is the direct outcome and consequence. On IPE, see B. J. Cohen, *International Political Economy, An Intellectual History*, Princeton, Princeton University Press, 2008. The relatively recent triumph of econometricians, or what is the same, the full 'purification' of economic

focusing on the interplay between political decision-making, legal norms and economic activities; and in the sense of aiming at elucidating, exposing and criticizing the actual principles which constitute and govern the socio-economic structure of the European Union.⁹

Before concluding this section, it must be added that in line with the characterisation of the 'democratic deficit' question in RECON, WP 7 is designed on the assumption that the framework of the European socio-economic structure is amenable to democratic decision-making. This amounts to saying that the concrete configuration of the socio-economic structure of the European Union is not fully predetermined by forces beyond the reach of existing or potential political will. However, the refusal of 'determinism' does not entail the endorsement of a blind economic *voluntarism*. The democratic malleability of the socio-economic constitution is clearly compatible with the acceptance of the premise that the present shape of the socio-economic structure and the general social and political dynamics already unfolding determine the scope within which political choice is indeed possible, and the level of government at which decision-making can be both efficient and legitimate. Politics matters, democratic legitimacy matters, because there is room for meaningful and transformative choice based on arguments about what is just and correct to do. But the status quo, and the ways in which it has been reached, set limits to the choice of means of reform and to the actual outcomes which can be achieved through reform.

Application of the RECON models to WP 7

The research framework of WP 7 consists of the specification of the three RECON strategies to the socio-economic configuration of the European Union by means of considering how each model proposes the rearrangement of the relationship between the three key socio-economic institutions (markets, welfare systems and states) so as to increase the democratic legitimacy of the European Union; three analytical dimensions (and several subdimensions) together with the companion indicators corresponding to each RECON socio-economic model. This renders the three RECON models analytically powerful and normatively

analysis, through exclusive reliance on a set of – allegedly non-ideological – axioms and mathematical and statistical calculus to go along marks a contrast between the 'contextual' analysis of the economic reality and the 'autonomous' and 'pure' consideration which cuts across debates.

⁹ We thus follow an approach not dissimilar to J. Parkinson, A. Gamble and G. Kelly (eds) *The Political Economy of the Company*, Oxford, Hart, 2000.

salient when reconstructing and assessing the socio-economic structure of the European Union.

It may be pertinent to say as a preliminary side remark that the research framework assumes the justifiability of market (should one say capitalistic?) arrangements (or what is the same, the troika of private property rights on a sizeable part of the available economic resources, free exchange of such rights through contracts, and the availability of the legal vessel of the corporation as a means of both gathering capital and limiting the personal liability of shareholders). Quite obviously, this does not entail legitimising any market or capitalistic socio-economic configuration. It only implies accepting that market structures, given certain properties of the institutional configuration and/or of the actual distribution of resources, may be justified, or at the very least, provide the most plausible normative baseline by reference to which to consider the democratic legitimacy of the socio-economic configuration of the European Union.

Defining the three RECON model configurations in the politico-economic field

The specification of the three RECON models to the socio-economic field is undertaken by means of considering how each RECON model would require rearranging the relationships between the three key socio-economic institutions so as to ensure a higher democratic legitimacy to the European Union as a whole, such key socio-economic institutions being *markets* – through which economic resources are produced and allocated, as well as the ensuing economic risks; *welfare systems* – through which socio-economic entitlements to public resources are assigned, and socio-economic risks are thus placed in common; and public institutions or in short states – the institutional structure and collective decision-making processes which mediate the relationship between markets and welfare systems.

This results in a direct *translation* of each RECON conception to the socio-economic field, and the distinction of some variants relevant to WP 7.¹⁰

¹⁰ This distinction is not intended to put into question the triadic model of the general project, but only serves the purpose of fine-tuning the analytical capacities of the general conceptions to the specificities of the politico-economic field.

Renationalising the legitimacy basis of the socio-economic structure

The renationalising strategy claims that a democratically legitimate European Union would be one where a supranational community of economic risks (the single European market) is established and its legitimacy is anchored to national institutions and decision-making processes, which retain an exclusive competence to define the national welfare systems.

The combination of a supranational community of economic risks and a collection of national welfare systems is conceivable under two different sets of assumptions, which correspond to the two variants that we distinguish within the first RECON model when applied to the socio-economic configuration of the European Union.

First, it could be assumed that the legitimacy of the supranational regulatory framework of the single market as the European community of risks could be established by defining the supra-national institutional setup and decision-making processes in such a way as to ensure the aggregative nature of the European general will, or what is the same, that no European market-making norm could be contrary to the democratic will forged through the relevant national decision-making processes. Additionally, mechanisms of audit democracy at the supranational level could further guarantee that the actual implementation of the common supranational norms does not result in undermining the division of competences on which the European socio-economic settlement is based, and particularly the almost exclusive reserve of power to national institutions and decision-making processes on what concerns the regulation of welfare structures. The implicit assumption being that there is a clear structural difference between the legitimacy requirements of the norms regulating markets and welfare systems, as the background value consensus between member states at both the constitutional and legislative levels is markedly different concerning each institution (all member states share a basic commitment to a market structure based on the five fundamental economic freedoms – the four plus undistorted free competition – while there are wide differences in the values enshrined in the national welfare systems, and even more in the ways in which such values are institutionally operationalised). To the extent that supranational politics remains intergovernmental politics, it can be assumed that there would not be major challenges to the coherent steering of the relationship between a supranational community of economic risks and a set of national welfare

systems, given that national institutions and decision-making processes remain capable of influencing the shape of both.

Second, it could be assumed that the legitimacy of the supranational regulatory framework of the single market as the European community of risks is to be anchored to the *cognitive* superiority of the (non-political) institutions and decision-making processes assigned with the competence to define it. This implies a clear-cut distinction between the *regulatory* nature of market-making and the *political* nature of market-correcting norms. The transfer of *regulatory* powers concerning the definition and operation of markets to supranational institutions is not problematic from a democratic perspective, due to the very non-political nature of these competences. Indeed, the litmus-test of the legitimacy of regulatory institutions and decision-making process is not the extent to which it reflects the *general will* (as proper of democratic government), but the *best judgment* (as a superior governance mechanism). The latter depends on the institutional ability to collect and apply specialised technical knowledge to the institutional definition and operation of markets. The advocates of a regulatory characterisation of the European Union tend to claim that only at the national level we find the proper institutional setup, decision-making processes and substantive means of social integration required for guaranteeing the democratic legitimacy of welfare arrangements. The proper national political steering of welfare institutions render easier, not more difficult, by the creation of supranational regulatory institutions, to the extent that the latter are capable of providing a better regulation of markets. Consequently, the democratic legitimacy basis of the European socio-economic configuration is to be anchored to the (nationally established) democratic legitimacy of welfare systems.

Federalising the legitimacy basis of the socio-economic structure

The federalising strategy claims that the Europeanisation of markets as communities of economic risk should proceed hand in hand with both the Europeanisation of welfare systems and of state structures for highly interrelated normative and functional reasons. Firstly, even if it is possible to draw a clear analytical line between markets and welfare systems, between market-making and market-correcting norms, both sets of norms are so intertwined that it is at best fuzzy in functional terms, and irrelevant from a normative perspective. Secondly, a supranational market distributing economic risks and opportunities among European citizens cannot be neither normatively justified nor

functionally stabilised (among other reasons, precisely because of its lack of normative legitimacy) unless there is an overlap between the community of economic risks, the scope of insurance arrangements and the community of citizens. There is thus a need for forging a common general European will governing the definition of both communities of economic risk and of communities of insurance.

The federalising strategy is compatible with two structurally similar but substantively antithetic conceptions. Firstly, the federalising strategy is supported by those who claim that the legitimacy of the socio-economic structure requires a wide range of insurance arrangements because the legitimacy of markets cannot be ensured without major countervailing provisions of public goods and services and the redistribution of economic resources (the market is not the source of its own legitimacy but can only be legitimate if embedded in strong welfare institutions). Given that redistributive tasks correcting market allocations need to be partly discharged at the higher level of government to ensure the equality of all members of the political community, then federalising should result in the sharing of such powers among different levels of government (including the supranational one), and shielding the transfer of structural powers to non-political decision-making processes.

Secondly, the federalising strategy is also supported by those who argue that the legitimacy of the basic socio-economic institutions depends on the proper limitation of political power by a robust acknowledgment of the right to private autonomy. Given that such affirmation can only be effective at the supranational level, there is a strong case for affirming negative supranational constitutional principles limiting the power of national public institutions. Federalising results in the limitation of national discretion to limit the right to private property an embodiment of the right to private autonomy.

Table 1.1: Application of RECON conceptions to the political economy of the European Union

RECON general strategy	Political economy specific strategy	Variation A	Variation B
Renationalisation of democratic decision-making	Europeanisation of the community of economic risks (single market)	<i>Indirect Democratic Legitimacy Variant:</i> Supranational institutional structure and decision-making processes as transmission belts of national democratic legitimacy; competences basically limited to market making; plus audit democracy mechanisms that further guarantee the terms of the European socio-economic settlement	<i>Governance Variant:</i> Clear-cut Division of Competences (market-making vs. market-correcting) and establishment of governance procedures capable of collecting and applying technical knowledge to the first set of tasks, plus supranational audit democracy mechanisms ensuring that governance institutions remain agents in accordance with their mandates
Federalising strategy	Europeanisation of markets, welfare systems and states	<i>Supranational Constitutional Distributive Justice:</i> Establishing supranational insurance arrangements capable of ensuring the legitimacy of supranational markets	<i>Supranational Constitutionalism:</i> Establishing constitutional limits to political power at the supranational level, and structurally empowering non-political decision-making processes
Cosmopolitan strategy	Europeanisation of bits and pieces of markets and welfare systems governed by the aggregation of reflexive national political processes or by smart multi-level governance arrangements		

Towards a post-national and cosmopolitan basis of the legitimacy basis of the socio-economic configuration

The cosmopolitan strategy claims that the Europeanisation of economic risks and of insurance arrangements can proceed without the need of fully Europeanising the decision-making processes, or what is the same, that the progressive supranational opening of national communities of economic risk and of insurance can be launched and governed without having to resort to processes of formation of a general European democratic will that necessarily results in the creation of a multinational federation. Opening national economies and national welfare states without fusing them can be done by means of defining a general European will alternative to the mere aggregation of general wills or the full-blown articulation of an autonomous European general will unmediated by national political processes. This 'alternative' general will results from process aimed at making mutually compatible national general wills (by means of ensuring that they are attuned to certain substantive principles, such as the principle of non-discrimination on the basis of nationality, reflecting the existence of relevant interests beyond those articulated through national political processes; or by creating procedural devices through which they can be reflexive of interests expressed in other national political arenas) or by means of creating new, non-hierarchical collective decision-making processes (such as supranational governance arrangements which have the integrative capabilities required without impinging upon the pluralistic character of a cosmopolitan European Union).

The three analytical dimensions

Three dimensions should be considered: ideology of European socio-economic integration (which, in WP 7, necessarily refers to the 'single market'); institutional configuration, including institutional embedding; type and range of decision-making procedures; type and range of policy instruments; and the final dimension of social stabilising factors that integrate the socio-economic structure

Ideology of European socio-economic integration

It is well known that the key means through which European integration has proceeded has indeed been economic integration. In particular, the three founding Treaties of the European Communities set as their purpose the creation of common markets through the establishment of a set institutional structures, of decision-making procedures, and of supranational public policies, with a view to realise the four fundamental

economic liberties (plus free and undistorted competition) *and* the set of objectives described in Articles 2 and 3 TEC. Not by chance the shorthand by which the European institutional framework was known until relatively recently was the ‘common market’; and not by chance most legal and political analysis has tended to concentrate on the economic aspects of the process of integration.

Still, there are rather contrasting conceptions of what is the actual purpose of socio-economic integration. It seems to us that the ideology of European socio-economic integration is characterised by reference to two sub-dimensions: firstly, whether and to what extent socio-economic integration concerns the removal of all national economic borders (which moves in the continuum from a fully integrated and open socio-economic structure, which would not even have external borders vis-à-vis third countries); secondly, whether and to what extent the economic system is to be regarded as an autonomous social system, or as part of the general social and political order (which moves in the continuum from a self-regulating economic system to a fully embedded economic system, with a middle step consisting in the need of establishing a fixed regulatory framework within which market forces should be left to operate autonomously).

Table 1.2: The ideology of socio-economic integration

	Reconfiguring national socio-economic borders	Partial deletion of national socio-economic borders	No national socio-economic borders
Autonomous economic system			Neoliberal single market
Regulated economic system		Regulatory common market	
Embedded socio-economic system	Liberal common market	Cosmopolitan socio-economic structure	Supranational social <i>Rechtsstaat</i>

The relationship between the economic system and the overall socio-economic configuration of society

The characterisation of the economic system as *an autonomous social system* assumes that the founding Treaties of the Communities did enshrine a transcendental definition of the ‘single market’, the validity of which is a precondition of democratic legitimacy, and not the reverse

(indeed, the normative force of the five economic freedoms would not derive from their being enshrined in the Treaties; the opposite would indeed be more plausible, namely, that the legitimacy of the Treaties stems from the fact that they actually enshrine the four fundamental economic freedoms). The 'self-contained' conception of the common market indeed amounts to an updated version of Lockean constitutionalism, with the five economic freedoms playing the role assigned to the right to private property in the original version of the theory. Thus, the five economic freedoms would be the necessary guarantees of private autonomy, and consequently, of the sheltering of individuals from any kind of coercion or force other than the one deriving from the limited character of economic resources and the actual cost of life plans. As a consequence, this conception firstly stresses too much the role as yardsticks of European constitutionality of economic liberties, together with civic fundamental rights, while rendering relative the fundamental status of both political rights and especially of socio-economic, welfare rights (which should be subject to a very close scrutiny when reviewing their European constitutionality); secondly, it presents fundamental economic freedoms as transcendental values, whose actual definition should not be subordinated to national constitutional standards, but be directly derived from an ideal conception of an undistorted market; Treaty provisions should be constructed by reference thus to a normative ideal of an autonomous single market, not by reference to positive constitutional standards (not even the literal tenor of the Treaty provisions). And finally, it is associated with 'negative' integration, that is, with the active review of 'European constitutionality' of national (and also supranational) norms that set limits to economic liberties.

The 'embedded' conception of economic integration presupposes that the economic sphere is but a part of the overall social order; very critically, its legitimacy cannot be established by exclusive reference to its substantive traits, but depends on the legitimacy of the political order (thus the idea of 'embeddedness'). Hence, setting economic integration as the key means of European integration necessarily implies a program of transformation which goes beyond economic regulations, and necessarily covers those aspects of social and political regulation which are part and parcel of the legitimacy framework of the economic order as a whole. Consequently, economic integration aiming at the creation of an embedded internal European market rings a chord with liberal, social-democratic political theories. As a consequence, this conception

stresses the equal constitutional standing of civic, political and socio-economic (welfare rights), and affirms that the proper weighing and balancing of rights when in conflict is first and foremostly to aim at the full realisation of equal political freedom. The conception also presents fundamental economic freedoms as values to be shaped and determined by reference to the overall canon of constitutionality, and whose constitutional weight depends on the extent to which they operationalise specific civic, political and socio-economic fundamental rights (otherwise, their constitutional weight being less than that assigned to fundamental rights *proper*). In addition, the conception emphasises the key role played by 'positive integration' in the actual realisation of the constitutional principles which frame the operation of the economic system. Finally, it highlights the key importance of temporary and exceptional measures to shelter the fabric of the socio-economic order from dangerous stress in the phases of adaptation.

The 'regulatory' conception of economic integration affirms the relative autonomy of the economic system. It is relative because it presupposes the existence of a set of rules creating the basic institutional structure of the economic system (such as private property rights, contracts or companies) which the economic system itself cannot produce by itself (thus not being self-regulating); however, it affirms that once the regulatory framework is in place, it should not be altered or transformed, but at most interstitially fine-tuned, and that such a task should be trusted to *independent regulatory agencies*, whose institutional structure guarantees that regulation aims at the realisation of goals within an adequate time span, sheltered from the vagaries of representative politics.

European economic integration and national economic borders

The socio-economic powers, characteristically exercised by modern nation-states (regulation, taxation, redistribution, macro-economic management), presuppose a close correlation between state capabilities and the creation and maintenance of economic borders, or what is the same, of limits to the flow of goods, services, capital and persons across borders. Economic borders play an essential role in providing public authorities with the cognitive basis and the coercive capacities necessary to ensure the effectiveness of the political and legal steering of the socio-economic structure. Borders may be drawn, maintained and policed by means of limiting cross-border economic activity, or alternatively, by creating the means for public institutions to have full knowledge of the

economic implications of such activities (and thus of the economic ability to pay related to cross-border economic activities). The affirmation of economic integration as the main means of European integration left rather open the question of what effect and impact integration was supposed to have on national economic borders, with two outstanding and contrasting extreme options.

European integration could require the elimination of national economic borders, and thus lead to the creation of a complete internal market, which would result, either through positive integration or through regulatory and tax competition, in the emergence of a single European socio-economic configuration. If that was the case, all national norms which place an obstacle on the movement of goods, services, capital or persons across borders should be immediately regarded as *prima facie* contrary to European constitutional law, and only be justified if they can be proven to further a supranational goal (not if they aim at the realisation at the national scale of a national constitutional principle).

Alternatively, it could be argued that European integration would only call for the reconfiguration of national economic borders, so as to ensure that all citizens of member states of the European Union receive equal treatment in each and every Member State. This would result in the putting in common of all national economic systems, without the immediate emergence of a single economic system in the Union. If that was the case, European integration would render suspect two sets of national norms. First, those who aim exclusively at keeping non-national economic actors, products or factors of production away from the national economic system, or what is the same, the standard protectionist mechanisms of customs duties and quantitative restrictions. Second, those who, while aiming at a meaningful policy objective other than keeping non-nationals out, exclude the application of the legal regime applicable to nationals to non-nationals, or in other words, that discriminate against citizens of another member states on account of their nationality.

Between these two options, one could find the characterisation of European integration as aiming at piece-meal integration, resulting in different degrees and types of integration depending on whether we are considering goods, services, capital or persons (or different types of goods, services, capitals and persons) or even which territories or time periods we are referring to. This results in a panoply of legal and

economic regimes to be governed through ad hoc institutional structures and defined through differentiated legal regimes.

Combining the two axes

These results in a grid with nine potential conceptions of the ideology of European integration, five of which are easily identifiable to the different conceptions of the European socio-economic configuration described in the previous section.

The intergovernmental model favours a 'Liberal Common Market' defined by the reconfiguration of national economic borders (which need to be preserved to make sense of the national exclusive power over welfare systems) with the characterisation of the resulting European economic system as one embedded in national welfare systems. The governance model favours a 'Regulatory Common Market', premised on the reconfiguration of national economic borders (which cannot be eliminated without putting in peril the legitimation ground provided by national political decision-making over welfare systems) with the characterisation of the European economic system as a partially autonomous one (with the regulatory task being entrusted to supranational administrative structures). The social-democratic federal model supports the construction of a European *Social Rechtsstaat*, characterised by the complete removal of national economic borders and the full embedding of emerging single supra-national market in the supranational socio-economic configuration. The neo-liberal federal model supports the complete removal of national economic borders and the characterisation of the supranational economic order as an autonomous and self-stabilising and regulating one. Finally, the cosmopolitan model supports a partial and variable deletion of economic borders, leading to the embedding of the peculiar resulting supranational economic system (see Table 1.3).

Two final comments. First, the complex character of the European political order renders it possible to claim that 'economic integration' at the national level must be structured around the embedding of market institutions, while at the supranational level the only option is to establish a 'self-contained' market. One line of defence of such a position could be that the 'embedding' of the market calls for a decision-making process capable of producing democratic legitimacy which would be simply not available at the supranational level. It still remains to be seen whether the inner logic of a supranational self-contained market not will

render it impossible to sustain the 'embedded' market at the national level. Second, the fact that research is being conducted by reference to specific sub-policy fields entails that it is relevant to consider discourses concerning the ideology of each policy field, as either being autonomous or being aimed at wider socio-economic or political goals.

Institutional configuration

The second analytical dimension corresponds to the institutional configuration of the European Union, and comprises (a) the allocation and exercise of powers over the socio-economic structure of the Union (how they are allocated, to which institutions and/or decision-making process, and what grounds justify the assignment of competences to supranational institutions and decision-making processes); (b) the supranational institutional setup on socio-economic matters (its nature, the actors involved, the actors which are given preeminence in decision-making processes, and the principles governing relationships between institutions within and especially across different levels of government); (c) the structure of supranational decision-making processes (including the purpose of setting up supranational decision-making processes, and the actual configuration of decision-making processes along normative levels - constitutional, legal and statutory - and along stages of the process - initiative, policy shaping, formal decision-making, monitoring of implementation, feedback); (d) the policy instruments which carry supranational decisions on socio-economic matters (including the type of common action norm: hard law, soft law, international agreements) and the degree of institutional robustness of the supra-national socio-economic normative framework (low, medium, high).

Allocation and exercise of powers over the socio-economic structure of the European Union

The *intergovernmental model* is characterised by the assignment of a limited set of intergovernmentally negotiated competences over the European economic system to supranational institutions. This is grounded on the assumption that supranational action is only justified as a means of overcoming the erosion of the effectiveness of national capabilities. It is translated into constitutional language through the affirmation of residual national powers and the primacy of national constitutional norms over conflicting Community norms.

The *regulatory governance model* is defined by the assignment of constitutionally limited and specified powers over the European

Table 1.3: The four institutional analytical subdimensions

<p>Allocation and exercise of powers</p>	<p>How are competences allocated (international agreement, constitution, ad hoc negotiation)?</p> <p>Who does what on socio-economic matters (who defines markets, who defines welfare systems)?</p> <p>What justifies the exercise of powers through supranational decision-making processes? (Making good for lost state capabilities, insulating decision-making from political decision-making –in the name of efficiency and stability, or in the name of private autonomy-, full realisation of socio-economic principles at the right level of government, ensuring the universalisability of socio-economic decisions)</p>
<p>Institutional setup</p>	<p>What kind of supranational institutional framework (universal, agent –political or regulatory-, facilitator)?</p> <p>Which actors are involved (institutional, non-institutional, non-EU actors)?</p> <p>Which is the preeminent supranational institution on socio-economic matters (Council, Commission, European Parliament, European Court of Justice)?</p> <p>Which are the principles governing relationships between institutional actors across and within levels of government (comity, loyalty, specialisation, competition, partnership)?</p>
<p>Decision-making processes</p>	<p>What is the purpose of deciding at the supranational level (proper transmission of legitimacy, either directly or indirectly; cognitive superiority of supranational regulators and experts, substantive superiority of supranational constitutional standards, reconciling collective interests at different levels of government)?</p> <p>Who decides on the different constitutional levels of decision-making (constitutional, statutory, implementation, adjudication)?</p> <p>Who decides what on different stages of the decision-making process (initiative, policy-shaping, formal decision-making, monitoring of implementation, feedback)?</p>
<p>Policy instruments</p>	<p>Types of Supranational Common Action Norms (hard law, soft law, international agreements)</p> <p>Degree of Institutional Robustness of the supranational socio-economic normative framework (low, medium, high)</p>

economic system to supranational regulatory institutions. This corresponds to the assumption that the proper discharge of such regulatory tasks requires delegation to agents insulated from the vagaries of the political process, and that a supranational delegation is best placed to ensure that regulators are capable of gathering and applying the best 'technocratic' knowledge. This implies a primacy of supranational regulatory norms, based on its 'specialised' character, which also implies that such primacy has a narrow and limited breadth and scope.

The *constitutional federal model* presumes the need of assigning universal competences over the socio-economic structure of the Union to supranational institutions and decision-making processes, as defined and specified in supranational (and democratic) constitutional law. This is necessary to create regulatory, redistributive and macro-management capacities at the supranational level so that supranational markets can be regulated and corrected. This translates into a democratic discipline of powers, which favours solving competence conflicts by reference to the principle of proportionality, and which assigns residual primacy to Community norms when conflicting with any national norm whatsoever.

The *neoliberal federal model* assumes a clear-cut division of positive and negative competences over the socio-economic structure. The legitimacy of the supranational level deriving from the constitutional entrenchment of private autonomy and fundamental economic freedoms, the main socio-economic powers assigned to it are of a negative character, aimed at ensuring the discipline of the exercise of public power across all levels of government. The supranational constitutional discipline of power over the European socio-economic configuration is essentially negative on what concerns public power, and this results in the opening up of large spaces where 'societal subsidiarity' is realised (implying a 'devolution' of socio-economic power to non-public decision-making processes, for example those governed by the money medium).

The *cosmopolitan post-national model* is based on a flexible and variable allocation of competences on socio-economic matters. The justification of action at the supranational level being grounded on the need of increasing the chances of universalisable socio-economic regimes, the wide range of interests and actors renders unavoidable a definition of competences according to a rather variable geometry.

Institutional setup

The intergovernmental model is premised on the characterisation of the institutional setup of the European Union as a complex political agent of member states. Supranational decision-making involves exclusively institutional actors ('intergovernmental'), which are expected to show comity towards each other, and engage into cooperative relations. The key institution in the supranational institutional setup is the Council, as carrier of the democratically legitimated expressions of the national interest.

The regulatory governance model assumes that the institutional setup of the European Union is a complex supranational regulatory agency that aims at discharging the tasks it has been assigned by its principals. Supranational decision-making should involve not only institutional actors, but also all relevant stakeholders; relationships between institutions across levels should be based on the principal/ agent model, with a clear-cut division of tasks and allocation of responsibilities. The key supranational institutional actor are the Commission, which plays a role similar to that of a supranational agency on what concerns the single internal market, and the specialised regulatory agencies, with the European Central Bank as the most outstanding one.

The constitutional federal model characterises the institutional setup of the European Union as a full-blown multinational federation with 'universal' competences on socio-economic matters. Supranational decision-making should involve mainly and paramountly institutional actors (which should remain open to be influenced by larger communicative processes in civil society), which should interact according to the principle of constitutional loyalty, thus assuming that they should cater for the supranational public interest, and not only for a narrow national or regional public interest. The key supranational institution is the European Parliament, as capable of forging directly democratically legitimated common action norms.

The neoliberal federal model portrays the institutional setup of the European Union as part of the limited and limiting government of a federation of states with limited governments. Supranational decision-making should be as far as possible devolved to non-public institutions and actors ('social' subsidiarity), who should be legally empowered to trigger reviews of the constitutionality of all forms of legislative action. Public institutions should engage into a competitive market of public

regulation. The key supranational institution under this characterisation of the EU is the European Court of Justice, as both ultimate interpreter of negative constitutional principles, and as addressee of individual claims concerning the constitutionality of specific legal norms.

The cosmopolitan post-national model defines the institutional setup of the European Union as a system of multilevel governance. Such a system should be led by institutional actors, but be open to the participation of all kind of actors, including non-Community ones. Relationships between participants should be based on the principle of ad hoc partnerships. The flexible and dynamic character of the institutional setup does not render possible to determine the key or determinant institution.

Decision-making processes

The sub-dimension of decision-making processes should deal with three aspects of the European institutional configuration, namely a) the identification of the overarching principle governing supra-national decision-making; b) the configuration of decision-making along normative lines (how is constitutional, legal and regulatory power actually exercised on those matters within the powers of supranational institutions); c) the configuration of decision-making along stage lines (how is the power of initiative, of policy shaping, of formal decision-making, of monitoring and of regulatory feedback actually exercised). The actual characterisation of this sub-dimension is to be postponed until representative empirical research is available from different partners.¹¹

Policy instruments

The intergovernmental model is based on the combination of a Treaty based framework with secondary Community hard law instruments (regulations and directives) concerning the European economic structure, as a means of mutual ensuring against default. To the extent that supranational decisions affect welfare systems, the intergovernmental model comes hand in hand with a preference for directives, or even for non-binding legal instruments, such as

¹¹ An analysis of the allocation supranational tax decision-making processes can be found in A. J. Menéndez, 'Reconstituting Democratic Taxation in Europe: The Conceptual Framework', RECON Online Working Paper 2008/15, Oslo: ARENA. Available at: <http://www.reconproject.eu/main.php/RECON_wp_0815.pdf?fileitem=545640>.

recommendations. This entails a variable degree of institutional robustness: high on economic matters (hard law supported by the compulsory jurisdiction of the European Court of Justice) and low on welfare matters (with hard law mediated by national decision-making processes and a limited role for the European Court of Justice given the exclusive competences of member states).

The *regulatory governance model* is based on the combination of a Treaty based framework through which the constitutional mandates of supranational institutions is established and of hard, but merely regulatory law, produced by supranational institutions in their regulatory role; it may be open to the use of soft law mechanisms on what concerns welfare systems. This implies a high degree of institutional robustness on market-making, and no institutionalisation of supranational decisions on welfare systems.

The *constitutional federal model* is based on the combination of a federal constitution and hard law instruments through which supranational socio-economic powers are exercised. This implies a high degree of institutional robustness all across the socio-economic board.

The *neoliberal federal model* is based on the combination of a federal constitution which severely limits the scope of statutes and statutory regulations affecting the shape and structure of the supranational economic structure. Instead, the legal instrument of choice to specify the constitutional framework is the ad hoc, case-based judicial ruling. This implies a high but negative institutional robustness all across the socio-economic board.

The *post-national cosmopolitan model* does clearly lean towards the use of soft-law mechanisms through which alternative formulations of a supranational collective will can be established, and which keep open a variable set of actors and a variable geometry of objective and subjective binding character. This results in a low degree of institutional robustness.

European socio-economic integration and the stability of the socio-economic order

The third analytical dimension concerns the means of socio-economic integration in the European Union. Smooth conflict-solving and coordination of collective action on what concerns the production, allocation and distribution of economic resources is especially problematic given the immediate connection of the socio-economic configuration of any political community to the *who gets what, when and how* question (to paraphrase behavioural political science); the obvious and immediate relevance of substantive resources when considering the socio-economic structure places under major stress any social integrative mechanism. The importance of this dimension is extremely high for democratic institutions, given that they rely on a massive degree on spontaneous compliance and self-application of socio-economic legal norms on the side of citizens.¹² In the case of the European Union, socio-economic integration is especially problematic, given the mismatch between the huge regulatory powers of the Union and the very limited amount of resources at the direct disposal of supranational institutions, which result in an extremely limited capacity to transfer economic resources directly to citizens.

There are two relevant sub-dimensions to be considered here, namely (1) which is the main mechanism of social integration; it is possible to distinguish self-interest, thick communitarian ideal and welfare programs of redistribution of economic resources as alternatives; and (2) which is the unit of social integration, the two main options being states

¹² Socio-economic institutions in democratic systems are all designed assuming that citizens will massively comply in a spontaneous manner with the obligations specified by the legal framework. That is not necessarily the case in non-democratic political systems. The modern income tax and modern means-tested welfare benefits can only subsist when citizens are willing to offer an honest assessment of their economic means. On the correlation between democracy and the income tax, see E. R. A. Seligman, *The Income Tax: A Study of the History, Theory and Practice of Income Taxation at Home and Abroad*, New York, MacMillan, 1911. At the same time, it has been observed once and again that the fact that most citizens are willing to comply with their tax obligations without being forced to do so explains why democracies can impose not only higher tax burdens but also why the criteria for allocation of taxes can be more complex and sophisticated. On this, see D. C. North, *Institutions, Institutional Change and Economic Performance*, Cambridge, Cambridge University Press, 1990, especially chapter 6. This explains the factual convergence between the tax systems of democratic states. See S. Steinmo, *Taxation and democracy: Swedish, British, and American approaches to financing the modern state*, New Haven, Yale University Press, 1993.

Table 1.4: Socio-economic integration

	Spontaneous integration through vested self-interest	Appeal to a communitarian identity	Welfare programs which cover basic socio-economic risks and ensure a certain equality of economic resources
Individual socio-economic integration	Neoliberal Federal Model (may accept welfare expenditure in the form of flat minimum income)	Constitutional Federal Model	
Socio-economic integration among states			Intergovernmental Model (taxes and expenditures calculated by reference to national, not individual wealth)
No socio-economic integration at the european level			Governance Model

Note: It is unclear how the cosmopolitan and post-national model will structure European socio-economic integration

or individuals; this entails different yardsticks with the help of which to measure socio-economic obligations.

The *intergovernmental model* will favour mechanisms of social integration with member states as units of European socio-economic integration; this entails that both the collection of supranational revenue, and its expenditure, will be calculated by reference to indicators of national, not individual wealth. Given that all member states are social *Rechtsstaats* with levels of taxation and public expenditure at the high end of the OECD (with a couple of exceptions among the new member states), the intergovernmental model tends to be premised on the need of ensuring social integration through formal equality before the legal order and welfare programs of redistribution of economic resources.

The *regulatory governance model* affirms that there is no other European socio-economic integration but that resulting from the aggregation of all national mechanisms of socio-economic integration. Assuming, as the intergovernmental model, that all member states are social *Rechtsstaats* where welfare benefits are key mechanism of social integration, democratic legitimacy requires that national democratic processes remain exclusively competent to determine the breadth and scope of such welfare programs.

The *constitutional federal model* is prone to consider the individual as the main if not exclusive unit of European socio-economic integration (along with programs focusing on the individual, there could well be programs focusing on regions or even states), and to sustain that welfare and redistributive programs should be the key mechanism of European socio-economic integration, ensuring the (partial or complete) putting in common of certain economic risks, and a minimum degree of access to economic resources to all citizens. However, the constitutional federal model could also stress the need of developing some form of communitarian identity, supportive of the willingness to sacrifice personal economic gains for the sake of other members of the community, with which one shares a common identity.

The *neoliberal federal model* defends the individual as the main unit of European socio-economic integration, and defends that, beyond the eventual guarantee of a minimum income, socio-economic integration is best ensured by a constitutional and legal framework which ensures equal opportunities to all members of the political community. This

provides benefits to all citizens, which in their own self-interest should be prone to support the reproduction of that society.

The *cosmopolitan model* will support a variable range of units of European socio-economic integration; it will be supportive of a variable set of welfare programs, characterised by defining entitlement in inclusive terms (extending even to non-European citizens) and in context-sensitive ways, which render the level of benefits dependent on the concrete terms according to which the program is defined in personal and spatial terms.

The federal structure of the European political order introduces a higher degree of complexity, given that it is possible to claim either that all subsystems are stabilised by the same form or by different types of collective identity. In particular, it is frequently argued that while the national tax subsystems are stabilised by a civic or a communitarian collective identity, which goes hand in hand with contemplating robust tasks for such subsystems, the supranational tax subsystem is exclusively stabilised by an interest-based identity.

Three specific research questions

In addition to the general 'overarching' themes stemming from the general design of RECON, WP 7 aims at contributing to answering three 'specific' cross-cutting research questions, concerning (1) the nature of the so-called 'social deficit of the European Union; (2) the democratic implications of the division of socio-economic competences between the European Union, its member states and the European regions; (3) the preconditions for effective and lasting democratisation of the institutional setup and decision-making process in the socio-economic sphere.

First, WP 7 aims at elucidating the actual nature of the so-called 'social deficit', a vague notion which refers to the deficiencies in the constitution of the European socio-economic order which hamper the democratic legitimacy of the European Union. While there is almost perfect consensus on the existence of a 'social deficit' of the European Union, the remedies proposed to overcome it are so disparate that they betray the lack of a clear diagnosis of the problem. By means of reconstructing and assessing the actual institutional set up and decision-making processes through which socio-economic decisions are taken, the work package will establish which of the two definitions of the

'social deficit' is more adequate, or the extent to which each one captures a part of the actual legitimacy equation of the European Union. These two theses are: (1) whether there is a substantive 'social deficit' of the European Union, the source of which will be the specific principles governing the socio-economic constitution of the Union, which would require the actual change (whether democratic or not) of the said principles (by, for example, reducing the weight assigned to economic freedoms when in conflict with wider collective goods or policies); and (2) whether the 'social deficit' is but a concrete manifestation of the wider democratic legitimacy problems of the European Union, and in particular, results from the lack of consistency in the institutional setup and decision-making processes governing market-making and market-correcting decisions (in which case, the correction of the 'social deficit' of the European Union is but one concrete aspect of the general democratic legitimacy problems of the Union). In other terms, the reconstruction and assessment of the institutional set up and the decision-making process of the Union can clarify to what extent the 'social deficit' is a matter of the substance of constitutional norms governing the European socio-economic structure, or of the procedure through which such norms are decided upon; and what is the relationship between the two. This key question is, as we will see, related to the first analytical dimension described below (ideology of socio-economic integration).

Second, WP 7 will consider whether the democratic legitimacy of the national level of government only can derive from the assignment of exclusive competence over a number of competences, said to be essential to preserve both the 'constitutional identity' of each Member State, and the 'vibrancy' and 'relevance' of national decision-making processes; or whether it is closely dependent on the overall legitimacy of the European political order. The partial reconstruction of the actors and processes through which some socio-economic decisions are taken, which was undertaken in CIDEL¹³, revealed a degree of Europeanisation of powers far beyond what is assumed by such theories, and which requires the thorough reconsideration of the democratic implications of divisions of powers among levels of government without unsupported assumptions about which of those are critical for the maintenance of democratic politics at all levels of government. In particular, the work

¹³ CIDEL – Citizenship and Democratic Legitimacy in the EU – a 3-years (2003-2005) joint research project with ten partners in six European countries, funded by the European Commission's Fifth Framework Programme for Research.

package will aim at determining what degrees and levels of Europeanisation of the institutional set-up and the decision-making process of each policy field are sufficient and required to reconstitute European democracy, thus being compatible with the overall democratic legitimacy of the Union at all its levels of government. Furthermore, WP 7 aims at examining what the interrelationships across policy fields are. In particular, are there specific configurations which are incompatible with the democratic legitimacy of the Union as a whole? Can democratic legitimacy be achieved if a very different institutional set up and decision-making processes are applied to the constitution of socio-economic relationships (market-making) and to the rectification of distributional outcomes in order to realise specific social goals (of social justice, to ensure a certain pattern of distribution of economic resources)? Related to this, WP 7 aims at determining whether the way in which the socio-economic configuration of the European Union is conceived has an influence upon the way in which public institutions are characterised, and thus, on the very principles which govern public action, and consequently, affect the legitimacy equation of the European political order. In particular, research will test the democratic effects of alternatively public action informed by the principle of mutual cooperation between institutions and mutual complementary relationship between policies and public action informed by the principle of regulatory competition and selection of policies by reference to their autonomous financial viability. These two closely related questions will be answered by considering the elements falling under the second analytical dimension of the research project (the institutional structure of the European socio-economic configuration).

Third, WP 7 aims at determining whether European integration can be stable in the absence of major institutional and decision-making reforms, given that the persistence of democratic shortcomings of the Union might end up of undermining the stability of the European political order. This question, however, must be complemented with the reverse one, namely, whether major constitutional reforms of the European political order can be undertaken in the absence of stabilising procedures and outcomes which establish the necessary preconditions for the social acceptance of such transformations. In particular, focus on taxation, labour and social policies will lead to the critical consideration of the stabilising role played by mutual interest, civic commitment and pre-political membership, and the extent to which such stabilising factors can be mobilised in favour of European constitutional reform.

Table 1.5: Summary of analytical dimensions and indicators for the Renationalising variant 1: *Intergovernmentalism*

Ideology of socio-economic integration	Institutional configuration of the socio-economic structure of the European Union	Mechanisms of European socio-economic integration
	Allocation and exercise of Powers	Policy instruments
The liberal common Market	Intergovernmentally negotiated division of competences	Supranational political agents of national institutions
Intergovernmental market integration coupled with autonomous national welfare systems	Democratic hierarchy a) All powers to member states unless explicitly said something else (residual national powers) b) Primacy of National Norms	European decision-making process should ensure the transmission of national democratic legitimacy to European legal norms (classical Community method)
Economic freedoms as operationalisation of the principle of non-discrimination on the basis of nationality (review of national norms which exclude European citizens from rights granted to nationals)	Constitutional Norms over Supranational norms Action at supranational level justified as a means of overcoming the insufficient regulatory, taxing and macro-managing capacities of member states	Hard law, with preference for directives or recommendations on what concerns welfare systems High degree of institutional robustness on markets; low degree of institutional robustness on welfare systems
	Key role assigned to the Council as main transmission belt of national general wills Collaboration between institutions across different levels of government (comity)	European budget financed by national direct contributions (absence of genuinely European taxes) European expenditure levels calculated by reference to national contributions or national wealth (absence of individual entitlements)

Table 1.6: Summary of analytical dimensions and indicators for the Renationalising variant 2: Governance

Ideology of socio-economic integration	Institutional configuration of the socio-economic structure of the EU			Mechanisms of European socio-economic integration
	Allocation and exercise of powers	Institutional setup	Decision-making processes	
The single market through common regulation	Treaty-based rigid and clear-cut division of competences which includes specific mandates to supranational institutions	Supranational institutions as parts of a complex supranational regulatory agency or as means ensuring that principals (member states) can review compliance of the agent with the mandate	European decision-making processes confined to regulatory matters on economic issues	Denial of the relevance of mechanisms of supranational socio-economic integration
Regulatory market integration which stops at meddling with national welfare systems	Limited powers to European institutions based on constitutional mandate		High degree of institutional robustness on markets; No institutionalisation of common decisions on welfare systems	European budget limited to the operative cost of European institutions
Economic freedoms as limits to political intervention in the operation of markets (review of national laws aimed at protecting public interest in efficient regulation that maximises social welfare, not so much private autonomy)	Primacy of supranational norms based on their 'speciality' (and thus not extending to primacy over national constitutional norms)	Supranational decision-making involves institutional actors working in tandem with stakeholders		No European taxes (but for those with purely regulatory purposes or exclusively aimed at recouping the costs of running European institutions)
	Action at supranational level justified as a means of ensuring a stable and decision-making process for issues which require stability that politically influenced decision-making cannot offer ('depoliticisation' of economic regulation)	Preeminence of Commission and specialised agencies		No European expenditures aimed at individual persons

Table 1.7: Summary of analytical dimensions and indicators for the Federalising variant 1: *Deliberative constitutional politics*

Ideology of socio-economic integration	Institutional configuration of the socio-economic structure of the EU			Mechanisms of European socio-economic integration
	Allocation and exercise of powers	Institutional setup	Decision-making processes	
The supranational social rechtsstaat	Constitutionally established division of competences	Supranational institutions as part of a full-blown multinational federation with 'universal' political competences	European decision-making processes aimed at forging the European volonté générale	Major need of European socio-economic integration
Part of the whole structure of socio-economic integration, which implies an economic regulatory framework and institutions of distributive justice	Universal competences of supranational institutions Democratic hierarchy a) Proportionality test for the assignment of competences b) Primacy of supranational over national norms	Supranational decision-making mainly involves institutional actors	High degree of institutional robustness on markets and welfare systems	Equality of civic and political rights plus individualised redistribution of economic resources calculated by either reference to a baseline (the level of need of each individual) or to socio-economic differences (the disparity in the distribution of income in a given society)
Economic freedoms as (weaker) part of the canon of constitutionally protected freedoms (review of national norms aimed at 'defeasible' protection of economic freedom)	Action at the supranational level justified by need of creating state capacities at a level such that markets can be regulated and corrected (supranational reregulation)	Preeminence of European Parliament	Major European budget	Wide-range of European taxing powers, critically including the power to collect some of the key taxes of the tax system
		Collaborative relation between levels of government (constitutional loyalty)		Wide-range of European programs of individualised entitlements

Table 1.8: Summary of analytical dimensions and indicators for the Federalising variant 2: *Neoliberal constitutionalism*

Ideology of socio-economic integration	Institutional configuration of the socio-economic structure of the EU			Mechanisms of European socio-Economic integration
	Allocation and exercise of powers	Institutional setup	Decision-making processes	
The Neoliberal single Market	Constitutionalised division of competences	Supranational institutions as part of the limited government of a federation of member states with limited governments	European decision-making processes should be limited and self-contained (in accordance with the welfare systems paradigm of Lockean constitutionalism)	European socio-economic integration to be achieved spontaneously and cannot be actually fostered in a lasting way by European institutions
Single market as the means of entrenching the proper regulatory framework and avoiding its political distortion	Self-restrained exercise of universal competences (mainly as negative powers)		High degree of robustness on markets and welfare systems (with limited negative powers that foster non-public decision-making)	Equality of civic and political rights, plus stake in the higher welfare levels and economic opportunities deriving from European integration
Economic freedoms as transcendental values which compose the core of any yardstick of constitutionality (review of national legal 'obstacles' to the single market)	Normatively based division of competences a) 'Subsidiarity' of public/collective to private/individual b) Primacy of supranational over national norms	Supranational decision-making is as far as possible devolved to non-public institutions and actors (societal self-regulation)		European budget limited to render possible the provision of a limited number of public goods
	Action at the supranational level justified by reference to the need of protecting private autonomy (fully blocking politics into socio-economic matters)	Preeminence of the European Court of Justice as constitutional court competitive relation between levels of government ('a market of public regulation')		Allocation of negative constitutional power over taxes to the supranational level
				Welfare entitlements inexistent or limited to individualised flat guaranteed income

Table 1.9: Summary of analytical dimensions and indicators for the *Cosmopolitan post-national union*

Ideology of socio-economic integration	Institutional configuration of the socio-economic structure of the EU			Mechanisms of European socio-economic integration
	Allocation and exercise of powers	Institutional setup	Decision-making processes	
A piecemealed economic union of variable dimensions	Flexible division of competences (reflexivity based on cosmopolitan mechanisms)	Supranational institutions as means of structuring a system of multilevel governance	European decision-making processes aimed at	European socio-economic integration to be composed by national socio-economic integration and communicative forms of integration at a supranational scale
Compartmentalised levels of economic integration depending on area and objectives	Trust model in the exercise of competences Division of competences with variable geometry	Participation of both institutional, non-institutional and foreign but concerned actors	Low degree of Institutional robustness on both markets and welfare systems	
Flexible and variable degree of protection of both economic freedoms and fundamental rights	Action at the supranational level to be justified both upwards and downwards (contributing to democratic decision-making on socio-economic matters across the board)	Preeminence of ad hoc institutional structures where all formal institutions participate Collaborative relation between levels of government ('partnership')		

Chapter 2

When the market is political The socio-economic constitution of the European Union between market-making and polity-making

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By making it impossible to believe any longer in an automatic reconciliation of conflicting interests into a harmonious whole, the *General Theory* brought out into the open the problem of choice and judgment that the neo-classicals had managed to smother. The ideology to end ideologies broke down. Economics once more became Political Economy.¹

European integration or the complex reconfiguration of the relationship between economic, insurance and political communities.

The constitutional order of Europe circa 1951 was grounded on the overlapping geographical scope of the economic, political and social insurance communities. The community of economic risks involved in the process of production and distribution of goods and services included the very same citizens who pooled in collective insurance institutions the risks derived from both their economic activities (mainly unemployment, sickness and old age) and from the fragile

¹ J. Robinson, *Economic Philosophy*, Harmondsworth, Penguin Books, 1964, at p.73.

character of human existence (providing insurance against a variety of risks and guaranteeing social and political inclusion through redistribution of economic resources). The terms of the relationship between the community of economic risks and the community of social insurance were mediated by the political institutions through which the political community give itself the means of implementing the *volonté général*.² As is very well-known, law as a means of social integration was progressively tuned to this task, and indeed was transformed from a formal means of integration, basically aiming at solving conflicts, to a material means of integration, capable of progressively realising substantive goals which increasingly implied the coordination of the action of millions to achieve collective goods.³

In this context, the tax system in general, and income taxation in particular, played a key role. The affirmation of personal income taxation as one of the five fundamental sources of revenue of modern states was key in increasing the breadth and scope of democratic decision-making, not only as it provided the financial means to fund the modern welfare state, but also because it ensured that *we the people* could take collective decisions enforcing the mutual obligations that citizens have towards each other, and to steer economic activity at macro and micro economic levels. It is because central components of the tax system were progressive personal income taxes that the tax system as a whole could operationalise the solidaristic obligations which derive from membership in a political community *and* act as a countercyclical lever.⁴ Similarly, the emergence of the modern corporate income tax was motivated by serious concerns over the incidence that the rise of 'corporate' capitalism had over the actual feasibility of democratic government and of the need of ensuring a degree of control over investment decisions; corporate income taxation was developed as a way to make corporations pay for the

² Not always that was so. See A. De Swaan, *In Care of the State*, Oxford, Blackwell, 1988.

³ See J. Habermas, 'Law and Morality', in S. M. McMurry, *Tanner Lectures on Human Values*, vol 8, Salt Lake City, University of Utah Press, 1988, pp. 217-79.

⁴ Indeed, the relationship between democracy and personal taxation is very close and works both ways; the complex and protracted development of personal income taxes seems to indicate that there is an intimate association between personal income tax becoming a central element in national public finances and the consolidation of inclusive democratic political processes (indeed, a modern personal income tax can only be collected when citizens are capable of trusting each other as citizens of a democratic polity do).

public goods and services they were provided with (including the limited liability granted by law) but also to enable democratic decision-making curbing the excessive accumulation of power in the (potentially eternal) institutional structure of the corporation, and to influence private investment and contracting decisions so as to create the conditions under which *we the people* could realistically decide how and to what extent certain collective macro goals, such as stable growth and full employment, were to be aimed at.

Or to put it differently, the progressive development of modern personal taxes provided democratic governments with the tools with the help of which they could at the same time shape the contours of the community of economic risks, ensure that a part of the total product of society was channelled to the provision of key public goods and services through which all citizens were insured against a set of economic and existential risks, and do both things in such a way that decision-making on the socio-economic order of the polity would result in meaningful and effective decisions.

European integration may well be said to have aimed at recreating the structural relationships prevailing at the national level between the communities of economic risk, social insurance and political decision-making at the supranational level. Very specific historical factors,⁵ together with the sheer complexity of the task, both in

⁵ It is well-known that the achievement of durable peace and solid prosperity through supranational institutional structures and a supranational legal order had been the objective of generations of Europeans. After two devastating wars in twenty years, such a need was felt even more urgently. Of the manifold projects launched after 1945, the European Union was the one which bore fruit; not by chance it was characterised by aiming at political union through economic integration, assuming that the basis of enduring integration could only be laid if economic borders were redrawn and enlarged. That required establishing common institutions and decision-making processes, but given the concrete strategy followed, on a scale much more modest than what would have been the case in a federal union. Economic integration was thus the path of least resistance because it did not immediately and directly challenge the central role played by nation-states in the social and political integration of Europe. It was assumed that the establishment of a common market would not only increase the number of competitors and the size of the market, facilitating the economies of scale necessary to improve productivity, but would also make possible the widespread recognition of the citizens of all other Member States as members of the same political and economic community, thus nurturing the kind of *we-feelings* and solidaristic predispositions characteristic of modern democratic welfare states. Or what is the same, that it will result in the transformation of the

factual and normative terms, account for the fact that integration did not proceed by the constitution of a new and autonomous supranational political community (complete in institutional and decision-making terms), but through an open-ended process of synthetic construction of a supranational political community, firmly grounded for the time being on the institutional capabilities and legitimacy bases of national political communities.

This explains why the founding Treaties of the European Communities, and especially the Rome Treaty establishing the European Economic Community (hereafter TEC), launched three simultaneous processes.

First, they laid down a rather concrete and detailed set of specific initiatives to be undertaken on the way to establishing the foundations of a 'common market', critically including the establishment of a customs union and the consequent elimination of any tariffs, quantitative restrictions or measures having an equivalent effect in the internal relationships between Member States. The concreteness of the set of norms specifying what was to be done in each of the four stages towards the common market explains the persistence of the claim that Community law was indeed a 'regulatory' order in a technical legal sense.⁶ The immediate objective of the said norms was to 'open up' national economic and insurance communities, allowing access on equal conditions to physical and legal persons resident in other Member States (thus creating six common markets and six common welfare structures by means of *communitarising* all national markets and welfare structures). Or what is the same, national communities of economic risk and of insurance were expanded so as to include Community nationals (and the companies established in the Communities) with the same rights as

community of economic risk as a welfare community, as a result of the establishment of mechanisms of public insurance against economic risk underpinning the legitimacy of the socio-economic order. It can thus be said that the Community project drove a middle way between those blueprints which aimed at improving the intergovernmental mechanisms of the League of Nations, but left intact formal national sovereignty (i.e. the Council of Europe) and those projects which aimed at the direct and immediate establishment of a European federation (as European federalists advocated, and basically succeed in inscribing in the -failed- Military and Political Union of 1954).

⁶ Indeed, most of the Treaty establishing the Coal and Steel Community looked like a long and complex statutory regulation more than a statute.

nationals.⁷ Still, it must be noticed that inclusion in the insurance community remained conditioned for non-nationals on actual contribution to the national economy through the production of either goods or services.⁸

Second, and next to this set of detailed rules, the TEC set the objective of a fully integrated market by reference to a set of principles (now enumerated in Article 3 TEC) which should be progressively realised as integration proceeded. The long-term objective was to fully merge national economies into what (following the later terminology) could be referred to as a single market, in which the line drawn between nationals and Community citizens would be deleted. Key normative elements in this regard were the famous four economic freedoms, which were partially operationalised in the programme towards the common market, but the breadth and scope of which was clearly intended to be much larger. As all principles, the norms enshrined in Article 3 TEC aimed at progressive realisation as far as it was factually and normatively possible. This explains why the TEC was also regarded as an open-ended Treaty, contrasting in this regard with the 'regulatory' Paris Treaty (and in a certain sense, the Euroatom Treaty).

Third, and last but not least, the founding Treaty of the European Economic Community rendered explicit that both the 'common market' and the 'single market' were not ends in themselves, but aimed at achieving the political integration of Europe (even if the process was expected to take a long time; indeed the 'ever closer Union' was regarded as a frustrating avenue by federalists). The political ethos of the Treaty comes a long way to explain the insertion of grand phrases, and more specifically, the inclusion of the aims enumerated in Article 2 (recently edited and updated in the preamble

⁷ Quite obviously, the structural conditions which rendered the process a manageable one were not all of them under the direct control of European political institutions. It is rather obvious that European integration would have proceeded differently had the international financial architecture been different in the fifties and sixties. Indeed, the collapse of the Breton Woods system instigated by the Nixon administration was close to provoking the collapse of the key policies of the Communities. The process of European integration was then perhaps closer than ever to collapse.

⁸ Even if what was counted as a valid reason to include somebody will be extended so as to cover dependent relatives and those who did formally work; but such development was always dependent on a link to active work.

to the Charter of Fundamental Rights), which must be construed as reflecting the constitutional principles common to Member States, which are especially relevant in the realisation of a complex process of political integration.

By means of aiming simultaneously at these three aims, the TEC rendered clear that neither economic integration was a self-referential objective, nor the definition of the institutional setup of a European market could be undertaken without reference to the political objectives of the process of integration as a whole. But it left open most questions concerning how the integration of economic, insurance and political communities was to be achieved once the 'communitarisation' of national markets was completed. Indeed, the process of European integration was bound to alter the relationship between the three communities (economic, insurance and political) which make up the socio-economic structure of modern societies; but in what sense and with what results was not fixed once and for all.

During the 'common market'-stage, the democratic legitimacy of the process of integration was guaranteed by the 'double' anchoring of Community law and institutions to national constitutions and decision-making process. First, the constitutional framework of the Communities was supposed to mirror the constitutional order of the Member States, being constituted as it was by a 'deep constitution' consisting in the 'common constitutional traditions' of the Member States and a 'constitutional charter' enshrined in the founding Treaties of the Communities, which essentially rendered partially explicit what the common constitutional principles entailed for the process of integration of the economic, insurance and political communities. In particular, the four economic freedoms which were expected to underpin both the common and the single markets were constructed as entailing the expansion of the rights enjoyed by nationals within the national economic and insurance communities to other Community citizens. Second, the re-arrangement of socio-economic institutions so as to realise integration goals was foreseen to require *secondary* Community norms (i.e. regulations and directives) spelling out in detail the normative implications of integration; but those were to be deliberated upon and decided in processes which guaranteed that the Community general will was essentially the result of aggregating national general wills, as expressed by national governments accountable at the end of the day to the direct

representatives of citizens (this was in particular the case of the classical 'Community method', where the Council retained the exclusive power to transform proposals into what were laws in everything but name). On such a basis, the democratic legitimacy of the Communities was either transferred from national political processes to supranational decision-making procedures via the national constitution, and the national actors granted a veto right over Community decision-making; or it was grounded on Community norms and decisions limiting themselves to implementing decisions collectively taken in the founding Treaties (with Community institutions acting as a kind of supranational administrative agency).

As a result, economic borders did not disappear, but were essentially reconfigured. On the one hand, they were redrawn at the Community level vis-à-vis the rest of the world, and strengthened through the use of the panoply of tax and regulatory norms through which economic borders were erected in the system of sovereign nation-states which slowly emerged at the end of the XIXth century. On the other hand, national borders were rendered sufficiently porous to enlarge the right to equality in economic and social matters to all Community nationals, but were kept sufficiently firm as to shelter the autonomy of national political decision-making process, very especially on what concerned the configuration of the socio-economic order.

As a consequence, national political institutions retained most of the key powers shaping the communities of economic risk and of insurance, although they collectively exercised a modicum of them. No area or competence was to be shifted from the 'common markets' to the 'single market' side of the construction without an explicit political decision; moreover, temporary waivers or exceptional measures could be agreed, limiting the scope of the single market if regarded politically necessary.⁹ The European Court of Justice, in cooperation with the national courts which requested preliminary judgments from it, acted as a guardian of European constitutionality, of the set of principles which framed the Community legal order (and increasingly also national legal orders as integration advanced). But its legitimacy was based on its role as defender of the rights of 'transnational citizens' as Community citizens. Because such rights

⁹ Thus the numerous safeguards and firewalls built upon the TECSC and the TEC.

were deemed to emerge from Community constitutional norms which mirrored national constitutional norms, and because the Court limited its use as constitutional yardstick to the testing of national norms which placed non-nationals on a different footing than nationals, the Court could claim that it was acting in exclusive defence of the rights of those who were intensively affected by national norms, but were still excluded from democratic deliberation and decision-making processes. Indeed, European integration in general, and the constitutional role played by the European Court of Justice in particular, rendered national decision-making processes more responsive to the interests of non-national but Community citizens. The principle of non-discrimination on the basis of nationality contributed to frame the substantive exercise of national powers, rendering void national norms or decisions which discriminated against 'trans-national citizens' without weighty reasons.

The communitarisation of national markets was expected to be a transitory phase leading to further economic and political integration. Indeed, the objectives of the fourth stage of the common market, which according to schedule were to be reached on January 1st 1970, were declared fulfilled eighteen months earlier. How the key principles expected to govern the single market were to be realised in ways not destabilising national insurance and political communities, but allowing to project them to the supranational level, did only have a procedural answer in the Treaties. The Council was expected to agree on *how* to do it.

This proved a tall order in the stable political and macro-economic context of the *thirty glorious years of the post-war* (as the empty chair crisis, sparked by the assignment of taxing powers to the Union, proved); and a rather impossible task after the two oil crisis of the seventies questioned some of the basic premises on which European integration was grounded. The combination of the 'Nixon shock', the series of financial decisions taken by the United States in the early seventies and the two oil crisis of 1973 and 1979 dramatically transformed the international economic situation. The apparent intractability of a recession with spiralling inflation by mainstream 'Keynesian' policies put an end to the post-war socio-economic consensus in Western Europe. This created the conditions under

which neo-liberal ideas gained influence,¹⁰ even if to a different extent in different countries.¹¹ The economic crisis rendered evident that the European institutional structure was not attuned to serve the purpose of collective management of the crisis. Member States reacted in uncoordinated ways, which put into peril the stability of common economic policies (and consequently the *acquis communautaire*). Power was so fragmented that no actor seemed capable of actually deciding anything,¹² so the European political order seemed bound to slowly but steadily descend into irrelevance. This crisis, usually labelled as *Euro-sclerosis*, reinforced previous doubts about the adequacy of Community decision-making procedures. While the complex democratic legitimacy equation may have been a rather apt solution when the tasks ahead had been basically agreed in the Treaties, it was bound to paralyse decision-making when it was necessary to select the proper means to realise the general principles which underpinned the single market and the political integration projects.¹³

Slowly, but rather firmly, a consensus emerged among European elites concerning the need of inverting the relationship between economic and political integration. In the absence of a 'thick' political agreement on the way the complex relationships between economic, insurance and political communities should be governed, it was hoped that increasing the breadth and depth of integration of national communities of economic risk could relaunch integration. In particular, DG III of the Commission, seconded by the European Court of Justice and later by the Council of Ministers, proposed to 'relaunch' European integration by placing market integration at the very centre of the project. This meant focusing all energies in the

¹⁰ D. Harvey, *Brief History of Neo-Liberalism*, Oxford, Oxford University Press, 2004.

¹¹ On the extent to which Thatcher shattered the British and European political consensus (although not always in those ways in which she pretended or claimed), see A. Gamble, *The Free Economy and the Strong State*, Basingstoke, MacMillan, 1988; and also the collection edited by him and C. Wallis, *Thatcher's Law*, Cardiff, University of Wales Press, 1989.

¹² Leaving aside some symbolic decisions of the European Court of Justice (such as the one taken in Case 8/74, *Dassonville*, [1974] ECR 837).

¹³ There were several concurrent explanations of why this was so. But some of them claimed that the root of the evil was indeed in the combination of unanimous decision-making in the Council before any integration decision could be approved and the subjection of economic integration to political steering. After all, both were forms by ways of which politics meddled into the self-stabilising and adjusting capacities of (European) markets.

completion of the 'internal market without internal frontiers', which was to be regarded as immediately realisable through the mutual recognition of national regulatory standards. Certainly, European integration had always aspired to realise a 'single market without internal frontiers'. But this was understood not only as the vision of an ultimate and distant goal in need of being politically concretised;¹⁴ but it was also assumed that (a) the timing and the means of achieving it should be decided politically, (b) the said objective required a process of *positive integration* of national socio-economic institutions and legal norms, which would result in the recreation of many of the state capacities at the supranational level.¹⁵ Contrary to the previous consensus, the project of the single market, as launched by the Directorate General III of the Commission under Gaston Thorn, and fully fleshed out in the famous White Paper under Delors,¹⁶ detached economic integration from political and social integration. The politically driven creation of a single market was substituted by the vision of the 'instant' single market, to be created through the mutual recognition of regulatory structures.¹⁷ This seemed to offer equal promise to actors upholding rather contrasting conceptions of what the European Union should become. It was welcomed by the growing numbers of political actors who blamed on political meddling of the relationships between economic and insurance communities the economic crisis which affected the Union,

¹⁴ Indeed, the Rome Treaties were only specific on the four stages leading to the 'common market', or perhaps to be more precise, to the opening of national markets to economic agents of all Member States. On what a fully internal market would require, and how it was to be achieved, the founding Treaties were silent, if one leaves aside general open-ended principles and vague aspirations.

¹⁵ Under such circumstances, it was only natural that, as already indicated in the previous sections, personal taxes remained the exclusive competence of Member States, even if it was clear from the very first day that they should be Europeanised at some point if the aspiration of creating a 'single market' was to be realized. In line with the general expectations concerning the political road to the internal market, it was assumed that there would be an actual transfer of effective taxing powers to the supranational level, preserving the capacity of public institutions (both European *and* national) of making use of personal income tax to raise most of public revenue, redistribute income within the political community, and macro- and micro-manage the economy. In the meantime, economic integration should be pursued in such a way as to preserve the capacity of each nation-state to regulate, stabilize and correct each national economy.

¹⁶ G. Grin, *The Battle of the Single European Market: Achievements and Economic Thought 1985-2000*, London, Kegan and Paul, 2003.

¹⁷ J. Pelkmans, *European integration: methods and economic analysis*, Harlow, FT Prentice Hall, 2006, at pp. 25ff.

and who had been implementing an agenda which basically consisted in narrowing the community of social insurance and increasing the freedoms enjoyed by actors in markets (a double process of privatisation of communities of economic risk and of insurance). For such actors, the European Union held promise as the level of government at which the right constitutional norms setting up supranational markets could be established. At the same time, and for different reasons, pushing for further economic integration without additional Europeanisation of the insurance and political communities was regarded as a promising alternative route to achieve the ultimate reconstitution of a coherent relationship between economic, insurance and political communities at the supranational level. In particular, some of the actors upholding a federalising view of the Union came to believe that speeding up economic integration would necessarily result in strong demand for further social and political integration. For those actors, the Single European Act was indeed the kind of measure which was bound to generate the sequence of spill-overs¹⁸ which would lead the Communities to the original destination (political Union in a social-democratic fashion) only through a different route.¹⁹ In brief, neoliberals saw in the single market major opportunity to ensure intellectual victory. Christian-democrats and social-democrats became warm to the idea, betting that negative integration would revive the European project, and by itself create a supranational political constituency favourable to reregulation and redistribution at the European level, perhaps in a replay of the original dynamics unleashed by the Treaties of Rome.

Still, the wider objective of creating a single market was bound to disrupt the consistent overlap of economic, insurance and political communities. This was so because economic integration was really about erasing economic borders within the Union; this could not be without effect on the functioning of insurance and political communities, as they relied on the political power to buffer national economies through the exercise of various tax and regulatory powers. And as the structural power to draw borders was weakened, and

¹⁸ This forms the core of the 'spillover' mechanism, described by E. B. Haas, *The Uniting of Europe, Political, Social and Economic Forces*, Stanford, Stanford University Press, 1958. The argument of the spill-over is the background of the key Neumark report of 1962, 'Rapport du Comité Fiscal et Financier'.

¹⁹ See J. Delors, *Mémoires*, Paris, Olivier Orban, 2004, especially pp. 223, 228, 312 and 463; and R. Abdelal, *Capital Rules*, Cambridge, Harvard University Press, 2008.

indeed the legal and structural power of Member States acting alone to resort to functional equivalents was undermined, reliance on economic integration implied that there was no supranational political community in the making which could mediate the relation between (national) social communities and (supranational) economic communities. As a consequence, neither the states nor the weak supranational polity could really take decisions rectifying the distributive consequences of integration so as to re-establish a coherent relationship between the three communities. But if nobody could decide, there was a serious risk of affecting the very structural basis on which democratic government rested, and on which the sustainability of complex modern welfare states was dependent.²⁰

It is no surprise then that the democratic legitimacy of the process became less obvious as it shifted away from the 'transmission belt' plus 'governance' model to an unclear destination. On the one hand, the 'double' anchoring of Community law and institutions to national constitutions and decision-making process was simultaneously weakened. For one, the 'propelling' role assigned to economic freedoms implied assigning them a far superior weight and a different substantive definition than they had in the common constitutional traditions of the Member States. As a result, it was increasingly difficult to regard them as mirroring national constitutional norms, and consequently, transferring their democratic legitimacy to the Community legal order. They started to be regarded (for plausible if not always sound reasons) as the Trojan constitutional horse bound to undermine national constitutions. For two, a bifurcation was made on Community decision-making processes, by means of establishing a division of labour between the 'Community method' and a new hybrid process, which after some amendments would emerge as the co-decision procedure, where the European general will is defined as the aggregation of the majoritarian national will (as expressed by Member States) and the majoritarian European will (as expressed by the European Parliament. This was neither a new decantation of the 'transmission belt' legitimacy, nor still a source of direct democratic legitimacy for

²⁰ It may be the case that a good deal of the unrest and growing disaffection with the project of European integration has a lot to do with the inconsistencies and subversive effects unleashed by this asymmetric process of Europeanisation of markets unconstrained by the establishment of European political and insurance communities.

the Union, but something in between. Additionally, the criteria according to which labour is divided between the two procedures raises serious concerns about the existence of a structural bias of the constitutional setup of the Union in favour of certain substantive outcomes, especially on what concerns the socio-economic structure of the European political order. This explains the apparent paradoxical outcome that the more powers are granted to the European Parliament by expanding the scope of co-decision, the more the democratic legitimacy of the Union seems to be undermined.

As a result, the borders of the community of economic risks started to disappear, but this did not automatically result in the acceleration of either the process of Europeanisation of communities of economic risk, or of the creation of a supranational political community;²¹ instead, it may be argued that the outcome was a transfer of substantive decision-making processes from both national and European political decision-making processes to private decision-making processes. This process of 'private' empowerment was reinforced by the European Court of Justice, which has redefined in a transcendental sense the four economic freedoms, and transformed them step by step into a yardstick of constitutionality of all national norms, including those whose regulatory purpose is to mediate the 'internal' relationships between economic, insurance and political communities, and not substantially to affect 'transnational' citizens (even if they could have as a side and marginal effect that result).

The common structure of the second section of the report

The second section of this report contains four chapters which reconstruct and assess the historical evolution referred in the previous, focusing on the case law of the European Court of Justice. These chapters cover four key aspects of the socio-economic constitution of the Union: two of the four fundamental economic

²¹ It remains to be seen whether the 'transcendental' understanding of the single market as a constitutional order which empowers (some) private actors and narrows down both the insurance and political communities stands a chance of stabilising itself, or on the contrary fosters a process of recreation of the insurance and political communities at the supranational level.

freedoms (free movement of workers/persons, free movement of capital) and the two institutions that more directly articulate the distribution of public burdens among citizens: personal taxation and non-contractual liability of the state (the former allocating positive obligations regarding public burdens; the latter setting limits to what non-tax burdens individuals should bear).

It seems to us that, barring a systematic analysis of all socio-economic jurisprudence, the four areas here considered are the most revealing of the overall understanding of what kind of polity the European Union is, and of what are the normative bases on which its legitimacy rests, that is, of the kind of fundamental questions RECON deals with.

The European market, whether in its common market or single market phases, is indeed premised on the efficient use of factors of production at a European scale. But how the factors of production should be characterized and regulated depends on the specific conception of the European polity one has, of the different ways in which the community of economic risks (the market) is said to stand in relationship to the polity (in particular, the political institutions and decision-making set-up) and the society (as a community of welfare or social insurance). The way in which capital and labour are defined and regulated as factors of production is the clearest indicator of the different underpinning conceptions of European integration. Indeed, differences are starker among different conceptions of the Union when it comes to capital and labour than when it comes to, say, free movement of goods.

Personal taxes and non-contractual liability contain, as already indicated, the two sides of the same problem, namely, the allocation of the burdens resulting from politics and from the integration of society through political means. Both institutions have the most intimate connection with the whole set of constitutional principles, because they are means of choice to the realization of distributive justice and also of macro- and micro-economic objectives (grantedly, in a more obvious and direct fashion in the case of taxes). They are thus the most obviously collective and multilateral of the socio-economic institutions of modern democratic states. At the same time, they play a key role in drawing national economic borders. Taxes are fundamental in drawing and maintaining national economic borders

and the structural conditions under which states can monitor flows of income so as to allocate burdens fairly and justly. Both taxes and non-contractual liability recreate once and again the political community by marking who is and who is not part of the welfare or insurance community. It is for those reasons that the interplay between these two institutions and all four economic freedoms is extremely revealing of the conception of the European Union as a polity, and as a legitimate polity for that matter, held by different actors and institutions.

Indeed, the choice of these four areas is in our view a proper selection to meet one of the overall objectives of the work package (see chapter one of this report), that of operating a triple *reconnection* of the different policy areas, both (1) by reference to other policy areas where it stands in a relationship of mutual influence, i.e. areas the shape of which generates mutual structural limits to available choices (e.g. characterizing free movement of capital as the paramount economic freedom, and narrowing to the extreme the arguments which can be used to justify their breach, sets limits to policy choices on the taxation of capital income); (2) by reference to the overall design of the socio-economic constitution; (3) by reference to the normative principles underpinning the legitimacy of the European polity as a whole.

Besides being thematically intertwined, the four chapters that follow share a common focus and a common approach (were we not jurists, we may have dared to say methodology; but perhaps our method does not deserve being called a methodology according to the more stringent standards of political science). They all reconstruct the case law of the Court of Justice, they all try to determine the main phases in its evolution, and they all aim at determining which understanding of the European Union as a polity seems to be mainly at work in each of the phases of the evolution of the case law of the Court. This allows us to go beyond the usual conclusions that the Court is striving to make the law observed and further the process of integration, to consider what are the democratic implications of different ways of making the law observed and advancing the process of integration.

From a legal-dogmatic perspective, this allows us to reconstruct in detail the key categories in the evolution of the case law of the Court. In particular, the four case studies confirm that in substance, while

not in form, the Court has transformed itself into the umpire of European constitutionality of national laws,²² and that over time, it has developed the categories with the help of which the review has become stricter. In particular, there is a common pattern of evolution of the definition of economic freedoms as a yardstick of European constitutionality (an expanding construction of what constitutes a restriction to an economic freedom triggering the European invalidity of national norms) and of the justifications that Member States can invoke to justify *prima facie* breaches of the said economic freedoms.

From a normative perspective, the case studies make it very obvious that the idea of a transcendental conception of the single market, which would have been at place since the founding of the Communities, is a mere fiction at the service of a self-gratifying vision of the law as a closed system (and one which can only be rendered compatible with the changes in the conception of the market and of the polity underpinning the case law of the Court by the self-pious assumption that 'in a field such as direct taxation, the consequences arising from the freedoms of movement guaranteed by the Treaty have been only gradually made clear'²³). Indeed, the legal construction of economic freedoms and of their interplay with socio-economic institutions has shifted over time. From a democratic perspective, it is interesting to notice not only the change, but also to consider whether it can be satisfactorily explained by reference to changes in the constitutional and legal framework (Treaty reform, which for example accounts for the transformation of free movement of capital into a fully-fledged economic freedom, but hardly for its construction as *the* paramount freedom in the golden shares rulings, as Losada argues; or for the expansion of the personal breadth of free movement of workers, but hardly for the subjection to European constitutional review of non-contributory social benefits, as Carbonell shows), or are to be regarded as part of a process of judicialisation of

²² J. Weiler, *The Constitution of Europe*, Cambridge, Cambridge University Press, 1999; K. Alter, *Establishing the Supremacy of European Law: The Making of an International Rule of Law in Europe*, Oxford, Oxford University Press, 2003.

²³ A phrase of style which the ECJ has applied to disputes over the temporal effects of its tax judgments. Among others, see C-201/05, *Test Claimants in CFC and Dividend Group Litigation*, not yet reported, available at <http://www.curia.europa.eu/jurisp/cgibin/form.pl?lang=en&Submit=Submit&alldocs=alldocs&docj=docj&docop=docop&docor=docor&docjo=docjo&numaff=C201/05&datefs=&datefe=&nomusuel=&domaine=&mots=&resmax=100>, par. 124.

European law, which is much more ambivalent from a democratic perspective. As long as economic freedoms were regarded as the operationalisation of the principle of non-discrimination, they could be employed to correct the pathological exclusion of non-nationals from the enjoyment of rights; once they are regarded as self-standing standards, the link of democratic legitimacy back to national constitutions is broken, and judicialisation runs the risk of itself becoming a democratic pathology. Indeed, Letelier and Menéndez deal in the last sections of their papers with the structural limits of an aggressive review of European constitutionality in the absence of a full-fledged European political process. The Court did empower itself in both areas in the early nineties, only for the Luxembourg judges to realize, assisted by their Advocates General, that they may have overstretched both their institutional capacities and their legitimacy credit. This untidy conclusion may be deeply unsatisfactory from an aesthetic perspective, slightly frustrating from a normative one, but does indeed constitute a research challenge that seems to justify our endeavours (and in the view of rational choice theorists, the use of taxpayer money, albeit in far from lavish quantities, to keep on supporting research).

Indeed, the four chapters make it abundantly clear that the European Court of Justice faces two major problems when reviewing the constitutionality of national socio-economic laws.

The first one is indeed classical, and applies to all courts engaged in the review of constitutionality of statutes. Given that the law is supposed to be reflective of the common political will of 'we the people', it is problematic that a second constitutional opinion is left in the hands of a set of jurists. This is most of the time characterized as the counter-majoritarian difficulty. However, and at least in Europe, the problem is not so much the lack of a democratic legitimacy of judges (given that in most if not all national systems of constitutional review, and also in the case of the ECJ, constitutional judges do indeed enjoy an indirect democratic legitimacy resulting from the fact that they are selected and appointed by representative institutions), but the weaker democratic legitimacy they enjoy when compared to parliaments and/or directly elected Presidents.

The second problem is peculiar to the constitutional law of the European Union and in particular to the European Court of Justice as

an organ of constitutional review. The set of specific problems relates to the legitimacy of the yardstick of constitutional review and to the role played by the amorphous goal of integration in the whole process. On what concerns the yardstick of constitutional review, European constitutional law is peculiar in lacking a formal constitution (the Treaties having been constructed *as if* they were a key part of the constitution of the Union, and such construction being in itself open to contention), both a democratic constitutional debate – something which necessarily follows from the lack of a formal constitution – *and* an ongoing debate undertaken by reference to either a formal Constitution or a certain political and cultural understanding of the Constitution (which deprives the Court of a clear repository of politically authoritative understandings of what the Constitution means and requires). In that context, the affirmation of the four economic freedoms as the yardstick of European constitutionality is problematic (indeed, the Court is slowly coming to grips with the tension resulting from this standard approach and the recognition of an unwritten principle of protection of fundamental rights in the 1970s, as the recent case law shows)²⁴ and results in what from the national constitutional standpoint is the combination of the form of constitutional review with a very peculiar definition of constitutional substance, which falls very short from covering the whole array of constitutional principles enshrined in national fundamental laws. On what relates to the role of integration, resort to the open-ended goal of integration has allowed the Court to make good for blockages in the political process, but only at the price of reinforcing the substantive biases of the yardstick of European Constitutionality.

To summarise, the following four pages can be said to have five common purposes, namely:

(1) to elucidate the key leading cases in the evolution of the case law of the ECJ, and to determine the implications they have for the construction of the key legal understanding of each case by the Court, but to do so without losing track of the democratic dimension (that is, every leading case is relevant and as such a leading case in our study if it significantly affects the democratic equation of European Community law);

²⁴ The leading case being C-112/00, *Schmidberger*, [2003] ECR I-5659.

(2) to determine the *formal and substantive triggering factors* of major changes in the case law of the European Court of Justice, by means of considering what the ECJ formally presents as reasons to render leading judgments, and especially, the 'political signals' and the 'functional needs';

(3) to identify the key 'technical' concepts which structure the evolution of the interpretation of Community law, and very particularly the fundamental economic freedoms, namely direct discrimination, indirect discrimination, imposition of obstacles even if non-discriminatory (*entraves*), to establish a periodification for each relevant case study, and to individuate the triggering event which led the Court to consider expanding the understanding of a given economic freedom in general, or within a concrete sector area;

(4) to determine the *distributional and institutional implications of the judgments of the European Court of Justice*, which are sometimes hidden behind a technical characterisation of the underlying legal problem, and which are determinant of the way in which the case law of the European Court of Justice configures the relationship between economic, insurance and political communities within Europe;

(5) to reconstruct the *actual dynamics of the case law*, which has come to be obscured by the single perspective adopted by legal actors, and especially judges and scholars, namely that of the present, from which the past is reconstructed in a flat way, getting rid of the unavoidable nuances, (but all historical reconstruction necessarily implies that) and instilling a sense of unavoidability of which the normative world was not necessarily impregnated before each concrete decision was adopted

Outline of the four chapters

In Chapter three, Flavia Carbonell Bellolio reconstructs and assesses the evolving case law of the European Court of Justice on freedom of movement of workers. Although it has become commonplace to affirm that the status of European citizenship inserted in the TEC by the Treaty of Maastricht marks a watershed in the evolution of this economic freedom, and even in more general terms, of the Communities, Carbonell highlights the continuity in the case law of the Court, marked by the gradual but firm expansion of both the personal and the material scopes of free movement of workers. On

the one hand, the Court has managed to stretch the category of worker and transform into rightholders all those closely related to the worker herself, as well as those who had been engaged into work in another Member State at some point of their working careers. The leading case *Martínez Sala* certainly accelerated the underlying trend of the jurisprudence, and pushed the Court into explicitly acknowledging that the right to free movement was to be enjoyed by economically inactive citizens. But the underlying trend was easily discernible well before the said ruling. On the other hand, the Court has widened considerably the concept of 'social' advantage enshrined in Regulation 1612/68, has rendered free movement of persons a yardstick of European constitutionality of all national norms, including those related to a weak competence basis of the Union, and has proven ready to acknowledge the 'horizontal' effect of free movement of workers, or what is the same, its being directly applicable not only to the relations between the citizen and the state, but also between citizens (famously in *Laval* and *Viking Line*). This expansive reading of the literal tenor of the provisions on free movement of workers has been rendered possible by the accompanying sprawling construction of what constitutes a restriction to the said economic freedom. While the Court was attached for a rather long period to an understanding of free movement of persons as an operationalisation of the principle of non-discrimination, it has recently moved to regard also non-discriminatory obstacles as restrictions, extending (although with some delay, as in the case of personal taxation) the understanding of the single market applied to free movement of goods, freedom of establishment and free provision of services to the free movement of persons. This extensive reading has been fuelled by both functional concerns (as a common labour market cannot but be an integral part of a single market in which all national economies are merged into a supranational one) and by social and political aspirations (related to the solidaristic and welfaristic goals of national constitutional systems, and of European Union law itself). But no matter how much the Court strives to present its decisions as the logical application of the *telos* of the Treaties and as the very idea of a single market, the ECJ has adopted, expressly or by default, decisions which seriously affect the size of welfare communities, and the very terms under which their members are expected to be solidaristic towards others. The Europeanisation of communities of economic risk implicit in the single market thus comes with a limited and imperfect

Europeanisation of political communities, and with a very limited Europeanisation of the legislative competences and the institutional setups through which decisions are taken. As a consequence, the communities of welfare are Europeanised by stealth. The structural limits of this strategy explain the progressive consideration of justificatory strategies that can be followed by Member States to validate their social and welfare policies even if in breach of Community law. Still, the construction of free movement followed by the Court has led to a redefinition, in a more inclusive way, of welfare communities. It is far from obvious whether what has been lost in width, has not been lost in depth.

In Chapter four, Fernando Losada analyses the influence that constitutional, legislative and jurisprudential changes have had on the construction of free movement of capital as an economic freedom. The resulting story is that of the rise of what originally was conceived as a purely ancillary freedom (what some authors aptly characterize as free movement of capitals as freedom of cross-border payments for industrial and commercial activities) into the paramount freedom in the constitution of the European Union (as the rulings of the ECJ on the 'golden shares' kept by Member States in previously nationalized companies seem to indicate). Indeed, it seems plausible to conclude that while the phases of evolution in the understanding of this freedom are not dissimilar from those characterizing free movement of workers, the speed of change has been radically higher. Quite obviously, the key turning point is no other than the momentous decision to liberalise movements of capital, first within the Communities (in Directive 88/361) and then *erga omnes* (in the Maastricht Treaty). As Losada indicates, this move was in itself paradoxical, as ultimately reluctant national governments accepted the deal as a side concession to the realization of Monetary Union. That is, they were ready to give up structural power to control economic agents through capital controls with a view to regain structural power over the economy as a whole by means of recreating a degree of control over monetary and economic policy, lost after the demise of Bretton Woods in favour of the esoteric and rather obscure international financial markets. And for all the peculiarities of free movement of capital, the Court has followed a structural pattern very similar to that regarding other economic freedoms. Thus, the widening of the breadth and scope of the literal tenor of the provisions enshrined in the Directive and later in the Treaty

proceeded first by reference to the will of the constitution-maker and legislature (in what Losada refers to as the second phase in the case law of the ECJ), only to be replaced by a transcendental, autonomous interpretation of the economic freedom, under which it is granted a place of choice in the economic constitution of the Union (of such a choice as to be capable of prevailing over Treaty provisions such as Article 295 on the regime of property within Member States).

In Chapter five, Menéndez analyses the Europeanisation of personal taxes fuelled mainly, even if not exclusively, by the rulings of the European Court of Justice. The chapter gives an account of the peculiar trajectory of the case law on this policy area. The ECJ has moved from total self-restraint, to a very moderate form of review in the mid eighties and early nineties, and then to a very aggressive review of the European constitutionality of national personal tax norms. The key role played by personal taxes in realizing the whole set of national constitutional principles, and especially on providing the revenue basis on which the protection of individual and collective socio-economic rights are given actual content, was however bound to reveal the structural limits of a bold review of European constitutionality in the full absence of the exercise of law-making powers on tax matters at the European level. This explains the overall trend which can be observed in the most recent jurisprudence of the Court. And still, the lack of a clear self-realisation of the conceptions of market and polity that has been implicit in the different positions of the Court, partially accounts for the lack of coherence and consistency of the case law.

In Chapter six, Raúl Letelier reconstructs the evolution of the doctrine of state liability for the infringement of Community law. The chapter shows how the ECJ has filled the structural gap in the Treaties (which did not contain any provisions on the matter) by means of relying on the democratic legitimacy of analogous Treaty provisions (those covering the non-contractual liability of the European Union itself) and the common constitutional and legislative traditions (affirming the general principle of non-contractual state liability, and the obligation to compensate individuals suffering especially the burden of an infringement). Indeed, in its first rulings, the Court seemed to be filling the gap by reference to the democratic decisions undertaken at the supranational and national levels. However, and in a clear parallelism to the evolution of other lines of its case law here

considered, the Court has also moved to the effect of emancipating Community standards from national standards, by reference to the very structural properties of Community law as a means of supranational social integration. Thus, the judge-crafted doctrine of non-contractual state liability has been justified once and again as the logical consequence of the key structural principles of Community law, its direct effect and its primacy. If there is no right without remedy, and if Community law is not only law, but the supreme law of the land and directly effective, individuals whose Community rights have been infringed should be protected by redressing all wrongs having been caused. And it is because Community law is supreme that it should evolve its own conception of noncontractual state liability, which would then tend to exert a pressure on national rules out of the requirements of equal treatment and systemic coherence intrinsic to constitutional law. By doing that, the Court has managed to present in neutral, logical terms what, as Letelier shows, are really key political decisions, essentially different from those adopted in national constitutional systems. It is indeed a central assumption of national constitutional laws that private non-contractual liability and state non-contractual liability are essentially and qualitatively different. While in abstract terms the difference revolves around the *type* of justice at play (commutative vs. distributive justice), in technical terms it concerns the concrete tenor of specific rules on compensation (e.g. the limits to state liability stemming from the multilateral and collective nature of responsibility, which imply that while the Constitution is supreme, not all infringements of the Constitution should give rise to a non-contractual liability on the part of the state). The slow but steady affirmation of an autonomous supranational system of non-contractual liability does not only challenge the coherence of national systems, but enters into the policy domain. It affects the checks and balances at the core of national constitutional systems (by constructing public rules of liability as if they were private rules, it empowers private actors to the detriment of public institutions), it shifts power among institutions (indeed, the phenomenon is not so much of juridification *per se* as of *judicialisation*), and it becomes a powerful mechanism of distribution of public resources without a strong democratic legitimation.

Chapter 3

Free movement of persons What community and what solidarity?

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Introduction

Free movement of workers is a basic component of the socio-economic structure of the European Union, together with other policy areas such as taxes, free movement of capital, freedom to provide and receive services, and non-contractual liability for breaches of EU law. Political decision-making on these and other neighbouring areas is a major issue for European democracy, since the design of the socio-economic structure of this supranational polity is one of the main pillars in the general process of European integration. More generally, the underlying assumption is that the socio-economic design of any polity, in this case of the EU, is amenable of democratic decision-making.¹

It is a well-known fact that fundamental economic freedoms were crucial for building firstly a common market and subsequently a single market. The suppression of the barriers to free movement of persons, goods, services and capital, as stipulated in the Treaty of Rome, was a major task for the original member states in order to create the common market. Regarding workers, the member states established a compromise which abolished any discrimination based on nationality

¹ See A. Menéndez, chapter 1.

between non-national and national workers concerning access to employment, remuneration and other work conditions. Both nationals and non-nationals were thus supposed to enjoy the same employment conditions, derived from their status as workers. The member states were indeed aware that, for the effectiveness of freedom of movement, some measures needed to be adopted in the field of social security for the protection of migrant workers and their dependants. If the general socio-economic conditions for employment would have been disparate, it would have been unrealistic and unattractive for the labour force to move across the Community. Nevertheless, and despite these measures, member states kept their right to define the principles of their social security systems and regulate them thereof.

The implementation of free movement, then, implied progressively several decisions in other socio-economic connected fields, especially in granting rights to the workers and their family members, to facilitate the exercise of this freedom. Some of them were expressly settled by Community law,² while others were jurisprudentially recognised, as it will be seen through the reconstruction of the case law.

The democratic relevance of this freedom went beyond the economic rationale of strengthening the single market, and looked also to the human dimension of integration. Workers were seen not only as factors of production, but as human beings who cultivate family and group relations and are entitled to rights for social and economic development.

In this sense, it is worth noting that the tension between the freedom of movement and the access to national welfare systems³ – or between the need to balance workers/citizenship rights to move and reside against social welfare rights – existed from the very origins of the project of European economic integration. Moreover, the access of migrant

² For an evolution of some of this legislation, see *infra*, note 6.

³ For a distinction between the larger concept of public benefits and welfare benefits, see A.P. Van der Mei, *Free Movement of Persons within the European Community. Cross-Border Access to Public Benefits*, Oxford, Hart Publishing, 2003, at pp. 2-7. Welfare state benefits include minimum subsistence benefits, education and health care, 'with which governments seek to modify or correct market outcomes'. Welfare benefits may come in the form of cash benefits and benefits in kind (commodities), and they can be contributory (or insurance-based, where the insured pays premium that entitle them to access the benefits when the risk occurs, such as unemployment, sickness or disability) or non-contributory (funded through tax revenue).

workers to social, financial or other kind of benefits was a natural consequence of the exercise of the right to move freely about the Community by the labour force. The tension worsens when taking into account that competences for decision-making over socio-economic arrangements are distributed into different levels of government (member states and the Union) without considering cross-effects among diverse regulations.

This apparent clear-cut distinction between on the one hand, the Community's competence to create a market free from barriers and obstacles, to which free movement of workers contributed, and, on the other hand, national competences to define their social security schemes,⁴ was soon blurred. It is revealing, e.g., the numerous regulations and directives that have been approved in the field of free movement of persons – workers and citizens – concerning the access to and the coordination of social security schemes – first concerning employees, self-employed, students, and their family members –, right of residence, or special measures limiting movement and residence on grounds of public policy, public security or public health, among others. As a result of these regulations (which were voluntarily adopted by the member states) and of the generous interpretation of them by the Court, some of these public benefits have entered the scope *rationae materiae* of Community law, and as such, have been placed under the sphere of protection of the Court of Justice.

The role of the Court in modelling freedom of movement has been decisive. The judicial definition of situations, norms or acts that constitute discrimination, the incorporation of new figures considered to be forbidden by the Community law provisions, the delimitation of the personal and material scope of application of free movement of persons, and the interpretation of particular words used by the legislation, are all decisions that give content to, materialise or configure the meaning of this socio-economic principle. In other words, only through a case law analysis – or a study of the application of the law or law in action – we are able to identify what is the real meaning, content or extension of this fundamental freedom. Generally speaking, the interpretative assessment of this freedom by the Court has democratic

⁴ It will be seen below that both legally and judicially the EU has intervened also in other national reserved spheres when protecting free movement of persons, such as education, taxation, or criminal law.

implications that can be seen as positive or negative ones. Positive ones, if one focus on the potential power of the Court in providing an adequate interpretative framework, in making effective rights that otherwise would remain ineffective, or in the capacity of its decisions in reducing pathologies of the democratic process. Negative ones, if one considers the decisions as supplanting the will of political empowered decision makers – the classical problem of judicial review of democratically enacted legislation – as changing the institutional and/or distributional arrangements of the EU – empowering or cutting away powers of the member states, the Union or private actors – or as hiding democratic consequences of the case law decision-making processes – when legally qualifying or classifying a case as pertaining to the sphere of application of a given provision.

Free movement of persons within the Community is a largely studied topic by several disciplines (sociology, political science and law),⁵ which adopts different approaches (conceptual, descriptive and normative). A comprehensive analysis would need a careful identification of all the relevant variables, to determine how they interact and to what extent they condition one another.

My aim here is to reconstruct the case law of the European Court of Justice (ECJ), and to present an analysis of the case law by applying the theoretical framework provided by the three RECON models on how to reconstitute European democracy, namely, the Renationalisation model, the Federalisation model and the Cosmopolitan model. The Court of Justice, as a particular decision maker, has been an active actor in the evolution and actual configuration of free movement of persons. Several reasons support the interest in this case law analysis. Firstly, secondary legislation in this area has codified previous judicial

⁵ From a legal perspective, for example, most analysis focuses on the development of the ECJ's case law. Concerning free movement of workers, see, for example, G.F. Mancini, 'The Free Movement of Workers in the Case law of the European Court of Justice', in D. Curtin and D. O' Keeffe (eds) *Constitutional Adjudication in European Community and National Law*, Dublin, Butterworths, 1992; R. White, 'An Update on Free Movement of Workers' (1992) 17 *European Law Review*, at p. 522; Á. Castro Oliveria, 'Workers and other Persons: Step-by-Step from Movement to Citizenship - Case Law 1995-2001' (2002) 39 *Common Market Law Review*, 77-127. As for citizenship, see a recent collective volume in the *European Law Journal*, in particular the introduction by S. Besson and A. Utzinger, 'Introduction: Future Challenges of European Citizenship - Facing a Wide-Open Pandora's Box' (2007) 13 *European Law Journal*, 573-590; and F.G. Jacobs, 'Citizenship of the European Union - A Legal Analysis' (2007) 13 *European Law Journal*, 591-610.

decision-making. Secondly, the case law is a receptacle of arguments of different actors (member states, Advocates General (AG), the Commission, and the own Court). Thirdly, in defining the sphere of application of economic freedoms, the Court has acted as the main interpreter of Community law and as a guardian of these freedoms. Lastly, a great proportion of the legitimacy problems related to this freedom derive precisely from the definition of its sphere of application by the Court.

To that end, I will first focus on the broadening of the scope of this freedom through the Court's case law and its directions of enlargement, resulting in what could be called an *all-embracing case law*. Equally important are the cases, though being a minority, in which the Court has rejected claims of freedom of movement rights and protected some areas of discretion retained by member states, or recognised the legitimacy of some restrictions permitted by Community law, through what could be called a *cautious case law*. The analysis of the relevant cases and of the AG Opinions will show the reasons and arguments invoked for justifying a decision in one sense or another. These reasons, which also are indicators common to other socio-economic policy areas, play a key role in shaping a certain idea of the European polity, or more concretely, in defining the socio-economic structure of the European Community. The last section will present a reconstruction of the three RECON models applied to the case law on free movement of persons. The underlying idea is to see how and to what extent the ECJ's case law and the AG Opinions – particularly, their justifying reasons – reflect a given idea of the European Union and of solidarity among migrant nationals of the member states and among EU citizens. Furthermore, possible problems of democratic deficit produced by judicial decision-making over this particular freedom will be pointed out.

Broadening the scope of free movement

The all-embracing case law

It is a well known fact that both Community law⁶ and the ECJ's case law on free movement of persons have progressively widened its sphere of application. Concentrating on the case law, the different directions into which this freedom has extended can be grouped under

⁶ The main legal developments during the 1960s and 1970s were: Council Directive (EEC) 64/221 of 25 February 1964 on the co-ordination of special measures concerning the movement and residence of foreign nationals which are justified on grounds of public policy, public security or public health [1964] OJ 56/850; Council Regulation (EC) 1612/68 of 15 October 1968 on freedom of movement for workers within the Community [1968] OJ L257/2; Council Directive (EEC) 68/360 of 15 October 1968 on the abolition of restrictions on movement and residence within the Community for workers of member states and their families [1968] OJ L257/13; Regulation (EEC) 1251/70 of the Commission of 29 June 1970 on the right of workers to remain in the territory of a member state after having been employed in that State [1970] OJ L142/24 (repealed by Commission Regulation (EC) No 635/2006 of 25 April 2006 [2006] OJ L112/9); Council Regulation (EEC) 1408/71 of the Council of 14 June 1971 on the application of social security schemes to employed persons and their families moving within the Community [1971] OJ L149/2; Council Directive 72/194/EEC of 18 May 1972 extending to workers exercising the right to remain in the territory of a member state after having been employed in that State the scope of the Directive of 25 February 1964 on coordination of special measures concerning the movement and residence of foreign nationals which are justified on grounds of public policy, public security or public health [1972] OJ L121/32; Council Directive 73/148/EEC of 21 May 1973 on the abolition of restrictions on movement and residence within the Community for nationals of member states with regard to establishment and the provision of services [1973], OJ L172/14; Council Directive 75/34/EEC of 17 December 1974 concerning the right of nationals of a member state to remain in the territory of another member state after having pursued therein an activity in a self-employed capacity [1975] OJ L14/10; Council Directive 75/35/EEC of 17 December 1974 extending the scope of Directive No 64/221/EEC on the coordination of special measures concerning the movement and residence of foreign nationals which are justified on grounds of public policy, public security or public health to include nationals of a member state who exercise the right to remain in the territory of another member state after having pursued therein an activity in a self-employed capacity [1975] OJ L14/14. Today, the secondary legislation in force that regulate freedom of movement and residence within the territory of the member states are the Council Directive (EC) 2004/38 of 29 April 2004 on the right of citizens of the Union and their family members to move and reside freely within the territory of the member states [2004] OJ L158/77 and the Regulation (EEC) 1612/68, as amended by the former. Concerning coordination of social security systems, on the other hand, the regulations in force are Regulation (EC) 883/2004 of the European Parliament and of the Council of 29 April 2004 on the coordination of social security systems [2004] OJ L166/1, the Council Directive (EC) 98/49 of 29 June 1998 on safeguarding the supplementary pension rights of employed and self-employed persons moving within the Community [1998] OJ L209/46, and Regulation (EEC) 1408/71, generally repealed but in force regarding some specific acts (Art. 90 Regulation (EC) 883/2004).

two main categories: personal scope (*rationae personae*) and material scope (*rationae materiae*). In the latter case, one of the techniques for extending the material sphere of application of the freedom of movement has been the way the Court qualifies or defines the violation of free movement. Accordingly, three different periods can be distinguished: during the first period, the Court was especially concerned with cases of direct discrimination; in the second period, infringements to indirect discrimination were extended; and during the third period, a new and wider attack to this freedom was incorporated, namely obstacles. Nevertheless, in some cases, as it will be seen, personal and material scopes are interspersed, and the distinctions appears rather blurred.

Extending the personal scope

As different situations were brought before the Court, mostly through references for preliminary ruling, the Court faced the problems of defining who should be considered a worker, what were the requirements for configuring an employment relationship, and what benefits could he claim when migrating to a different member state, to name some of them, and by this means, the European case law began drawing and stretching the personal scope of free movement of workers.

Since early case law, the definition of a 'worker' was given a community scope and meaning, and ruled to be a matter of Community law, regardless the existence of national definitions. As such, it should be broadly constructed and not restrictively interpreted.⁷ A different interpretation would lead to the undesired consequence that each member state could fix and modify the concept at will, without any control by the community institutions, and could thus exclude some categories of persons from the protection provided by the Treaty to migrant workers. Despite this community meaning, the Court has argued that there is no single community definition of worker, but that it varies according to the area in which the definition is to be applied.⁸

⁷ Case 75/63, *Mrs M.K.H. Hoekstra (née Unger) v Bestuur der Bedrijfsvereniging voor Detailhandel en Ambachten (Administration of the Industrial Board for Retail Trades and Businesses)* [1964] ECR English special edition 177, par.2; Case 53/81, *D.M. Levin v Staatssecretaris van Justitie* [1982] ECR 1035, par. 11; Case C-337/97, *C.P.M. Meeusen v Hoofddirectie van de Informatie Beheer Groep* [1999] ECR I-3289, par. 13.

⁸ 'For instance' - the Court specifies - 'the definition of worker used in the context of Art. 48 of the EC Treaty and Regulation No 1612/68 does not necessarily coincide with the

Concerning the nature of the work, the Court established that also part-time workers were covered by the free movement provisions, when the activity pursued was effective and genuine.⁹ Part-time employment, it was further claimed, constitutes for many persons a helpful mean of improving their working and living conditions, and of promoting social advancement. If the rights conferred by the principle of free movement of workers were reserved solely for full-time workers, the objectives of the Treaty would be seriously jeopardised. It was up to national courts to establish in the concrete case if irregular and limited activities fulfilled these requirements, or on the contrary, were ancillary and marginal and did not qualify as work or employment.¹⁰ Tightly connected with this issue, the Court was asked if a low level of income could exclude mobilised workers from the sphere of protection provided by this freedom. The Court answered negatively: what counts is that the person pursues an effective and genuine activity as an employed person, even if he yields an income lower than the one considered in the host state, or in the sector under consideration, as the minimum required for subsistence, and independently from the fact that that person supplements or not that income with other funds.¹¹

definition applied in relation to Art. 51 of the EC Treaty and Regulation No 1408/71'. Case C-85/96, *María Martínez Sala v Freistaat Bayern* [1998] ECR I-2691, par. 31.

⁹ In this sense, the Court argues, 'the recitals in the preamble to Regulation (EEC) No 1612/68 contain a general affirmation of the right of all workers in the member states to pursue the activity of their choice within the Community, irrespective of whether they are permanent, seasonal or frontier workers or workers who pursue their activities for the purpose of providing services'. The Court further adds that 'the concepts of 'worker' and 'activity as an employed person' must be interpreted as meaning that the rules relating to freedom of movement for workers also concern persons who pursue or wish to pursue an activity as an employed person on a part-time basis only', even when their remuneration is lower than the minimum guaranteed in the sector under consideration. The activities to be excluded are only those pursued 'on such a small scale as to be regarded as purely marginal and ancillary'. Case 53/81, *Levin, supra*, note 7, pars 14-17. See also the decision of the Court in *Steymann*, where 'activities performed by members of a community based on religion or another form of philosophy as part of the commercial activities of that community constitute economic activities in so far as the services which the community provides to its members may be regarded as the indirect quid pro quo for genuine and effective work'. Case 196/87, *Udo Steyermann v Staatssecretaris van Justitie* [1988] ECR 6159, par. 14.

¹⁰ Case C-357/89, *V. J. M. Raulin v Minister van Onderwijs en Wetenschappen* [1992] ECR I-1027, pars 13-14.

¹¹ The Court maintains this decision, even if the worker asks for financial assistance payable from public funds of the host member state. Case 139/85, *R. H. Kempf v Staatssecretaris van Justitie* [1986] ECR 1741, pars 14 and 16.

In the same line, the Court defined largely the 'employment relationship', by means of three general circumstances – a person performing services of some economic value for a certain period, for and under the direction of another person, and in return for which he receives remuneration – rendering immaterial for the application of the provisions of free movement of persons both the sphere in which the services are provided – public or private – and the nature of the legal relationship between employee and employer.¹²

On the other hand, not only persons who were actually working or had a concrete offer of employment came under the scope of the free movement provisions. Persons that had been employed, but had voluntarily or involuntarily lost their job in the host state, were covered by the right of free movement of workers and had the right to stay in the territory of that member state after the employment had ceased.¹³ According to the purposes intended by the Treaty, the right to move and reside freely also applied to persons seeking employment, i.e. those who pursued an occupation,¹⁴ though the status was not completely assimilated to that of persons actually employed. In principle, job seekers, as currently economically inactive persons, were guaranteed equality only regarding access to employment, but not concerning social and fiscal advantages – e.g. unemployment insurance – that could be claimed exclusively by workers.¹⁵ Nevertheless, the Court refines this general rule by drawing a further distinction concerning job seekers: on the one hand, member state nationals who are looking for work for the first time in the host member state and thus have not yet entered into an employment relationship; and on the other hand, those who have worked in the host state but are no longer in an employment

¹² Case 66/85, *Deborah Lawrie-Blum v Land Baden-Württemberg* [1986] ECR 2121, par. 17.

¹³ The Court has ruled in several occasions that workers are guaranteed certain rights linked to the status as a worker, even when they are no longer in an employment relationship. See, i.e., Case C-35/97, *Commission of the European Communities v French Republic* [1998] ECR I-5325, par. 41 and Case C-413/01, *Franca Ninni-Orasche v Bundesminister für Wissenschaft, Verkehr und Kunst* [2003] ECR I-13187, par. 34.

¹⁴ Case 48/75, *Jean Noël Royer* [1976] ECR 497, pars 31-32. In the same sense, Case 53/81, *Levin*, *supra*, note 7, par. 17, affirming that these principles covers those who 'are desirous of pursuing an economic activity' in a different member state. See also Case C-292/89, *The Queen v Immigration Appeal Tribunal, ex parte Gustaff Desiderius Antonissen* [1991] ECR I-745, pars 13-14.

¹⁵ See Case 316/85, *Centre public d'aide sociale de Courcelles v Marie-Christine Lebon* [1987] ECR 2811, par. 26, and Case C-278/94, *Commission of the European Communities v Kingdom of Belgium* [1996] ECR I-4307, par. 40.

relationship. The latter category is assimilated to workers, and as such, they are entitled to the same social and tax advantages as national workers.¹⁶

This panorama of the evolution of free movement of persons would not be complete without reference to the right of the worker to be joined by his family. The extension of rights and protection to the spouse and children, independent of their nationality, was a necessary step for the consolidation of this fundamental freedom. The personal scope was broadened by extending the prohibition of discrimination to family members to three main areas: right of residence, social advantages and educational benefits.

As for the right of residence, the interpretation of the Court has been that the rights of movement and establishment granted to a Community national by Arts 48 and 52 of the Treaty are not fully effective if a person may be deterred from exercising them 'by obstacles raised in his or her country of origin to the entry and residence of his or her spouse'. Accordingly, when a Community national who has exercised these rights returns to his or her country of origin, 'his or her spouse must enjoy at least the same rights of entry and residence as would be granted to him or her under Community law' if the former chooses to enter and reside in a different member state.¹⁷

The same reasoning applies concerning a third-country national who is a member of the worker's family with respect to the right of the former to reside in the member state of which the worker is a national, 'even where that worker does not carry on any effective and genuine

¹⁶ Case 39/86, *Sylvie Lair v Universität Hannover* [1988] ECR 3161, paras 32 and 33.

¹⁷ Case C-370/90, *The Queen v Immigration Appeal Tribunal et Surinder Singh, ex parte Secretary of State for Home Department* [1992] ECR I-4265, paras 19-21 and 23. In a different case, '[t]hat deterrent effect would also derive simply from the prospect, for that same national, of not being able, on returning to his member state of origin, to continue living together with close relatives, a way of life which may have come into being in the host member state as a result of marriage or family reunification. Barriers to family reunification are therefore liable to undermine the right to free movement which the nationals of the member states have under Community law, as the right of a Community worker to return to the member state of which he is a national cannot be considered to be a purely internal matter', paras 35-37. Case C-291/05, *Minister voor Vreemdelingenzaken en Integratie v R. N. G. Eind* [2007] ECR.

economic activities' in that territory when returning to it.¹⁸

In the same flexible line of interpretation, the Court has held that the right of residence for the spouse of a migrant worker does not require that they must live under the same roof permanently (Art. 10.3 Regulation 1612/68). However, the Court has also claimed that this regulation does not confer on the members of a migrant worker's family an independent right of residence, but solely a right to exercise any activity as employed persons throughout the territory of the host state (Art. 11).¹⁹ In the light of the fundamental right to respect family life, Art. 49 of the Treaty has also been interpreted as providing for a derivative right of residence to the third-country national spouse of a provider of service, national of a member state, established in that state but providing services to recipients established in other member states.²⁰

Lastly, a very recent case²¹ has overruled the previous case law that required that 'the national of a non-member state, who is the spouse of a citizen of the Union, must be lawfully resident in a member state when he moves to another member state to which the citizen of the Union is migrating or has migrated', arguing that this requirement of previous lawful residence in a member state for conferring the rights of entry and residence to a different member state, was contrary to community provisions of free movement. Such a requirement would have the effect of deterring the EU citizen of exercising their rights and to have a normal family life in the host member state.²²

¹⁸ Moreover, '[t]he fact that a third-country national who is a member of a Community worker's family did not, before residing in the member state where the worker was employed, have a right under national law to reside in the member state of which the worker is a national has no bearing on the determination of that national's right to reside in the latter State'. Case C-291/05, *Eind*, *supra*, note 17, par. 45.

¹⁹ Case 267/83, *Aissatou Diatta v Land Berlin* [1985] ECR 567, par. 18 and 21.

²⁰ Case C-60/00, *Mary Carpenter v Secretary of State for the Home Department* [2002] ECR I-6279, pars 38-39 and 46, and the Opinion in this case by AG Stix-Hackl, pars 44-45.

²¹ Case C-127/08, *Blaise Baheten Metock and Others v Minister for Justice, Equality and Law Reform* [2008] ECR n.y.r., pars 54, 57 and 58.

²² Case C-109/01, *Secretary of State for the Home Department v Hacene Akrich* [2003] ECR I-9607, pars 50 and 61; and Case C-33/07, *Ministerul Administrației și Internelor - Direcția Generală de Pașapoarte București v Gheorghe Jipa* [2008] ECR n.y.r., par. 30 (community law does not preclude national legislation 'that allows the right of a national of a member state to travel to another member state to be restricted, in particular on the ground that he has previously been repatriated from the latter member state on account of his 'illegal residence' there')

The principle of non-discrimination reached also family members concerning social advantages. Thus, it was ruled that '[t]he equality of treatment enjoyed by workers who are nationals of member states and are employed within the territory of another member state in relation to workers who are nationals of that state, as regards the advantages which are granted to the members of a worker's family, contributes to the integration of migrant workers in the working environment of the host country in accordance with the objectives of the free movement of workers'.²³ In other words, these benefits should also be guaranteed to migrant workers 'in compliance with the principles of liberty and dignity, the best possible conditions for the integration of the Community worker's family in the society of the host country'.²⁴

The Court has consistently held that 'the principle of equal treatment laid down in Art. 7 of Regulation No 1612/68 is also intended to prevent discrimination to the detriment of descendants dependent on the worker'.²⁵ However, as it follows from *Lebon*, 'the members of a worker's family, within the meaning of Art. 10 of Regulation No 1612/68, qualify only indirectly for the equal treatment accorded to the worker himself by Art. 7 of that Regulation. This means that social benefits 'operate in favour of members of the worker's family only if such benefits may be regarded as a social advantage' for the worker himself.²⁶ Consequently, 'where the grant of financing to a child of a migrant worker constitutes a social advantage for the migrant worker, the child may itself rely on Art. 7.2 in order to obtain that financing if under national law it is granted directly to the student'.²⁷

Also concerning equal treatment to family members of a worker, and even when it was ruled that the term 'spouse' in Art. 10 of Regulation 1612/68 referred to marital relationship only, the Court decided that the right to be accompanied by an unmarried companion constituted a social advantage, falling within the scope of Community law, and thus,

²³ Case 316/85, *Lebon*, *supra*, note 17, par. 11.

²⁴ Case C-308/89, *Carmina di Leo v Land Berlin* [1990] ECR I-4185, par. 13; Case C-356/98, *Arben Kaba v Secretary of State for the Home Department* [2000] ECR I-2623, par. 20.

²⁵ See Case C-258/04, *Office national de l'emploi v Ioannis Ioannidis* [2005] ECR I-8275, par. 35; Case 94/84, *Office national de l'emploi v Jozsef Deak* [1985] ECR 1873, par. 22.

²⁶ Case 316/85, *Centre public d'aide sociale de Courcelles v Marie-Christine Lebon* [1987] ECR 2811, par. 12.

²⁷ Case C-3/90, *M. J. E. Bernini v Minister van Onderwijs en Wetenschappen* [1992] ECR I-1071, pars 26-29.

governed by the principle of non-discrimination on grounds of nationality. In this light, 'a member state which permits the unmarried companions of its nationals, who are not themselves nationals of that member state, to reside in its territory cannot refuse to grant the same advantage to migrant workers who are nationals of other member states'.²⁸

Concerning unemployment benefits and its exportability to a member state other than the competent one to grant them, during two decades the settled case law made a distinction, based on Art. 2 of Regulation No 1408/71, between workers – who must be nationals of a member state, stateless persons or refugees residing within the territory of one of the member states – and members of their families and their survivors. The former had a right in person, while the latter had only a derived right, acquired through their status as a member of a worker's family.²⁹ Some provisions of that regulation, as the ones ruling the coordination of rights to unemployment benefits, applied only to workers and not to family members. Therefore, the spouse of a Community worker could not rely on his or her status as a member of the worker's family, or in her own status of worker to acquire entitlement to unemployment benefits.

This case law was overruled by the Court, which adopted a more comprehensive view of the right of a worker to exercise freedom of movement with their families, and extended the equal of treatment rule to the latter. In this sense, it was stated that a contrary interpretation – maintaining the distinction among rights in persons and derivative rights – would adversely affect freedom of movement, and even more, 'it would run counter to the purpose and spirit of those rules [Community rules on coordination of national social security laws] to deprive the spouse or survivor of a migrant worker of the benefit of application of the principle prohibiting discrimination in the calculation of old-age benefits which the spouse or survivor would have been able

²⁸ Case 59/85, *State of the Netherlands v Ann Florence Reed* [1986] ECR 1283, pars 15 and 28-30.

²⁹ Being the leading judgment the one in Case 40/76, *Slavica Kermaschek v Bundesanstalt für Arbeit* [1976] ECR 1669. This distinction is further considered in Case 94/84, *Office national de l'emploi v Jozsef Deak* [1985] ECR 1873, pars 11 and 14-15; Case 157/84, *Maria Frascogna v Caisse des dépôts et consignations* [1985] ECR 1739, par. 15; Case C-243/91, *Belgian State v Noushin Taghavi* [1992] ECR I-4401, pars 7-8; Case C-310/91, *Hugo Schmid v Belgium State, represented by the Minister van Sociale Voorzorg* [1993] ECR I-3011, pars 12-13.

to claim, on the same conditions as nationals, if he or she had remained in the host State'.³⁰

Protection under the prohibition of discrimination clause was extended also concerning educational benefits for the descendant dependants of the worker and family members in general.³¹ Accordingly, residence requirement imposed to children of workers from other member states to be eligible for a study grant, while not imposed to children of national workers, was considered against the provisions ruling free movement.³²

Workers themselves were considered to be entitled to claim educational rights to improve their professional qualification, even when the link with previous work and studies in question was requested.³³ The following step was the extending of educational benefits to foreign

³⁰ The Court argues that 'the impossibility for a worker's spouse who, having accompanied the worker to another member state, decides to return to his or her State of origin with the worker or after the worker's death, to rely on the equal treatment rule in relation to the grant of certain benefits provided for by the legislation of the last State of employment would adversely affect freedom of movement for workers, which forms the context for the Community rules on coordination of national social security laws'. Case C-308/93, *Bestuur van de Sociale Verzekeringsbank v J.M. Cabanis-Issarte* [1996] ECR I-2097, par. 30.

³¹ Case 152/82, *Sandro Forcheri and his wife Marisa Forcheri, née Marino, v Belgian State and asbl Institut Supérieur de Sciences Humaines Appliquées - Ecole Ouvrière Supérieure* [1983] ECR 2323, par. 18.

³² According to Art. 12 of Regulation (EEC) No 1612/68 '[t]he children of a national of a member state who is or has been employed in the territory of another member state shall be admitted to that State's general educational, apprenticeship and vocational training courses under the same conditions as the nationals of that State, if such children are residing in its territory'. The Court has interpreted that 'under same condition' means 'not only to rules relating to admission, but also to general measures intended to facilitate educational attendance'. Case 9/74, *Donato Casagrande v Landeshauptstadt München* [1974] ECR 773, par. 9. Concerning access to education of descendant of migrant workers, however, the Court has decided that this rule –imposed by Art. 7 of Regulation (EEC) No 1612/68 – lays obligations only on the member state in which the migrant worker resides, and the exception to pay the enrolment fee cannot be invoked by the children of migrant workers residing in a different member state. Case 263/86, *Belgian State v René Humbel and Marie-Thérèse Edel* [1988] ECR 5365, pars 24-25.

³³ In *Brown*, the Court extended the concept of worker to a national of another member state who enters into an employment relationship in the host member state for a defined period 'with a view to subsequently undertaking university studies there in the same field of activity and who would not have been employed by his employer if he had not already been accepted for admission to university'. Case 197/86, *Steven Malcolm Brown v The Secretary of State for Scotland* [1988] ECR 3205, par. 23.

students who had no family member in the territory of the host state. Although educational policy was not included in the spheres which the Treaty entrusted to Community institutions, access to vocational training – i.e. any form of education which prepares for a qualification for a particular profession, trade or employment or which provides the necessary skills thereof – was considered connected with Community law. Moreover, students were seen as potential future workers and vocational training was held likely to promote free movement of persons; hence, an enrolment fee charged exclusively to non-national students was found, regarding nationals of the members states, contrary to the principle of equality.³⁴

The enlargement of the scope of persons entitled to move freely within the Community, to reside and to have access to the corresponding social benefits as ‘workers’ also reached posted workers³⁵ and recipients of economic services.³⁶ The change of addressees of the obligations

³⁴ Vocational training was considered an important way of promoting free movement of persons throughout the community, ‘by enabling them to obtain a qualification in the member state where they intend to work and by enabling them to complete their training and develop their particular talents in the member state whose vocational training programmes include the special subject desired’. Therefore, ‘the imposition on students who are nationals of other member states, of a charge, a registration fee or the so-called ‘minerval’ as a condition of access to vocational training, where the same fee is not imposed on students who are nationals of the host member state, constitutes discrimination on grounds of nationality contrary to Art. 7 of the Treaty’. Case 293/83, *Françoise Gravier v City of Liège* [1985] ECR 593, pars 24 and 26. See also Case 24/86, *Vincent Blaizot v University of Liège and others* [1988] ECR 379, par. 24, and see Case C-357/89, *Raulin*, *supra*, note 10, pars 31 and 34. In both cases the Court grants a right of residence for educational purposes.

³⁵ Case C-113/89, *Rush Portuguesa Lda v Office national d’immigration* [1990] ECR I-1417. See the Directive (EC) 96/71 of the European Parliament and of the Council of 16 December 1996 concerning the posting of workers in the framework of the provision of services, [1997] OJ L18/1.

³⁶ See, among others, Joined Case 286/82 and 26/83, *Graziana Luisi and Giuseppe Carbone v Ministero del Tesoro* [1984] ECR 377, par. 16. The Court considered tourists as recipients of services, and as such, protected by the prohibition of discrimination. Thus, ‘[w]hen Community law guarantees a natural person the freedom to go to another member state the protection of that person from harm in the member state in question, on the same basis as that of nationals and persons residing there, is a corollary of that freedom of movement. It follows that the prohibition of discrimination is applicable to recipients of services within the meaning of the Treaty as regards protection against the risk of assault and the right to obtain financial compensation provided for by national law when that risk materializes’. Case 186/87, *Ian William Cowan v Trésor public* [1989] ECR 195, par. 17. See also Case C-158/96, *Raymond Kohll v Union des caisses de maladie* [1998] ECR I-1931.

stemming from Community law is a relevant one, given that host member states must provide access to social advantages to these new beneficiaries, with the corresponding economic costs. Benefits were also extended to workers that exercised the rights derived from freedom of movement against their own states.³⁷ In this last case and related to EU citizenship, there is a concern among some scholars on the reverse discrimination effect that the dependence on a cross-border element for relying on those rights could generate, leading to situations in which nationals of a member states are not protected by citizenship provisions against discrimination by their own states.³⁸

The Treaty of Maastricht created a new status of persons entitled to move and reside freely within the territory of the member states: EU citizens. 'Union citizenship', the Court held, 'is destined to be the fundamental status of nationals of the member states, enabling those who find themselves in the same situation to enjoy the same treatment in law irrespective of their nationality, subject to such exceptions as are expressly provided for'.³⁹ Citizenship provisions continued to enlarge

³⁷ For example, the Court considered that the member states should recognize a trade qualification acquired by a national in the territory of another member state in which he had legally resided for the purpose of profiting from an authorization to practice certain trades. Case 115/78, *J. Knoors v Staatssecretaris van Economische Zaken* [1979] ECR 399. Similarly, the Court ruled in *Terhoeve* that 'Art. 48 of the Treaty and Art. 7 of Regulation No 1612/68 may be relied on by a worker against the member state of which he is a national where he has resided and been employed in another member state'. In this case, the imposition of 'higher social security contributions than those which would be payable, in similar circumstances, by a worker who has continued to reside throughout the year in the member state in question, without the first worker also being entitled to additional social benefits' deters a national of a member state to leave that state and transferred his residence to another member state in order to take up employment there, and hence, constitutes an obstacle for free movement of workers. Case C-18/95, *F.C. Terhoeve v Inspecteur van de Belastingdienst Particulieren/Ondernemingen buitenland* [1999] ECR I-345, pars 29, 39 and 40.

³⁸ Besson and Utzinger, *supra*, note 5, at p. 583. See the case law cited below, note 108-111 concerning 'purely internal situations'. The transnational element, contend the authors, has been attenuated in cases such as Case C-148/02, *Carlos García Avello v Belgian State* [2003] ECR I-11613; Case C-60/00, *Carpenter*, *supra*, note 20; and Case C-403/03, *Egon Schempp v Finanzamt München V.* [2005] ECR I-6421.

³⁹ Case C-184/99, *Rudy Grzelczyk v Centre public d'aide sociale d'Ottignies-Louvain-la-Neuve* [2001] ECR I-6193, par. 31. See also Case C-224/98, *Marie-Nathalie D'Hoop v Office national de l'emploi* [2002] ECR I-6191, par. 28; Case C-413/99, *Baumbast and R v Secretary of State for the Home Department* [2002] ECR I-7091, par. 82; Case C-148/02, *García Avello*, *supra*, note 38, pars 22-3; Case C-224/02, *Heikki Antero Pusa v Osuuspankkien Keskinäinen Vakuutusyhtiö* [2004] ECR I-5763, par.16; Case 76/05,

the scope of free movement of persons where the provisions of the economic freedom at stake had not been applied, especially concerning economically inactive persons, or where no more specific rights, such as freedom of movement of workers, services and establishment, were relevant.⁴⁰ This means that the Court continues to apply free movement of workers provisions, considered as a specific manifestation of the now general right to move and reside, and invokes the status of citizen when the other freedoms protecting those rights do not apply, mainly, then, in the case of non-economically active citizens that move.

It is also important to note that even when the right of EU citizens to move and reside freely within the territory of the Community has been mainly market-oriented, or included directly or indirectly an economic element⁴¹ – which has been a frequent concern among scholars⁴² – it is gradually emancipating from an exclusive economic rationale, constitutive of free movement of workers, into a wider conception of social and political citizenship.⁴³

The role of ECJ in this enlargement was decisive.⁴⁴ Citizens of the Union were granted ‘the right to move and reside freely within the territory of the member states, subject to the limitations and conditions laid down in this Treaty and by the measures adopted to give it effect’.⁴⁵ They also enjoyed the rights and were subjected to the duties laid down by the

Herbert Schwarz and Marga Gootjes-Schwarz v Finanzamt Bergisch Gladbach [2007] I-6849, par. 86.

⁴⁰ See Opinion AG Kokott in Case C-192/05, *K. Tas-Hagen and R. A. Tas v Raadskamer WUBO van de Pensioen- en Uitkeringsraad* [2006] ECR I-10451, par. 23, and the cases cited therein. See also Case C-100/01, *Ministre de l'Intérieur v Aitor Oteiza Olazabal* [2002] ECR I-10981, par 26.

⁴¹ Castro Oliveria, *supra*, note 5, at p. 78.

⁴² Besson and Utzinger, *supra*, note 5, at pp. 578-9. A meaningful political citizenship, they argue, would need important institutional reforms, to achieve social citizenship as a first step towards political citizenship.

⁴³ ‘EU citizenship is gradually emancipating *ratione materiae* from a purely legalistic and market-based conception of citizenship into a social and political citizenship, on the one hand, and *ratione personae* from a state-like exclusive form of membership to include non-nationals from European member states, on the other’. *Ibid.*, at p. 582. Nevertheless and paradoxically, this emancipation has taken place at the cost of social solidarity.

⁴⁴ Jacobs classifies the techniques used by the Court in this broadening in three categories: 1) using citizenship provisions to broaden the scope of the non-discriminatory principle; 2) using citizenship provisions to broaden the scope of the non-discriminatory principle in the context of market freedoms; 3) using citizenship as an independent source of rights. Jacobs, *supra*, note 5, at p. 593ff.

⁴⁵ Art. 18.1 EC Treaty.

Treaty, including the right not to suffer discrimination on grounds of nationality within the scope of application *ratione materiae* of the Treaty. An interpretation in this light led to the granting of equal treatment between nationals and non-nationals with respect to, e.g., family benefits and social advantages, that were within the material scope of Community law. A brief review of the most relevant cases usefully illustrates how citizenship provisions on free movement have been applied.

In *Martínez Sala*,⁴⁶ the Court decided, based on the citizenship provisions, that a Spanish national who had been legally residing for a long period in the host state, had previously been a worker in that state and was socially integrated, was entitled to receive a child-raising allowance, since as a citizen she was protected by the non-discriminatory principle. A similar ruling was made by the Court in *Baumbast*,⁴⁷ but in this case the person concerned had ceased his economic activity and was not legally resident in the host member state. The Court decidedly argued that citizens of the Union enjoy 'a right of residence by direct application of Art. 18.1 EC',⁴⁸ that is, merely by being a national of a member state. Since this judgment, citizenship provisions were recognised as having direct effect. The fact that this provision subject these rights to restrictions – as being covered by sickness insurance, or having sufficient resources to avoid becoming an unreasonable burden on the social assistance system of the host member, specified in secondary legislation – does not deprive it from its direct effect.⁴⁹

Minimum subsistence allowances – granted to non-nationals only if they were workers – was extended to a French national student, Rudy Grzelczyk,⁵⁰ a lawfully resident in Belgium who had paid his own costs of maintenance, accommodation and studies during three years, and who was, at the time of applying for the minimex, facing temporary economic difficulties. An analogous line of reasoning was settled in

⁴⁶ Case C-85/96, *Martínez Sala*, *supra*, note 8.

⁴⁷ Case C-413/99, *Baumbast*, *supra*, note 39.

⁴⁸ Cfr. with Case C-413/01, *Ninni-Orasche*, *supra*, note 14, where the right of residence is based on the Council Directives on residence, and not on citizenship provisions.

⁴⁹ On the direct effect of free movement of workers (ex Art. 39) see Case 41/74, *Yvonne van Duyn v Home Office* [1974] ECR 1337, pars 4-8; Case 13/76, *Gaetano Donà v Mario Mantero* [1976] ECR 1333, par. 20.

⁵⁰ Case C-184/99, *Grzelczyk*, *supra*, note 39.

Bidar,⁵¹ concerning grants for students covering their maintenance cost. In this case, the Court ruled that the requirement of being settled in the host member state and residence conditions prescribed by that national legislation provided to students citizen lawfully resident, led to an unjustified indirect discrimination based on nationality precluded by Community law.

Equal treatment among EU citizens was also interpreted as prohibiting national legislation which introduces a discriminatory condition, such as the requirement to complete secondary education 'in an establishment subsidised or approved by the Belgian State or by one of its communities' for granting a tideover allowance to a student. This was the discriminatory condition denounced by Ms. D'Hoop,⁵² a Belgian national that had completed secondary education in France and whose application for the allowance was rejected.

In *MRAX*,⁵³ citizenship provisions were invoked to decide that the right of residence of a third-country national did not derive from the authorisation of national authorities, but from their family ties with Union citizens. Also based on art 18, in *Zhu and Chen*,⁵⁴ the Court declared that a minor who was a national of a member state had the right to reside for an indefinite period in that State, if covered by appropriate sickness insurance and if the mother, a third-country national, had sufficient resources for not becoming a burden on the public finances of the host member state. The right of residence allows also the mother to reside in that State, even when the mother recognises that she made an abusive use of the Treaty provisions in order to arrange for her child to acquire the nationality of another member state.

The Court has also recognised that, due to the citizenship status, Mr. Collins,⁵⁵ a job seeking national of a member state not previously

⁵¹ Case C-209/03, *The Queen, on the application of Dany Bidar v London Borough of Ealing and Secretary of State for Education and Skills* [2005] ECR I-2119.

⁵² Case C-224/98, *D'Hoop*, *supra*, note 39.

⁵³ Case C-459/99, *Mouvement contre le racisme, l'antisémitisme et la xénophobie ASBL (MRAX) v Belgian State* [2002] ECR I-6591.

⁵⁴ Case C-200/02, *Kunqian Catherine Zhu and Man Lavette Chen v Secretary of State for the Home Department* [2004] ECR I-9925.

⁵⁵ Case C-138/02, *Brian Francis Collins v Secretary of State for Work and Pensions* [2004] ECR I-2703. Against the Court's ruling, see the Opinion of AG Ruiz-Jarabo Colomer, who after considering that Mr. Collins was not a worker, contents that concerning job seekers right to equal treatment does not extend to social advantages – as the income-based job

employed in the host member state could not be subjected to discriminatory treatment concerning a job seeker allowance, and that the grant of this benefit could only be restricted by objective justifications.

In *Trojani*,⁵⁶ the Court, for the first time, applied citizenship and equal treatment to an economically inactive citizen, that is, without reference to any economic factors. Mr. Trojani was not a student, a worker, a job seeker nor a previously employed person, and did not have the sufficient resources.

Recapitulating, the jurisprudential broadening of the personal scope of free movement of workers has progressively included job seekers, part-time workers, receivers of services, posted workers, students, and the family members of this wide range of right-holders. Citizenship, in turn, has continued and reinforced this enlargement tendency, including economically inactive individuals as entitled to move and reside within the Community.

Enlarging the material scope

The material scope of the provisions of the Treaty and secondary legislation on free movement of persons has also expanded, by means of three main techniques. The first one is the interpretation of what is to be considered a violation of this freedom. In this regard, and concerning individuals covered by the personal scope of free movement of workers, three periods can be distinguished: (1) a short initial period in which the Court insists on the fact that direct discrimination is prohibited by the Treaty provisions;⁵⁷ (2) a second period in which the Court ruled that the prohibition of discrimination on grounds of nationality precluded not only direct discrimination, but also any act, provision or requirement which leads to an indirect discrimination;⁵⁸

seeker's allowance involved – particularly if, as in the case under study, the EU citizen lacks any connection with the State or link with the domestic employment market (pars. 35, 69 and 76).

⁵⁶ Case C-456/02, *Michel Trojani v Centre public d'aide sociale de Bruxelles (CPAS)* [2004] ECR I-7573.

⁵⁷ See Case 1/67, *Stanislas Ciecchelski v Caisse régionale de sécurité sociale du Centre d'Orléans and directeur régional de la sécurité sociale d'Orléans* [1967] ECR 181, par. 2; Case 110/73, *G. Fiege v Caisse régionale d'assurance maladie de Strasbourg* [1973] ECR 1001, par. 14.

⁵⁸ Case 15/69, *Württembergische Milchverwertung-Südmilch AG v Salvatore Ugliola* [1969] ECR 363, par. 6: 'Art. 48 of the Treaty does not allow member states to make any exceptions to the equality of treatment and protection required by the treaty for all

and (3) a third period in which the Court added as a violation non-discriminatory obstacles, restrictions or obstructions to free movement.⁵⁹

Concerning indirect discrimination, requirements of residence or place of origin imposed by member states to foreign workers⁶⁰ or the dependant members of their families⁶¹ in order to enjoy some rights or benefits, the production of specific documents to prove certain capabilities for applying to employments,⁶² or the failure to recognise experience acquired in another state⁶³ were considered discriminatory since they could be more easily satisfied by national workers, and affected essentially or mainly to migrant workers, or else because they were not required to nationals.⁶⁴ In sum, Community law repealed any

workers within the community by indirectly introducing discrimination in favour of their own nationals alone'. See also Case 152/73, *Giovanni Maria Sotgiu v Deutsche Bundespost* [1974] ECR 153, par. 11, or Case C-27/91, *Union de Recouvrement des Cotisations de Sécurité Sociale et d'Allocations Familiales de la Savoie (URSSAF) v Hostellerie Le Manoir SARL* [1991] ECR I-5531, par. 10.

⁵⁹ See E. Johnson and D. O'Keefe, 'From Discrimination to Obstacles to Free Movement: Recent Developments Concerning the Free Movement of Workers 1989-1994' (2004) 31 *Common Market Law Review*, at p. 1313; L. Daniele 'Non-Discriminatory Restrictions to the Free Movement of Persons', (1997) 22 *European Law Review*, at p. 191.

⁶⁰ Therefore, 'a member state may not make payment of a social advantage within the meaning of Art. 7.2 of Regulation No 1612/68 dependent on the condition that recipients be resident within its territory'. Case C-57/96, *H. Meints v Minister van Landbouw, Natuurbeheer en Visserij* [1997] ECR I-6689, par. 50.

⁶¹ Case C-3/90, *Bernini*, *supra*, note 27, par. 28.

⁶² Such as the requirement of one particular diploma (type-B certificate of bilingualism in German and Italian, commonly known as the *patentino*) issued exclusively by a public authority of a member state at a single examination centre of one particular province as a condition to access to an employment. Case C-281/98, *Roman Angonese v Cassa di Risparmio di Bolzano SpA* [2000] ECR I-4139, pars 45-46.

⁶³ The Court considered that a clause on a collective agreement applicable to the public service of a member state which refuse to take into account for the purpose of promotion previous periods of comparable employment completed in the public service of another member state was contrary to the principle of non-discrimination. Case C-15/96, *Kalliope Schöning-Kougebetopoulou v Freie und Hansestadt Hamburg* [1998] ECR I-47, pars 23 and 28.

⁶⁴ 'The Court has consistently held that the equal treatment rule laid down in Art. 48 of the Treaty and in Art. 7 of Regulation No 1612/68 prohibits not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other distinguishing criteria, lead in fact to the same result'. Furthermore, '[u]nless it is objectively justified and proportionate to its aim, a provision of national law must be regarded as indirectly discriminatory if it is intrinsically liable to affect migrant workers more than national workers and if there is a consequent risk that

form of covert discrimination which, by applying some distinguishing criteria, in fact achieved the unlawful result of unequal treatment.

The abolition of discrimination on grounds of nationality entailed also equal treatment regarding remunerations.⁶⁵ Finally, it is not required that a discriminatory measure or provision affects in practice the migrant workers, it is sufficient that it is intrinsically liable to affect migrant workers more than national workers, placing the former at a particular disadvantage.⁶⁶

Furthermore, the Court specified in the third period, that violations to free movement went beyond direct and indirect discrimination, as to include any measure that constituted an obstacle for the exercise of this freedom or enjoyment of the rights derived from it, and all provisions that made less attractive or had a deterring effect on the freedom of movement.⁶⁷ The imposition to non-nationals of disproportionately different penalties for the failure to comply legislation of the host member states, the burden of greater social security contributions in a different member state without being entitled to additional benefits, or the rules that govern the transfer of football players, were considered as undue obstacles to free movement that had the effect of preventing or dissuading migrant workers from exercising their freedom.⁶⁸ After

it will place the former at a particular disadvantage'. Case C-35/97, *Commission of the European Communities v French Republic* [1998] ECR I-5325, pars 37-38. See, inter alia, Case 15/69, *Ugliola supra*, note 58, par. 6; Case 152/73, *Sotgiu supra*, note 58, par. 11 (insisting that equal treatment rules 'forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result'); Case C-237/94, *John O'Flynn v Adjudication Officer* [1996] ECR I-2617, par. 20; Case C-57/96, *Meints supra*, note 60, par. 45; and Case C-87/99, *Patrick Zurstrassen v Administration des contributions directes* [2000] ECR I-3337, par. 18.

⁶⁵ This means that '[t]he principle of equal treatment with regard to remuneration would be rendered ineffective if it could be undermined by discriminatory national provisions on income tax'. Case C-175/88, *Klaus Biehl v Administration des contributions du grand-duché de Luxembourg* [1990] ECR I-1779, par. 12.

⁶⁶ Case C-237/94, *O'Flynn supra*, note 64, par. 20; Case C-57/96, *Meints supra*, note 60, pars 20 and 21.

⁶⁷ See, e.g., the cases already cited *supra*, note 17 and 22, and Case C-224/02, *Pusa supra*, note 39, par. 19.

⁶⁸ According to these rules, 'professional footballer who is a national of one member state may not, on the expiry of his contract with a club, be employed by a club of another member state unless the latter club has paid to the former club a transfer, training or development fee'. Case C-415/93, *Union royale belge des sociétés de football association ASBL v Jean-Marc Bosman, Royal club liégeois SA v Jean-Marc Bosman and others and*

Bosman, several judgments followed this same line of reasoning:⁶⁹ unjustified obstructions or restrictions to free movement of persons are contrary to the Treaty, even when they result from the legitimate exercise of regulation powers or legal autonomy by member states or even private associations.⁷⁰ As some commentators have argued, the Court seems to have used a similar interpretative strategy as the one used in *Cassis de Dijon* for free movement of goods,⁷¹ and afterward free provision of services.⁷²

Free movement of citizens, on the other hand, has had a similar development concerning provisions or measures contrary to the prohibition of discrimination clause, though not yet equally consolidated. As some scholars correctly noted, until recently the Court had not yet extended the material scope of the rights to move and reside freely, derived from citizenship to obstacles that did not constitute a discrimination measure.⁷³ However, it seems that the Court is relaxing this interpretation, including also other obstructions or restrictions that affect or interfere in the exercise of these rights. As AG Jacobs argues in his opinion in *Pusa*, the Treaty provisions on European

Union des associations européennes de football (UEFA) v Jean-Marc Bosman [1995] ECR I-4921, par. 114. See also the Opinion of AG Lenz in this case, par. 190. A comment to this judgment can be found in J. M. Fernández Martín, 'Re-defining Obstacles to the Free Movement of Workers', (1996) 21 *European Law Review*, at p. 313.

⁶⁹ C-106/91, *Claus Ramrath v Ministre de la Justice, and l'Institut des réviseurs d'entreprises* [1992] ECR I-3351; C-19/92, *Dieter Kraus v Land Baden-Württemberg* [1993] ECR I-1663; C-55/94, *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165.

⁷⁰ This reasoning was already present in Case 36/74, *B.N.O. Walrave and L.J.N. Koch v Association Union cycliste internationale, Koninklijke Nederlandsche Wielren Unie et Federación Española Ciclismo* [1974] ECR 1405, par. 18. In the same sense Case C-415/93, *Bosman supra*, note 68, par. 83.

⁷¹ Case 120/78, *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein* ('Cassis de Dijon') [1979] ECR 649.

⁷² Case C-76/90, *Manfred Säger v Dennemeyer & Co. Ltd.* [1991] ECR I-4221, par. 12: 'It should first be pointed out that Art. 59 of the Treaty requires not only the elimination of all discrimination against a person providing services on the ground of his nationality but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other member states, when it is liable to prohibit or otherwise impede the activities of a provider of services established in another member state where he lawfully provides similar services'. See also C-275/92, *Her Majesty's Customs and Excise v Gerhart Schindler and Jörg Schindler* [1994] ECR I-1039.

⁷³ See J. Kokott, 'EU Citizenship - citoyens sans frontières?', European Law Lecture, 2005, Durham European Law Institute Online Paper 9; Besson and Utzinger, *supra*, note 5, at p. 584 (reflecting on what they call the *discrimination-dependence* of EU citizenship rights)

citizenship prohibit not only discriminatory measures on grounds of nationality, but also non-discriminatory measures that constitute an obstacle or a burden on citizen's rights.⁷⁴ Similar considerations can be found in the judgment in *Schempp*,⁷⁵ or in the Opinion AG Geelhoed in *De Cuyper*,⁷⁶ who points out that the question is whether there is any restriction on the exercise of the right to move and reside freely of Art. 18, and if so, whether such a restriction may be justified. Moreover, recent cases may be understood as supporting this line of reasoning, in which the Court explicitly discusses the existence of an obstacle to the free movement of citizens of the Union.⁷⁷

The second technique has been the extensive interpretation of the concept 'social advantages'⁷⁸ that migrant workers – and later students and citizens – could claim in the host member state. They are to be

⁷⁴ 'The conclusion' – which is consistent with and complementary to the Court's judgments in *D'Hoop* and *Baumbast* – 'must thus be that, subject to the limits set out in Art. 18 itself, no unjustified burden may be imposed on any citizen of the European Union seeking to exercise the right to freedom of movement or residence. Provided that such a burden can be shown, it is immaterial whether the burden affects nationals of other member states more significantly than those of the State imposing it' [emphasis added]. Opinion in Case C-224/02, *Pusa*, *supra*, note 39, point 22. See also *Jacobs*, *supra*, note 5, at p. 591.

⁷⁵ Case C-403/03, *Schempp*, *supra*, note 20, pars 42-45, where the Court considers if unfavourable tax consequences could be or not considered as an obstruction, and decides that the Treaty offers no guarantee to a citizen of the Union that transferring its activities to another member state will be neutral as regard taxations.

⁷⁶ Opinion delivered in Case C-406/04, *Gérald De Cuyper contra Office national de l'emploi* [2006] ECR I-6947, point 104 and 108.

⁷⁷ Case C-76/05, *Herbert Schwarz and Marga Gootjes-Schwarz v Finanzamt Bergisch Gladbach* [2007] ECR I-6849, par. 83ff., and also Joined Cases C-11/06 and C-12/06, *Rhiannon Morgan v Bezirksregierung Köln (C-11/06) and Iris Bucher v Landrat des Kreises Düren (C-12/06)* [2007] ECR I-09161, par. 26.

⁷⁸ By social advantage for the purpose of Art. 7.2 of Regulation 1612/68 the Court understands 'all the advantages which, whether or not linked to a contract of employment, are generally granted to national workers primarily because of their objective status as workers or by virtue of the mere fact of their residence on the national territory and whose extension to workers who are nationals of other member states therefore seems likely to facilitate the mobility of such workers within the Community'. Case C-85/96, *Martínez Sala*, *supra*, note 8, par. 25. See also Case 249/83, *Vera Hoeckx v Openbaar Centrum voor Maatschappelijk Welzijn, Kalmthout* [1985] ECR 973, par. 20; Case C-57/96, *Meints*, *supra*, note 60, par. 39; Case C-213/05, *Wendy Geven v Land Nordrhein-Westfalen* [2007] ECR I-6347, par. 12. Concerning child-raising allowance, following the reasoning of *Martínez Sala*, see Case C-212/05, *Gertraud Hartmann v Freistaat Bayern* [2007] ECR I-6303, pars 22-27. Earlier case law also followed this same line of argument concerning childbirth loans. Case 65/81, *Francesco Reina and Letizia Reina v Landeskreditbank Baden-Württemberg* [1982] ECR 33, par. 12.

distinguished from social security benefits.⁷⁹ The Court ruled that the concept of 'social advantages' could not be interpreted restrictively,⁸⁰ as it defines the substantive area of application of equality of treatment among workers, and hence must include all social and tax advantages, whether or not attached to the contract of employment.⁸¹ In the opinion of the Court, there are two requirements for being entitled to those benefits: the objective status of a worker or residence in the national territory, and the suitability of the benefit in facilitating their mobility within the Community, which depends on the nature of the benefit.⁸² The broadening of the breadth and scope of social advantages was further developed, including such as the minimum subsistence allowance (*minimex*),⁸³ allowances or reduced fares for large families,⁸⁴ guaranteed income for old persons that are dependent relatives in the ascending line of a worker,⁸⁵ tideover allowances,⁸⁶ unemployment benefits to dependent, job seeking children of a working national of a

⁷⁹ Social security benefits are the ones enumerated by Art. 4.1 of Regulation 1408/71, such as sickness and maternity benefits, invalidity benefits, old-age benefits, unemployment benefits, or family benefits. Social and medical assistance is excluded from the sphere of application of this regulation (Art. 4.4). Even if this list has been in principle considered exhaustive, the Court has ruled that the specific branches of social security are to be distinguished from the broader concept of social security, protected by Art. 51 EC. Thus, to determine if a certain benefit is or not a social security benefit it has to be taken into account the constituent elements of each particular benefit, in particular its purposes and the conditions on which it is granted, independent of whether a benefit is classified as a social security benefit by national legislation. In other words, a benefit falls within this definition if it has an 'intrinsic social security character'. See the Opinion of AG Cosmas in Case C-160/96, *Manfred Molenaar and Barbara Fath-Molenaar v Allgemeine Ortskrankenkasse Baden-Württemberg* [1998] ECR I-843, pars 29-35, 40-41 and the case law cited therein.

⁸⁰ Case 32/75, *Anita Cristini v Société nationale des chemins de fer français* [1975] ECR 1085, par. 12.

⁸¹ Case 207/78, *Criminal proceedings against Gilbert Even et Office national des pensions pour travailleurs salariés (ONPTS)* [1979] ECR 2019, par. 22.

⁸² Case C-85/96, *Martínez Sala*, *supra*, note 8, par. 25.

⁸³ Case 249/83 *Hoeckx* [1985] ECR 973, par. 22; Case 122/84, *Kenneth Scriver and Carol Cole v Centre public d'aide sociale de Chastre* [1985] ECR 1027, par. 26; Case C-184/99, *Grzelczyk*, *supra*, note 39, par. 27.

⁸⁴ Case 32/75, *Anita Cristini v Société nationale des chemins de fer français* [1975] ECR 1085 (railway tariffs for large families), Case C-185/96, *Commission of the European Communities v Hellenic Republic* [1998] ECR I-6601 (national benefits for large families)

⁸⁵ Case 261/83, *Carmela Castelli v Office National des Pensions pour Travailleurs Salariés (ONPTS)* [1984] ECR 3199, par. 11; Case 157/84, *Maria Frascogna v Caisse des dépôts et consignations* [1985] ECR 1739, par. 21.

⁸⁶ Case C-278/94, *Commission of the European Communities v Kingdom of Belgium* [1996] ECR I-4307, par. 25; Case C-224/98, *D'Hoop*, *supra*, note 39, par. 17; Case C-258/04, *Ioannidis*, *supra*, note 25, par. 34.

different member state,⁸⁷ disability allowances,⁸⁸ assistance educational grants for maintenance⁸⁹ and childbirth and maternity allowances,⁹⁰ even when attending the Court to the particular circumstances of the case.⁹¹

However, there are cases in which it has been recognised that it is legitimate for a member state to condition the eligibility for an allowance to the existence of a real link between the person concerned – person seeking work – and the member state,⁹² between the applicant for the benefit and the geographic employment market,⁹³ or even a sufficient degree of integration of the claimant within the educational

⁸⁷ Case 94/84, *Office national de l'emploi v Jozsef Deak* [1985] ECR 1873, par. 24.

⁸⁸ Case C-310/91, *Hugo Schmid v Belgium State, represented by the Minister van Sociale Voorzorg* [1993] ECR I-3011, pars 23-24. However, not all disability benefits are exportable social security benefits, since art 4(4) of the Regulation (EEC) No 1408/71, expressly excludes from its scope 'benefits schemes for victims of war or its consequences'. Opinion of Mr Advocate General Poiras Maduro delivered in Case C-499/06, *Halina Nerkowska v Zakład Ubezpieczeń Społecznych Oddział w Koszalinie* [2008] ECR n.y.r., point 13. Other benefits, such as an early retirement pension without reduction for those who are in receipt of war service invalidity pension, were considered neither exportable social security pensions, nor social advantages. See Case 207/78, *Criminal proceedings against Gilbert Even et Office national des pensions pour travailleurs salariés (ONPTS)* [1979] ECR 2019, pars 13-15 and 24. The same reasoning concerning allowances for former prisoners of war can be found in Case C-386/02, *Josef Baldinger v Pensionsversicherungsanstalt der Arbeiter* [2004] ECR I-8411, pars 16-19.

⁸⁹ Case 39/86, *Lair*, *supra*, note 16, par. 16.

⁹⁰ Case C-111/91, *Commission of the European Communities v Grand Duchy of Luxembourg* [1993] ECR I-817.

⁹¹ Even the right to obtain permanent residence (indefinite leave to remain) has been considered a social advantage. See Opinion of AG La Pergola in Case C-356/98, *Kaba*, *supra*, note 24, par. 41.

⁹² However, 'while a residence requirement is, in principle, appropriate for the purpose of ensuring such a connection, if it is to be proportionate it cannot go beyond what is necessary in order to attain that objective. More specifically, its application by the national authorities must rest on clear criteria known in advance and provision must be made for the possibility of a means of redress of a judicial nature. In any event, if compliance with the requirement demands a period of residence, the period must not exceed what is necessary in order for the national authorities to be able to satisfy themselves that the person concerned is genuinely seeking work in the employment market of the host member state.' Case C-138/02, *Collins*, *supra*, note 55, par. 72.

⁹³ 'In such a context it is legitimate for the national legislature to wish to ensure that there is a real link between the applicant for that allowance and the geographic employment market concerned', since such tideover allowance provided for by Belgian legislation 'gives its recipients access to special employment programmes, aims to facilitate for young people the transition from education to the employment market'. Case C-224/98, *D'Hoop*, *supra*, note 39, par. 38.

system. One common condition has been a certain period of residence,⁹⁴ which has been found appropriate in principle by the Court,⁹⁵ but only when it is unrelated to nationality and does not exceed what is necessary to achieve the objectives pursued by the rule.⁹⁶ On the other hand, 'a single condition concerning the place where the diploma of completion of secondary education was obtained is too general and exclusive in nature' to ensure this real link.⁹⁷ More important in assessing the genuine degree of connection are the individual circumstances of the applicant, such as the age at which the person was integrated into the society of the host member state. Accordingly, the degree of integration of a person who has moved when he was a minor and followed secondary education in the host state is likely to be greater than a person who moved to a different member state, say, after concluding higher education.⁹⁸

Lastly, it was disputed if, in addition to the status of citizen, the claim of rights to move and reside must rely on a matter on which Community law itself contains rules or poses objectives to be attained.

⁹⁴ AG Kokott, *Tas-Hagen*, *supra*, note 40, par. 62ff. As AG Kokott argues, '[i]n spite of its broad margin of discretion in determining the degree of integration required, the relevant member state must at least formulate the residence requirement in such a way that it accurately reflects the desired degree of integration', that is, being this criterion appropriate and necessary to attain the legitimate aim pursued. She concluded that the residence requirement in this case was inadequate and unnecessary, since the national legislation does not require that the persons concerned maintain their residence in the country conferring the benefit throughout the period they receive it, nor to hold residence there for a long period when applying for the benefit (par. 64ff.).

⁹⁵ Contrary to the ruling of the Court Case C-192/05, *K. Tas-Hagen and R. A. Tas v Raadskamer WUBO van de Pensioen - en Uitkeringsraad* [2006] ECR I-10451, where the residence requirement imposed by the national legislation to grant the benefit to civilian war victims in the present case was considered not proportionate and thus, not justified, constituting a violation of Art. 18.1 EC.

⁹⁶ 'In the absence of Community provisions prescribing a period during which Community nationals who are seeking employment may stay in their territory, the member states are entitled to lay down a reasonable period for this purpose. However, if after expiry of that period, the person concerned provides evidence that he is continuing to seek employment and that he has genuine chances of being engaged, he cannot be required to leave the territory of the host member state'. Case C-344/94, *Commission of the European Communities v Kingdom of Belgium* [1997] I-1035, par. 17. See also Case C-292/89, *The Queen v Immigration Appeal Tribunal, ex parte Gustaff Desiderius Antonissen* [1991] ECR I-745, par. 21.

⁹⁷ Case C-258/04, *Ioannidis*, *supra*, note 25, par. 31; Case C-224/98, *D'Hoop*, *supra*, note 39, par. 39.

⁹⁸ Case C-209/03, *Bidar*, *supra*, note 51, par. 57.

In some cases, the Court stated that citizenship of the Union was not intended to extend the scope *ratione materiae* of the Treaty to purely internal situations, or to situations which have no link with Community law, but it considered that there was a sufficient link when the situation had a cross-border or supranational dimension.⁹⁹ Furthermore, it ruled that it was not necessarily any further connection with matters within the material scope of Community law, and that the personal citizen status and the exercise of free movement were enough for applying the prohibition of discrimination on grounds of nationality and other rights conferred by the Treaty. More clearly, the Court has argued that there is a situation which falls within the material scope of Community law when a Union citizen exercises the right to free movement according to Art. 18 EC, even in situations in which the only links to Community law are the exercise of the right to move or the status as Union citizens.¹⁰⁰

Other arguments used by the Court that have contributed to far reaching effects on the provisions on free movement are, for example: a) that the mere failure of a national of a member state to complete legal formalities concerning access, movement and residence are not constitutive of these rights, and hence cannot justify a deprivation of those rights, or an order of expulsion;¹⁰¹ b) that the non-discrimination

⁹⁹ It has been held that 'citizenship of the Union, established by Art. 8 of the EC Treaty, is not intended to extend the scope *ratione materiae* of the Treaty also to internal situations which have no link with Community law.' Any discrimination which nationals of a member state may suffer under the law of that State fall within the scope of that law and must therefore be dealt with within the framework of the internal legal system of that State'. Case C-64/96 and Case C-65/96, *Land Nordrhein-Westfalen v Kari Uecker and Vera Jacquet v Land Nordrhein-Westfalen* [1997] ECR I-3171, par. 23.

¹⁰⁰ 'Those situations' - says the Court - 'include those involving the exercise of the fundamental freedoms guaranteed by the Treaty and those involving the exercise of the right to move and reside within the territory of the member states, as conferred by Art. 18 EC'. Case C-209/03, *Bidar*, *supra*, note 51, par. 33. See cases Case C-403/03, *Schempp*, *supra*, note 20, par. 18; Case C-184/99, *Grzelczyk*, *supra*, note 39, par. 33; and Case C-274/96, *Criminal proceedings against Horst Otto Bickel and Ulrich Franz* [1998] ECR I-7637, pars 15-16 (concerning freedom to go to another member state to receive service)

¹⁰¹ In *Royer*, the Court clearly stated that '[t]he mere failure by a national of a member state to comply with the formalities concerning entry, movement and residence of aliens is not of such a nature as to constitute in itself conduct threatening public policy and public security and cannot therefore by itself justify a measure ordering expulsion or temporary imprisonment for that purpose'. Case 48/75, *Jean Noël Royer* [1976] ECR 497, par. 51. See also the recent judgment of the Court in Case C-215/03, *Salah Oulane v Minister voor Vreemdelingenzaken en Integratie* [2005] ECR I-1215, par. 42 (where the failure to present a valid identity card or passport was considered by the Court as unable to affect the right of residence for recipients of services, as a right derived directly from the

rule applies to all legal relationships, both the ones that entered into force and the ones that take effect within the territory of the community;¹⁰² and c) that the benefits related to free movement can also include those that are outside the scope of the Treaty, inasmuch the citizenship status is invoked together with the principle of equality of treatment among nationals of the member states.¹⁰³

It has to be added that the Court has ruled that prohibition of discrimination has also indirect or horizontal effect concerning private persons, that is, applies not only to the action of public authorities – that includes central power, federal authorities and other territorial entities – but extends to private actors, such as rulers of any nature that regulate gainful employment and provision of services in a collective manner

Treaty, and that a detention order with a view to deportation for this failure to comply with an administrative formality was considered disproportionate and undue restriction on the freedom to provide services, even when the Court recognises that the host member state may require them to provide evidence of their identity and nationality by other means). Nevertheless, leaving aside deportation, not all other penalties (i.e. fines or detention) are incompatible with the provisions of the Treaty concerning free movement. In fact, the Court recognizes that ‘national authorities are entitled to impose penalties in respect of a failure to comply with the terms of provisions requiring foreign nationals to notify their presence which are comparable to those attaching to infringements of provisions of equal importance by nationals’ when they are proportionate to the gravity of the infringement and do not become an obstacle to the free movement of persons. Case 118/75, *Lynne Watson and Alessandro Belmann* [1976] ECR 1185, par. 21. In the same sense Case C-378/97, *Criminal proceedings against Florus Ariël Wijzenbeek* [1999] ECR I-6207, par. 44.

¹⁰² In this sense, ‘the rule on non-discrimination applies in judging all legal relationships in so far as these relationships, by reason either of the place where they are entered into or of the place where they take effect, can be located within the territory of the Community’. Case 36/74, *Walrave, supra*, note 70, par. 28. In the same sense, the Court has consistently held that ‘provisions of Community law may apply to professional activities pursued outside Community territory as long as the employment relationship retains a sufficiently close link with the Community’. Case C-214/94, *Ingrid Boukhalfa v Bundesrepublik Deutschland* [1996] ECR I-2253, par. 15, and the cases there referred.

¹⁰³ See Opinion AG Kokott in *Tas-Hagen, supra*, note 40, where she deeply analysis both the personal and material scope of the provisions of the Treaty applicable to the case (citizens (Art. 17.1) that exercise their right to move (Art. 18.1, par. 24). ‘Union citizens can assert their right to free movement even if the matter concerned or the benefit claimed is not governed by Community law’ (par. 33) (See to this effect Case C-148/02, *García Avello, supra*, note 38, pars 24 and 25; Case C-224/02, *Pusa, supra*, note 39, pars 17 and 22, and Case C-403/03, *Schempp, supra*, note 20, pars 18 and 19). AG continues her argument pointing out that ‘[a]s a fundamental freedom, Art. 18.1 EC is directly applicable and to be interpreted broadly. In particular, this provision has, like the classic fundamental freedoms of the internal market, a scope which is not restricted to specific matters’ (par. 34).

(for instance, collective agreement of trade unions,¹⁰⁴ world-wide federations,¹⁰⁵ or other associations not governed by public law),¹⁰⁶ and binds even unilateral behaviour of private actors¹⁰⁷ (such as banks or private corporations). Fundamental freedoms have direct effect, both vertical and horizontal, and as a result, they create individual rights that national legislators and administrations must respect and national courts must protect. To reason otherwise would compromise the objectives of the community regarding the creation of a common market.

Backwaters: the cautious case law

The need to account for democratic legitimacy led to a different attitude by the Court, restraining the exponential broadening of free movement of persons in some cases. Following a cautious position, the Court ruled, firstly, that purely internal or wholly domestic situations are

¹⁰⁴ Case C-341/05, *Laval un Partneri Ltd v Svenska Byggnadsarbetareförbundet, Svenska Byggnadsarbetareförbundets avdelning 1, Byggettan and Svenska Elektrikerförbundet* [2007] ECR I-11767, pars 88, 95 and 98-99; Case C-438/05, *International Transport Workers' Federation and Finnish Seamen's Union v Viking Line ABP and OÜ Viking Line Eesti* [2007] ECR I-10779, pars 33-34. In this last case, the Court ruled that 'the fact that certain provisions of the Treaty are formally addressed to the member states does not prevent rights from being conferred at the same time on any individual who has an interest in compliance with the obligations thus laid down, and, second, that the prohibition on prejudicing a fundamental freedom laid down in a provision of the Treaty that is mandatory in nature, applies in particular to all agreements intended to regulate paid labour collectively.' (par. 58). See also Case C-15/96, *Kalliope*, *supra*, note 63, par. 28.

¹⁰⁵ The Court has stated that freedom of movement of persons and provisions of services 'would be compromised if the abolition of barriers of national origin could be neutralized by obstacles resulting from the exercise of their legal autonomy by associations or organizations which do not come under public law'. Case 36/74, *B.N.O. Walrave and L.J.N. Koch v Association Union cycliste internationale, Koninklijke Nederlandsche Wielren Unie et Federación Española Ciclismo* [1974] ECR 1405, par. 17, and Case C-415/93, *Bosman*, *supra*, note 68, par. 83.

¹⁰⁶ For example, a professional organization such as the Bar Association of the Netherlands, that had passed a Regulation that contained the prohibition of multi-disciplinary partnerships of members of the Bar and accountants. The Court found that this prohibition was not contrary to Arts 43 EC and 49 EC. Case C-309/99, *J. C. J. Wouters, J. W. Savelbergh and Price Waterhouse Belastingadviseurs BV v Algemene Raad van de Nederlandse Orde van Advocaten*, *intervener: Raad van de Balies van de Europese Gemeenschap* [2002] ECR I-1577, par. 120.

¹⁰⁷ See Case C-281/98, *Angonese*, *supra*, note 62, pars 30-32, where it was held that the principle of non-discrimination set out in Art. 48 was drafted in general terms and was not specifically addressed to the member states.

outside the scope of Community law,¹⁰⁸ and hence are not covered by the rights of freedom of movement, such as situations concerning national workers who have never exercised the right to freedom of movement within the Community.¹⁰⁹ Similarly, the Court dismissed claims in which there were no real link between the worker and the labour regional market.¹¹⁰ In a different case, the Court ruled that national law granting workers an entitlement to a compensation on termination of employment, unless termination of the contract was on its own initiative, did not constitute an obstacle for a worker who wanted to move to a different member state, because the same would happen if he finished his contract and looked for a job in the same host member state. The compensation was considered a future hypothetical event, too uncertain and indirect to be an obstacle.¹¹¹

A diverse line of reasoning for producing backwaters in the vertiginous expansion of the scope of freedom of movement has been to recognise the legitimate use of the exceptions granted by the Treaty to the member states. Free movement of persons is subjected to the limitations justified on grounds of public policy, public security and public health (Art. 39.3). Despite the fact that they can be accepted as legitimate exceptions, the concept of public policy must be, according to the consistent case law, interpreted strictly and cannot be determined unilaterally by each member state.¹¹² Since exceptions can be used as a justification for derogating the fundamental principle of non-discrimination on grounds of nationality applied to a fundamental freedom, judicial control over their definition and use by national authorities is thorough and usually takes into account the particular

¹⁰⁸ Case 175/78, *The Queen v Vera Ann Saunders* [1979] ECR 1129, par. 11; Case 298/84, *Paolo Iorio v Azienda autonoma delle ferrovie dello Stato* [1986] ECR 247, par. 17.

¹⁰⁹ Case 35-36 and 82, *Elestina Esselina Christina Morson v State of the Netherlands and Head of the Plaatselijke Politie within the meaning of the Vreemdelingenwet; Sweradjie Jhanjan v State of the Netherlands* [1982] ECR 3723, pars 16-18, where the dependent relatives in ascending line of the national of a member state claimed the right to install with him.

¹¹⁰ Case C-224/98, *D'Hoop*, *supra*, note 39, par. 18.

¹¹¹ Case C-190/98, *Volker Graf v Filzmoser Maschinenbau GmbH* [2000] ECR I-493, pars 24-26.

¹¹² '[T]he concept of public policy in the context of the Community and where, in particular, it is used as a justification for derogating from the fundamental principle of freedom of movement for workers, must be interpreted strictly, so that its scope cannot be determined unilaterally by each member state without being subject to control by the institutions of the Community' Case 41/74, *Yvonne van Duyn v Home Office* [1974] ECR 1337, par. 18.

context and facts of the case.

Regarding the exceptions, the authorities of the member states have an area of discretion for determining the circumstances under which the exception will be applied and for taking into account certain personal conducts of individuals that, in a certain country and in a certain period, can be considered as dangerous or harmful for public policy, public security or public health.¹¹³ Nevertheless, the Court has argued that member states have to refrain from justifying restrictions on free movement by general considerations or invoking the economic ends of the service. Instead, the restriction has to be applied when the presence or conduct of a national of any member state that enters, stays or move within the territory of another member state 'constitutes a genuine and sufficiently serious threat to public policy'.¹¹⁴ A more strict interpretation points out that the recourse to the exception of public policy presupposes, in addition to the perturbation of the social order produced by the infringement of the law, 'a genuine and sufficiently serious threat to the requirements of public policy affecting one of the fundamental interests of society'.¹¹⁵ However, in some cases

¹¹³ In this sense, the Court has held that 'the particular circumstances justifying recourse to the concept of public policy may vary from one country to another and from one period to another, and it is therefore necessary in this matter to allow the competent national authorities an area of discretion within the limits imposed by the Treaty'. This area of discretion allows a member state, in imposing restrictions justified on grounds of public policy, 'to take into account, as a matter of personal conduct of the individual concerned, the fact that the individual is associated with some body or organization the activities of which the member state considers socially harmful but which are not unlawful in that state, despite the fact that no restriction is placed upon nationals of the said member state who wish to take similar employment with these same bodies or organizations' Case 41/74, *Yvonne van Duyn v Home Office* [1974] ECR 1337, pars 18 and 24. Contrary to this last resolution concerning the legality of the differentiation between nationals and non-nationals, the Court has decided that 'although Community law does not impose upon the member states a uniform scale of values as regards the assessment of conduct which may be considered as contrary to public policy, it should nevertheless be stated that conduct may not be considered as being of a sufficiently serious nature to justify restrictions on the admission to or residence within the territory of a member state of a national of another member state in a case *where the former member state does not adopt, with respect to the same conduct on the part of its own nationals* repressive measures or other genuine and effective measures intended to combat such conduct' [emphasis added] Case 115 and 116/81, *Rezguia Adoui v Belgian State and City of Liège; Dominique Cornuaille v Belgian State* [1982] ECR 1665, par. 8.

¹¹⁴ Case 36/75, *Roland Rutili v Ministre de l'intérieur* [1975] ECR 1219, pars 28-30.

¹¹⁵ Case 30/77, *Régina v Pierre Bouchereau* [1977] ECR 1999, par. 35; Case C-348/96, *Criminal proceedings against Donatella Calfa* [1999] ECR I-11, pars 21 and 24-27 (where it is held that previous criminal convictions cannot in themselves constitute grounds for

the Court accepts vague criteria for justifying restrictions to EU citizenship rights, that have been outlawed concerning economic freedom, such as 'public expenditure', 'genuine link', 'a certain degree of financial solidarity' or 'a certain degree of integration in the member state'.¹¹⁶

A further area from which free movement provisions can be excluded is public services, according to Art. 39.4 EC. Community law allows member states to reserve for its own nationals those posts which involve direct or indirect the participation in the exercise of powers conferred by public law and duties designed to safeguard the general interest of the state or of public authorities.¹¹⁷ The public service derogation or exception has been accepted in some cases by the Court, but nevertheless confined only to admission of non-nationals to public post, and not to the employment conditions after they have been admitted.¹¹⁸ Additionally, the 'public service' exception has to be interpreted strictly, taking into account, on the one hand, that 'provisions protecting Community nationals who exercise that fundamental freedom must be interpreted in their favour', and on the other hand, considering that the Court is the guard of uniform

the taking of measures of expulsion on grounds of public policy by national authorities, but that it must also be taken into account the personal conduct of the offender or of the danger which that person represents for the requirements of public policy)

¹¹⁶ Besson and Utzinger, *supra*, note 5, at p. 587.

¹¹⁷ In other words, these posts 'presume on the part of those occupying them the existence of a special relationship of allegiance to the State and reciprocity of rights and duties which form the foundation of the bond of nationality'. On the other hand, the exception 'does not cover posts which, whilst coming under the State or other organizations governed by public law, still do not involve any association with tasks belonging to the public service properly so called'. Case 149/79, *Commission of the European Communities v Kingdom of Belgium* [1980] ECR 3881, par. 7. To that effect, see also Case 307/84, *Commission of the European Communities v French Republic* [1986] ECR 1725, par. 12; Case 66/85, *Deborah Lawrie-Blum*, *supra*, note 12, par. 27; Case C-473/93, *Commission of the European Communities v Grand Duchy of Luxemburg* [1996] ECR I-3207, par. 2, and AG Léger's Opinion on this case, point 18; Case C-290/94, *Commission of the European Communities v Hellenic Republic* [1996] ECR I-3285, par. 2.

¹¹⁸ Indeed, the Court clearly puts forward the telos of this provision when it argues that 'the interests which this derogation allows member states to protect are satisfied by the opportunity of restricting admission of foreign nationals to certain activities in the public service. On the other hand this provision cannot justify discriminatory measures with regard to remuneration or other conditions of employment against workers once they have been admitted to the public service'. Case 152/73, *Sotgiu*, *supra*, note 64, par. 4.

interpretation and application of Community law.¹¹⁹ Although the Court has acknowledged the argument put forward by national authorities that the preservation of the member states' national identities is a legitimate aim respected by the Community legal order, the Court has ruled that if this legitimate aim can be safeguarded by other less restrictive means, the requirement of nationality to be eligible for a post as a teacher in an educational institution violated the principle of non-discrimination on grounds of nationality.¹²⁰

Concerning language knowledge requirements found necessary as for the nature of the post to be filled,¹²¹ the Court held that 'a permanent full-time post of lecturer in public vocational education institutions is a post of such a nature as to justify the requirement of linguistic knowledge [...] provided that the linguistic requirement in question is imposed as part of a policy for the promotion of the national language [Irish] which is, at the same time, the first official language and provided that that requirement is applied in a proportionate and non-discriminatory manner'.¹²²

The acceptance by the Court of other possible grounds for justifying indirect discrimination, outside the scope of the above mentioned restrictions, have been also a step backwards to the unrestricted application of free movement. This has been the case when considering justified a residence requirement for personal tax allowances,¹²³ or for

¹¹⁹ The Court has ruled that 'the need for uniform application of Community law and the principle of equality require that the terms of a provision of Community law which makes no express reference to the law of the member states for the purpose of determining its meaning and scope must normally be given an autonomous and uniform interpretation throughout the Community; that interpretation must take into account the context of the provision and the purpose of the legislation in question'. Case C-357/98, *The Queen v Secretary of State for the Home Department, ex parte Nana Yaa Konadu Yiadom* [2000] ECR I-9265, pars 24-26.

¹²⁰ See Case C-473/93, *Commission v Luxemburg*, par. 35.

¹²¹ Art. 3.1 Regulation 1612/68, *supra*, note 6.

¹²² Case 379/87, *Anita Groener v Minister for Education and the City of Dublin Vocational Educational Committee* [1989] ECR 3967, pars 19-21 and 24.

¹²³ Case C-279/93, *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-225. It is interesting to follow the reasoning of the Court: firstly, affirming that 'discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations' and that 'the situations of residents and of non-residents are not, as a rule, comparable' in relation to direct taxes; secondly, pointing out 'that Art. 48 of the Treaty does not in principle preclude the application of rules of a member state under which a non-resident working as an employed person in that member state is taxed more heavily on his income than a

the deducibility of insurance and pension contributions from income tax only if paid in the territory of the member state conferring the benefit.¹²⁴ However, the justification of these restrictions must be founded in objective considerations, independent of the nationality of the persons concerned, and they have to be proportionate to the legitimate aim of the national provisions, or what is the same, they must not go beyond the need to achieve those objectives.¹²⁵ Thus, it is not enough to adduce that the aim is reasonable and legitimate, e.g. that there are good administrative reasons (such as to ensure tax collection or avoid the risk of tax evasion¹²⁶) or that there is a need of preventing situations that can give rise to abuse, it has to be demonstrated that there is no less restrictive means available for achieving it.

In a similar vein, in a couple of cases before *Martínez Sala* and *Baumbast* the Court refused to accept claims of right to free movement based directly on Union citizenship provisions.¹²⁷ By adopting a cautious attitude, the Court did so when it considered it not necessary to answer questions related to direct applicability of citizenship provision where no harmonisation rules have been yet enacted, or were the questions of the referring court could be answered without reaching those provisions.¹²⁸

In addition, socio-economic reasons have prevented the Court of extending rights to migrant persons. Firstly, the application of the freedom to move and reside freely should avoid covering situations of

resident in the same employment'; thirdly, differentiating this general rule with the case of a 'non-resident who receives the major part of his income and almost all his family income in a member state other than that of his residence' in which 'discrimination arises from the fact that his personal and family circumstances are taken into account neither in the State of residence nor in the State of employment'; and finally, deciding that this discrimination between non-resident Community nationals and nationals resident was not justified (pars 31-32, 34, 38 and 42)

¹²⁴ Case C-204/90, *Hanns-Martin Bachmann v Belgian State* [1992] ECR I-249, pars 27-28 and 35, where this conditionality was found contrary to the Treaty, but nevertheless justified by the need to preserve the cohesion of the Belgian tax system; and Case C-300/90, *Commission of the European Communities v Kingdom of Belgium* [1992] I-305, par. 21.

¹²⁵ Case C-406/04, *De Cuyper*, *supra*, note 76, pars 39-42.

¹²⁶ See Case C-520/04, *Pirkko Marjatta Turpeinen* [2006] ECR I-10685, par. 35; Opinion of AG Kokott in Case C-470/04, *N v Inspecteur van de Belastingdienst Oost/kantoor Almelo* [2006] ECR I-7409, par. 117.

¹²⁷ See Case C-348/96, *Calfa*, *supra*, note 115, par. 30; and the cases cited *supra*, note 99.

¹²⁸ See cases cited *supra*, note 40.

social tourism – that is, to ‘travel with the sole or main purpose of taking advantage of what may be more favourable social welfare benefits in the host country’¹²⁹ – since they are excluded from the objectives of the Treaty.

Secondly, in cases concerning non-economically active nationals, their right to reside in the territory of the Community, recognised by the residence directives of the nineties¹³⁰ and thus even before the incorporation of citizenship provisions, were subjected to justified restrictions, as it were the requirements of not becoming themselves and the members of their families an unreasonable burden on the social assistance system of the host member state during their period of residence.¹³¹ Sickness insurance coverage in respect of all risks and sufficient resources had to be ensured, although member states could not require a specific amount or a certain documentary proof as evidence of the sufficiency of resources,¹³² and applied those conditions while respecting the limits imposed by Community law and the principle of proportionality.¹³³

¹²⁹ Opinion of AG Lenz delivered on Case 186/87, *Cowan*, *supra*, note 36, par. 39.

¹³⁰ Council Directive (EEC) 90/364 of 28 June 1990 on the right of residence [1990] OJ L180/26; Council Directive (EEC) 90/365 of 28 June 1990 on the right of residence for employees and self-employed persons who have ceased their occupational activity [1990] OJ L180/28; Council Directive (EEC) 90/366 of 28 June 1990 on the right of residence for students [1990] OJ L180/30. This last directive was replaced by Council Directive (EEC) 93/96 of the Council of 29 October 1993 on the right of residence for students [1993] OJ L317/59. In 2004 all of them – including some of the regulations cited *supra*, note 6 – were repealed by the Council Directive (EC) 2004/38 of 29 April 2004 that coordinates and orders previous legislation, and also implements some case law. See, for example, premise 17 and Arts 12-14 and 24 of the Directive.

¹³¹ Case C-184/99, *Grzelczyk*, *supra*, note 39, pars 38 and 40.

¹³² The Court interprets the provisions requiring sufficiency of resources as referring to a mere declaration, or such alternative means as are at least equivalent. Case C-424/98, *Commission of the European Communities v Italian Republic* [2000] I-4001, par. 44 and Case C-184/99, *Grzelczyk*, *supra*, note 39, par. 40.

¹³³ Case C-158/96, *Kohll*, *supra*, note 36, pars 17-19, where it is held that member states have the power to organise their social security systems, but in doing so they must comply with Community law. The Court has consistently ruled that ‘even if, in the areas which fall outside the scope of the Community’s competence, the member states are still free, in principle, to lay down the conditions governing the existence and exercise of the rights in question, the fact remains that, when exercising that competence, the member states must nevertheless comply with Community law’. Case C-438/05, *Viking*, *supra*, note 104, par. 40. See, in the same sense, among others Case C-120/95, *Nicolas Decker v Caisse de maladie des employés privés* [1998] ECR I-1831, pars 22 and 23; Case C-158/96, *Kohll*, *supra*, note 36, pars 18-19; Case C-341/05, *Laval*, *supra*, note 104 par. 87.

Thirdly, the Court has recognised that the risk of seriously undermining the financial balance of the social security system may constitute an overriding reason of general interest¹³⁴ which may justify a limitation to the freedom to provide services concerning a migrant worker.¹³⁵ Similarly, reasons such as the objective of maintaining a high quality balanced medical and hospital service open to all,¹³⁶ or the maintenance of treatment capacity or medical competence on national territory, have been considered appropriate to justify restrictions to the freedom to provide and receipt hospital services.¹³⁷

In synthesis, this cautious case law is founded either on judging the matter to be out of the scope of or unconnected with Community law (as a purely internal situation), on considering justified the restrictions to free movement based on considerations explicitly stated in the treaties and secondary legislation (as related to public policy, public

¹³⁴ The Court has declared that 'the risk of seriously undermining the financial balance of the social security system may constitute an overriding reason in the general interest capable of justifying a barrier' to the fundamental principle of freedom to provide services. Case C-158/96, *Kohll*, *supra*, note 36, par. 41. See also Case C-157/99, *B.S.M. Geraets-Smits v Stichting Ziekenfonds VGZ and H.T.M. Peerbooms v Stichting CZ Groep Zorgverzekeringen* [2001] ECR I-5473, par. 72; Case C-385/99, *V.G. Müller-Fauré v Onderlinge Waarborgmaatschappij OZ Zorgverzekeringen UA and E.E.M. van Riet v Onderlinge Waarborgmaatschappij ZAO Zorgverzekeringen* [2003] ECR I-4509, par. 67; and Case C-372/04, *The Queen, on the application of Yvonne Watts v Bedford Primary Care Trust and Secretary of State for Health* [2006] ECR I-4325, par. 103.

¹³⁵ Relating overriding reasons of general interest laid down by national law which are capable of justifying obstacles to the freedom to provide services, see some of the reasons recognised by Court's case law pointed to by AG Ruiz-Jarabo Colomer in his Opinion in the Case C-369/96 and Case C-376/96, *Criminal proceedings against Jean-Claude Arblade and Arblade & Fils SARL (Case C-369/96) and Bernard Leloup, Serge Leloup and Sofrage SARL (Case C-376/96)* [1999] ECR I-8453, par. 59.

¹³⁶ Case C-158/96, *Kohll*, *supra*, note 36, par. 41; Case C-157/99, *Geraets-Smits*, *supra*, note 134, par. 73.

¹³⁷ Case C-158/96, *Kohll*, *supra*, note 36, par. 50; Case C-157/99, *Geraets-Smits*, *supra*, note 134, par. 74. AG Ruiz Jarabo-Colomer clearly points out that an analysis of the case law reveals three types of overriding reasons in the general interest which, where they are fulfilled, are capable of justifying restrictions on the freedom to provide services: 'one consists in avoiding the risk of seriously undermining the financial balance of the social security system; another is the objective of maintaining a balanced medical and hospital service open to all, which may also fall within the derogations on grounds of public health under Art. 46 EC, in so far as it contributes to the attainment of a high level of health protection; and the final reason is maintenance of a treatment facility or medical service on national territory, which is essential for the public health and even the survival of the population'. Opinion in Case C-385/99, *Müller-Fauré*, *supra*, note 134, par. 44.

security, public health and public service posts), or on accepting judicially further restrictions to free movement when they can be held as objective and proportionate to the legitimate aim pursued (as the socio-economic reasons).

Case law rationale: identifying common arguments

The broadening of the scope of free movement of persons in the different directions pointed out above has been justified by several reasons. Three of them are particularly important and frequently used by the Court: a) the purpose of economic integration; b) the specific aims of free movement of persons; and c) the competence for decision-making on this policy area. In turn, the latter argument is mainly used when the Court follows a self-restraint position in issuing a cautious case law.

The purpose of economic integration

The realisation of an internal market across the territory of the member states is the core aim of the process of European economic integration, the implementation of which has been led by the market freedoms. A broad interpretation of these freedoms, and specifically of free movement of workers, has been frequently justified by means of this economic ratio: it is indispensable to the elimination of all kind of obstacles and differences among workers of the member states to create a common labour market, which is, in turn, necessary for achieving a common market free of internal barriers. The establishment of a common market, together with the approximation of the economic policies of the member states, contributes to the achievement of the aims of the European Community contained in Art. 2 of the EC Treaty. This chain of reasoning can be regarded as a simple teleological interpretation sequence, strongly influenced by economic ends.

member states have early assumed the duty to promote not only the improvement of working conditions for the mobility of labour, but more comprehensively, of living standards of their nationals, as it will be argued in the next section.¹³⁸ These developments are tightly

¹³⁸ Recital 3 Regulation 1612/68 states that '[w]hereas freedom of movement constitutes a fundamental right of workers and their families; whereas mobility of labour within the Community must be one of the means by which the worker is guaranteed the possibility of improving his living and working conditions and promoting his social advancement, while helping to satisfy the requirements of the economies of the member states ;

dependent on and only possible through the functioning of the common market, which comprises an area without internal frontiers in which free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaty.

A line of reasoning as the foregoing that has been used by the Court to support the extension of freedom of movement – and of the other classic fundamental freedoms – to matters not governed by Community law, that is ‘in respect of which the Treaty grants the Community no powers or otherwise contains rules’, arguing that it is crucial for the implementation of an internal market without obstructions to the economic freedoms. ‘The internal market would not have the comprehensive aim of providing an area without internal frontiers (Art. 14.2 EC), but would be merely fragmentary as it would be limited to individual products and activities governed by specific rules of Community law’.¹³⁹ Concerning freedom to provide services, it has been likewise argued that ‘its substantive scope must be oriented towards the model of a common market in which all economic activities within the Community are freed from all restrictions on grounds of nationality or residence’.¹⁴⁰ Moreover, the direct effect¹⁴¹ of the fundamental freedoms would be jeopardised if they cannot apply to fields not yet harmonised through Community law or to fields in which member states retained the powers to enact rules.¹⁴²

In achieving the objectives of eliminating all internal barriers, abolishing any restrictions on trade to form a common/single market and to strengthen the unity of the member states economies, free movement of workers played a key role. This market integration process implied a redefinition of the economic borders, from the

whereas the right of all workers in the member states to pursue the activity of their choice within the Community should be affirmed’

¹³⁹ Opinion of AG Kokott, *Tas-Hagen*, *supra*, note 40, par. 35.

¹⁴⁰ Opinion of AG Lenz in Case 186/87, *Cowan*, *supra*, note 36, par. 13.

¹⁴¹ In this sense, the Court has prescribed that, since ‘the provisions of Art. 48 and of Regulation No 1612/68 are directly applicable in the legal system of every member state and Community law has priority over national law, these provisions give rise, on the part of those concerned, to rights which the national authorities must respect and safeguard and as a result of which all contrary provisions of internal law are rendered inapplicable to them’. Case 167/73, *Commission of the European Communities v French Republic* [1974] ECR 359, par. 35.

¹⁴² See, to this effect, the sound arguments exposed in extenso by AG Kokott, *Tas-Hagen*, *supra*, note 40, pars 36-37, and the extensive line of precedent cited there.

territory of each member state to the sum of the territories of all the member states; a new supranational and single market governed by its own rules for movement of factors of production, where the participants share losses and benefits, and throughout which the four basic economic freedoms, the free and undistorted competition and the prohibition of discrimination on grounds of nationality were foundational.

As the single market has become a supranational space ruled by Community law, and, since the market functions as a provider of public goods and services also contributes to the redistribution of economic resources, the question of the legitimacy of decision-making over the market and the connected socio-economic areas becomes an important one. member states have entrusted the definition and regulation of the internal market to the Community since its origins, leading to a supranational configuration of the community of risks. What kind of market a certain polity wants to implement, e.g. how economic losses or costs are distributed, or how the different factors of production interrelate, is part of the polity's deep socio-economic structure. In the case of the European Community, the single market has been implemented in an important extent through an extensive judicial reading of the four economic freedoms.

Socio-economic aims of free movement of persons

As argued in the previous paragraph, the fundamental purpose of free movement of workers provisions was in its origins ment to favour economic integration. Nevertheless, further aims were soon attached to this freedom by the systematic interpretation of this freedom in the light of the *telos* of the Treaties, of the process of European integration in general, and by the reinforcement of the human and social dimensions. The human and social dimensions were incorporated both in the secondary legislation - regulating the social security regime for workers and workers and citizens right to reside and move freely - and in the judgments of the Court and Opinions of AG.

Together with the economic rationale, the interpretation and contextualisation of this freedom focused on the human dimension of the mobility of nationals of the member states. A clear sign of this can be found already in the mid- seventies, in an Opinion of AG Trabucchi

The migrant worker is not regarded by Community law - nor is

he by the internal legal system – as a mere source of labour but viewed as a *human being*. In this context Community legislature is not concerned solely to guarantee him the right to equal pay and social benefits in connection with the employer-employee relationship, it also emphasised the need to eliminate obstacles to the mobility of the worker, *inter alia* with regard to the ‘conditions for the integration of his family into the host country’.¹⁴³

This view was supported by AG Jacobs, when he contended that the third recital of Regulation (EEC) No 1612/68 ‘makes it clear that labour is not, in Community law, to be regarded as a commodity and notably gives precedence to the fundamental rights of workers over satisfying the requirements of the economies of the member states’.¹⁴⁴ More emphatically, Jacobs claim that:

A Community national who goes to another member state as a worker or self-employed person under Arts 48, 52 and 59 of the Treaty is entitled not just to pursue his trade or profession and to enjoy the same living and working conditions as nationals of the host State; he is in addition entitled to assume that, wherever he goes to earn his living in the European Community, he will be treated in accordance with a *common code of fundamental values*, in particular those laid down in the European Convention on Human Rights. In other words, he is entitled to say ‘*civis europeus sum*’ and to invoke that status in order to oppose any violation of his fundamental rights.¹⁴⁵

Considerations of the worker from a ‘human point of view’ are also incorporated in the argumentation of the Court when ruling about the right of the migrant worker to be accompanied by its family.¹⁴⁶

¹⁴³ Opinion of AG Trabucchi in Case 7/75, *Mr. and Mrs. F. v Belgian State* [1975] ECR 679, at p. 696.

¹⁴⁴ Opinion in Case 344/87, *I. Bettray v Staatssecretaris van Justitie* [1989] ECR 1621, par. 29.

¹⁴⁵ Opinion of AG Jacobs, Case C-168/91, *Christos Konstantinidis v Stadt Altensteig – Standesamt and Landratsamt Calw – Ordnungsamt* [1993] ECR I-1191, par. 46 [my emphasis]

¹⁴⁶ It is apparent from the provisions of the regulation, taken as a whole, that in order to facilitate the movement of members of workers’ families the Council took into account, first, the importance for the worker, from a human point of view, of having his entire family with him and, secondly, the importance, from all points of view, of the

On the other hand, social cohesion,¹⁴⁷ integration into the society of the host member state,¹⁴⁸ solidarity,¹⁴⁹ improvement of living and working conditions,¹⁵⁰ social progress¹⁵¹ and consolidation of an ever closer union¹⁵² constitute further aims of free movement of persons as some recitals and provisions of Community law reveal.

The integration of non-national workers or citizens in the society of the host member state has been a defining feature inspiring free movement provisions, particularly put forward in secondary legislation. Forming a closer union among the people of Europe, a desire which was included in the preamble of the EC Treaty is only possible if at least the basic socio-economic living conditions are granted for the citizens moving across the Union. Minimum means of subsistence, education and health are benefits that can be regarded as preconditions for the exercise of the right to free movement, and for workers and their families to integrate into the workforce, the society and the cultural life of a host member state.

A decisive role in this direction has been the case law, quoted above, which has contributed to the widening of the principle of equality to the family members of a migrant worker,¹⁵³ the broad definition of social advantage,¹⁵⁴ the recognition of educational rights to the worker and their family members,¹⁵⁵ the consideration of the degree of integration of citizens in the host society for granting them non-contributory benefits,¹⁵⁶ and the taking into account of the individual circumstances of the applicant to determine the genuine degree of connection with the

integration of the worker and his family into the host member state without any difference in treatment in relation to nationals of that State' Case 249/86, *Commission of the European Communities v Federal Republic of Germany* [1989] ECR 1263, par. 11.

¹⁴⁷ Recital 17 Directive 2004/38 and Art. 2 TEC.

¹⁴⁸ Recital 5 Regulation 1612/68 and recital 18 Directive 2004/38.

¹⁴⁹ Recital 5 TEU, recital 6 TEC and Art. 2 TEC.

¹⁴⁹ Recital 6 TEC and Art. 2 TEC.

¹⁵⁰ Recital 3 Regulation 1612/68, recital 1 Regulation 883/2004, recital 3 TEC and Art. 2 TEC.

¹⁵¹ Recital 8 TEU and recital 2 TEC.

¹⁵² Recital 12 TEU and recital 1 TEC.

¹⁵³ See cases quoted *supra*, note 17ff.

¹⁵⁴ See *supra*, note 78ff.

¹⁵⁵ See the cases cited *supra*, note 31 and 32.

¹⁵⁶ See Case C-209/03, *Bidar*, *supra*, note 51, par. 52, and Joined Cases C-11/06 and C-12/06, *Morgan*, *supra*, note 77.

society or market (and not exclusively the period of residence).¹⁵⁷

A non-economic rationale is also behind the right of citizens to move and reside freely across the territory of the member states. The ultimate purpose of citizenship provisions, in the words of AG La Pergola, is 'to bring about increasing equality between citizens of the Union, irrespective of their nationality'.¹⁵⁸

There has been intense theorisation around EU citizenship.¹⁵⁹ Shaw, for example, identifies the interaction between on the one hand, a narrow and formal concept of citizenship, and on the other, a broader notion of membership 'comprising constitutional, political and socio-economic elements in a multilevel (non-state) polity which is developing under post-national conditions involving fractures (state and individual) identities'.¹⁶⁰ It is not my intention here to analyse these theoretical contributions, but I will use the following lines to examine the relevant arguments put forward by some AGs in their opinions concerning citizenship rights.

The Court has consistently held that citizenship of the Union is aimed at being the fundamental status of nationals of the member states.¹⁶¹ From this standpoint, it has been argued that the exercise of the rights conferred by this status is dissociated from purely economic

¹⁵⁷ See Opinion of AG Geelhoed in *Bidar*, *supra*, note 51, par. 60.

¹⁵⁸ Opinion of AG La Pergola delivered in Case C-4/95 and Case C-5/95, *Fritz Stöber (Case C-4/95) and José Manuel Piosa Pereira (Case C-5/95) v Bundesanstalt für Arbeit* [1997] ECR I-511, par. 50. In the same sense, it was claimed that European citizenship 'embraces aspects which have already largely been established in the development of Community law and in this respect it represents a consolidation of existing Community law. However, it is for the Court to ensure that its full scope is attained. If all the conclusions inherent in that concept are drawn, every citizen of the Union must, whatever his nationality, enjoy exactly the same rights and be subject to the same obligations. Taken to its ultimate conclusion, the concept should lead to citizens of the Union being treated absolutely equally, irrespective of their nationality. Such equal treatment should be manifested in the same way as among nationals of one and the same State'. Opinion of AG Léger in Case C-214/94, *Boukhalfa*, *supra*, note 102, point 63.

¹⁵⁹ See, for example, the literature cited by Besson and Utzinger, *supra*, note 5, 573-4, fn 2-3. They identify three main areas of concern regarding citizenship: its right-base nature, its material scope and its personal scope (576-82).

¹⁶⁰ The conception resulting from this interaction is an ideal type that the author terms as 'an active conception of social citizenship based on a politically defined community'. J. Shaw, 'The Interpretation of European Union Citizenship' (1998) 61(3) *Modern Law Review*, 293-317, at p. 294.

¹⁶¹ See the case law cited *supra*, note 39.

considerations since it is founded on a new political and juridical basis.¹⁶² Similarly, it has been claimed that '[c]itizenship of the Union took on greater significance, in contrast to the perception of individuals as purely economic factors which had underlain the EC Treaty. The conditions on which freedom of movement may depend are now *no longer economic in nature*'.¹⁶³ Moreover, citizenship 'is not merely a hollow or symbolic concept, but [...] constitutes the basic status of all nationals of EU member states, giving rise to certain rights and privileges in other member states where they are resident', particularly to equal treatment with nationals of the host member state in respect of situations within the substantive scope of Community law.¹⁶⁴

AG La Pergola has been categorical in affirming that the contribution made to European construction by the introduction of the new citizenship is not merely potential:

The Treaty now thus embodies the idea of a common status which individuals, whose subjectivity is recognised in the law of the Union (see Art. 8 of the EC Treaty), acquire merely by being nationals of a member state. And it is a fertile idea: on the basis of the Union between member states, as historical experience teaches us, the union of peoples which the Treaties of Maastricht and Amsterdam envisage may grow and develop: the preamble to the Treaty on European Union refers to the decision to continue the process of creating an ever closer Union among the peoples of Europe.¹⁶⁵

Finally, it is less frequent to find considerations of citizenship as a political status. AG Ruiz-Jarabo Colomer has included this political dimension in some of his opinions:

The creation of citizenship of the Union, with the corollary described above of freedom of movement for citizens throughout the territory of the member states, represents a considerable qualitative step forward in that it separates that freedom from its

¹⁶² Case C-171/96 *Rui Alberto Pereira Roque v His Excellency the Lieutenant Governor of Jersey* [1998] ECR I-4607, note 63, par. 46.

¹⁶³ Opinion of AG Alber, Case C-184/99, *Grzelczyk*, *supra*, note 39, par. 52. [emphasis added]

¹⁶⁴ Opinion of AG Geelhoed, Case C-209/03, *Bidar*, *supra*, note 51, par. 28.

¹⁶⁵ Opinion delivered in Case C-356/98, *Kaba*, *supra*, note 24, par. 53.

functional or instrumental elements (the link with an economic activity or attainment of the internal market) and raises it to the level of a genuinely independent right inherent in the political status of the citizens of the Union.¹⁶⁶

Competences for decision-making related with free movement of persons

Competences to define the single market are located at the European level, while competences regarding welfare states are, in principle, out of the scope of Community law, being located at the national level. Nevertheless, in exercising of the latter, national regulations cannot violate Community law principles, such as the fundamental market freedoms. On the other hand, both at the national and the European level, decisions are taken by political collective actors.

It should be added that most of the time, the relationship among national and supranational decision-making procedures is governed by the competition principle (i.e., strict separation of powers), particularly when the competences are allocated at the supranational level. By contrast, also a cooperative relation can be found among the two levels regarding, e.g., coordination of social security schemes.

However, as it has been briefly pointed out, the allocation of competences for defining national social security systems has been, without formally being detached from the national sphere, destabilised due, on the one hand, to the regulations adopted by the member states in this area, and on the other, to the progressive extension of the right to free movement of persons through case law. The erosion of member states competences in defining welfare policies and the weakening of the national control on their borders and on the entrance and residence of workers/citizens, leads evidently to a redefinition of the interaction between national and supranational levels. The basic problem here is that competences on socio-economic policies are entrusted to different actors, and the decision-making procedures are of diverse nature, although in practice the diverse policies are interdependent. This

¹⁶⁶ Opinion of AG Ruiz-Jarabo Colomer in Joined Cases C-11/06 and C-12/06, *Morgan*, *supra*, note 77, par. 82, repeating the reasoning introduced in his Opinions in Case C-65/95 and Case C-111/95, *The Queen v Secretary of State for the Home Department, ex parte Mann Singh Shingara (Case C-65/95) and ex parte Abbas Radiom (Case C-111/95)* [1997] ECR I-3343, point 34, and Opinion in Case C-386/02, *Josef Baldinger v Pensionsversicherungsanstalt der Arbeiter* [2004] ECR I-8411, point 25.

imbalance reflects a fragmentary view of the process of European integration that undermines the achievement of its objectives. If ruling and deciding in one field, i.e. market freedoms, has, as it has been shown, deep effects in other fields (such as social security systems), some coordination or political response is expected at the legislative level to overcome the socio-economic problems mentioned so far.

The competence argument has been used in several ways. The Court, e.g., argues that it is competent to define the community meaning and scope of concepts such as worker or employment relationship, to give a strict interpretation to restrictions on economic freedoms, and to guarantee the realisation of the principle of equality. On the other hand, the ECJ, by means of introducing open standards that national judges should apply, recognises the division of competences between the European and the national level, and empowers those levels of judicial decision-making to take an active role in applying Community law, in an attempt to articulate judicial cooperation. A similar self-restraint attitude can be identified when the Court states that some matters, such as the fixing of a reasonable residence period to confer some rights or to admit a person as job seeker, correspond to the community legislator, and not to the Court.

In a recent case, the Court justified, based on competences entitlement, an extensive interpretation of the provisions of free movement of persons, so as to include the right residence of a third-country national that is a family member of a EU citizen, even if he has not legally resident on the member state where he resided before moving to a different one. By means of the division of competences between the member states and the Community rules established in Arts 18.2, 40, 44 and 52 EC, the Community has competence to enact the necessary measures to guarantee and encourage freedom of movement for Union citizens. A correct understanding of this freedom must include the right of the Community legislature to 'regulate the conditions of entry and residence of the family members of a Union citizen in the territory of the member states' where a contrary interpretation would interfere with his freedom of movement by discouraging citizens to move.¹⁶⁷

¹⁶⁷ Case C-127/08, *Blaise Baheten Metock and Others v Minister for Justice, Equality and Law Reform* [2008] ECR n.y.r., pars 60-63.

What community and what solidarity?

RECON models applied

The way of featuring and shaping free movement of persons is conditioned in a considerable way by the underlying conception of Europe adopted. As Menéndez has argued regarding free movement of workers,¹⁶⁸ it was far from obvious, from the original provisions of the treaties, whether to consider this economic freedom as a policy of a functional problem-solving organisation – which provided administrative and legal resources for the labour force to move and enabling, by this way, the achievement of a common market – or as a key principle of a supranational political community, i.e. as a vehicle of political integration – where nationals of member states that move around in the community were considered human beings, entitled with social rights (as a seed of European citizenship). In the light both of secondary legislation and ECJ's case law, the functional approach soon appeared as inadequate to give account of the nature and evolution of free movement of persons. The second interpretation, a federal understanding of the Community, was held to cover in a better way the general framework of this freedom. The two approaches regard workers differently, that is, the first see workers as factors of production, the second interpretation has a more comprehensive human and social dimension, respectively, and again the second position prevailed.¹⁶⁹ On the other hand, these competing conceptions of free movement of persons can be understood as concrete applications of a wider debate concerning which kind of polity the EU is or should be.

Conceptions of the European Union

It is possible to reconstruct the conception of EU backing the decisions of the Court by applying the three ways of understanding and reconstituting democracy in Europe proposed by the RECON project, namely the Renationalising model, the Federalising model and the

¹⁶⁸ A.J. Menéndez, 'European Citizenship after *Martínez Sala* and *Baumbast*: Has European law Become More Human but Less Social?', RECON Online Working Paper 2009/05, available at <http://www.reconproject.eu/main.php/RECON_wp_0905.pdf?fileitem=5456218>. In this sense, as early as 1976, there were scholars concerned about a common European citizenship. See R. Plender, 'An Incipient Form of European Citizenship', in F.G. Jacobs (ed.) *European Law and the Individual*, Amsterdam, North-Holland Publishing Co., 1976.

¹⁶⁹ A. Arnulf, A. Dashwood, M. Ross and D. Wyatt, 'Freedom of Movement for Workers' in id., (eds) *European Union Law*, London, Sweet & Maxwell, 2000, at pp. 380-3.

Cosmopolitan model. Under these strategies, the European Union is conceived, correspondingly, as a functional (problem-solving) international organisation, as a federal state based on a collective identity, and as a rights-based post-national union with an explicit cosmopolitan imprint.¹⁷⁰

Applied to the sphere of political economy in the EU, these models are further defined by the relationship between the community of economic risks (the market communities), the community of social insurance (the welfare communities) and the processes of collective decision-making (the state and other collective (public and non-public) institutions). Applying the three models to political economy matters, thus, results in a specific combination of these three elements considering if they are or not Europeanised.¹⁷¹

Having in mind the evolution of the Court's case law and the main arguments supporting it, it is interesting to note that both the renationalising and federalising strategy can be identified without too many difficulties. Thus, in the majority of the cases the Court, when broadening the scope of free movement of persons, argues that the competences both for creating a market free of obstacles and for facilitating the enjoyment by citizens of the right to move and reside are Community ones. In guarantying these freedoms, the Court interprets them broadly, and at the same time rules that national legislations have to comply with Community law provisions even in matters within their reserved areas of competences.

Therefore, as a general rule in the area of free movement of persons, the Court sees the European polity as a federal state, being both a community of risks and a community of insurance Europeanised, and

¹⁷⁰ See the leading working papers of this project by E. O. Eriksen and J. E. Fossum, 'Europe in Transformation. How to Reconstitute Democracy?', (2007) RECON Online Working Paper No. 01/2007, available at <http://www.reconproject.eu/main.php/RECON_wp_0701.pdf?fileitem=5456091>; and 'A Done Deal? The EU's Legitimacy Conundrum Revisited', (2007) RECON Online Working Paper No. 16/2007, available at <http://www.reconproject.eu/main.php/RECON_wp_0716.pdf?fileitem=16662534>.

¹⁷¹ A. Menéndez, 'The Political Economy of the European Constitution. Some General Observations', (2008) paper presented at the meeting of WP7, Arena, Oslo, 5 September 2008. 'Community of risk' is understood here as the space wherein markets operate and factors of production circulate freely. Community of insurance, in turn, is the extension of social coverage provided by welfare states to their members so they can face economic risks, or can correct market outcomes.

being clothed all levels of collective decision-making with democratic legitimacy. Judicial broadening of this freedom not only potentiates European competences, but also brings into the scope of Community law, and thus Europeanises, some issues that strictly speaking correspond to national decision-making, extending, e.g., the number of entitled to social advantages, or of educational benefits and grants to non-nationals. This presupposes accepting the existence of a certain degree of solidarity among member states and the expectations of a deeper integration among European citizens.

On the other hand, when the Court adopts a cautious case law, it generally reinforces the competences retained by the member states, by judging that a certain issue is out of the scope of Community law, or by accepting as legitimate, justified and proportionate certain restrictions on this policy area. In these cases, the Court visualises the EU as a problem-solving organisation, thus adopting a functional or renationalising approach, which translated to political economy matters means that only the community of risks (the single market) is Europeanised, but that there is no Europeanisation of the community of insurance, and no need of direct democratic legitimacy at the EU level.

However, this understanding can lead to a paradox. On the one hand, the Court rules that member states have discretion to impose some restrictions on economic freedoms and to define some policy areas; on the other hand, in exercising judicial review powers, the Court conditions or influences national decision-making by modelling, defining and interpreting restrictions and discretionary powers.

The third model is more difficult to identify in the case law under analysis. This is so because this topic is subjected to division of competences established by the treaties, while the cosmopolitan strategy is characterised by having no clear distribution of functions among levels and by operating through governance arrangements. As the cases brought before the Court normally dispute an infringement of Community law, and cosmopolitan techniques – at least in this descriptive stage – takes place mainly at the political level, it is only possible to detect certain weak tendencies in this direction in some judgments. It can be mentioned cases in which the Court constructs dikes, open standards or abstract parameters, and leaves others actors to take the decision, namely national administrations or courts. For example, in *Collins* the Court ruled that Mr. Collins could not be

considered as a worker, but nevertheless that it correspond to the national court to determine if the concept of worker in national legislation is also understood as in Community law.¹⁷² Leaving this margin of discretion for the national courts to decide the correspondence of a certain national measure or provision with that standard can lead to, on the one hand, a uniform interpretation of the framework concept or provision at European level, admitting, at the same time, the possibility of diverse application of those provisions within national spheres. Further cases are decisions using a criterion of reasonableness, which appeal to a kind of common European rationality.

Assessing solidarity for mobilised workers and citizens

Welfare systems function within the national territory and are mainly defined by national legislations. At first glance, the creation of a community of workers did not distort national design of welfare since workers had access to social security benefits insofar they contributed to the systems, following the same pattern as national workers. But the extension of some non-contributory benefits – which follow a redistributive logic since the beneficiary does not pay directly for that benefit, but they are funded by taxes revenue – to economically inactive migrants under certain circumstances, and even more striking, the construction of a community of citizens, changes this panorama.

Even if the social benefits remain to be distributed by the member states inside their national borders, judicial decision-making, coming from the supranational sphere, forces the redefinition of the social solidarity model at stake. As it has been argued along this paper, the enlargement of the scope of free movement of persons results, in practice, in obligating the member state concerned to share some social welfare benefits, granted at national level, with non-contributory nationals of a different member state.

Although Community law timidly enunciates solidarity among the principles and recitals of the EC Treaty, the welfare state tradition, embedded in the principle of redistributive justice, has encouraged the Court to recognise in some decisions, either explicitly or implicitly, the

¹⁷² Case C-138/02, *Collins*, *supra*, note 55, par. 33.

principle of solidarity. It has been argued that de facto solidarity,¹⁷³ or a certain degree of financial solidarity,¹⁷⁴ is necessary for ensuring economic integration. But what does this degree of solidarity entail?¹⁷⁵ And to what extent should member states share their welfare with non-nationals?¹⁷⁶ These are inquiries far from being pacific, and concerning the EU they have been theorised and answered in several ways.

The concept,¹⁷⁷ categories¹⁷⁸ and scope of solidarity, the identification of

¹⁷³ See the Schuman Declaration of 9 May 1950, available at <http://europa.eu/abc/symbols/9-may/decl_en.htm> (accessed 3 July 2009).

¹⁷⁴ The Court has interpreted the residence directives as accepting 'a certain degree of financial solidarity between nationals of a host member state and nationals of other member states, particularly if the difficulties which a beneficiary of the right of residence encounters are temporary', and this difficulties do not transformed him in an unreasonable burden on the public finances of the host member state. Case C-184/99, *Grzelczyk*, *supra*, note 39, par. 44. See also the Opinion of AG Geelhoed delivered in the Case C-413/01, *Ninni-Orasche*, *supra*, note 14, point 96, claiming that there is a need for a minimum degree of financial solidarity towards those residents EU nationals who are in a specific situation and have already resided legally for a considerable period in another member state before claiming social benefits.

¹⁷⁵ In his Opinion on *Bidar* (Case C-209/03, *supra*, note 51) AG Geelhoed asks what is meant by 'a degree' of financial solidarity. 'Clearly' – he contends – 'the Court does not envisage the member states opening up the full range of their social assistance systems to EU citizens entering and residing within their territory. To accept such a proposition would amount to undermining one of the foundations of the residence directives. It would seem to me that this is a further reference to the observance of the principle of proportionality in applying the national requirements in respect of eligibility for social assistance'. The proportionality requirements would imply 1) that the social benefits are granted for the purposes for which they are intended; 2) that concerning EU citizens, who have been lawfully resident within their territory for a relevant period of time, may equally be eligible for such assistance where they fulfil the objective conditions set for their own nationals, the criteria and conditions for granting such assistance cannot discriminate directly or indirectly between their own nationals and other EU citizens; 3) that those criteria and conditions are clearly stated and made known in advance; 4) that the application to social benefits is subject to judicial review; and 5) that the application of the benefits take account of the particular individual circumstances of applicants, where refusal of such assistance is likely to affect the substantive core of a fundamental right granted by the Treaty (pars 31-32 and 45)

¹⁷⁶ AG Jacobs, *supra*, note 5, p. 597-8. This author highlights the difficulties of defining some 'shared interest' of the Community beyond economic integration that could justify welfare solidarity among EU citizens, from competences not yet harmonized. In this scenario, he argues, '[i]t might be better to let the Community legislature decide on the extent of financial obligations of states towards citizens instead of broadening the member states' obligations through the case law on citizenship'.

¹⁷⁷ Solidarity has been defined, e.g., as consisting of sharing 'resources with others by personal contribution to those in struggle or in need and through taxation and redistribution organised by the state [...] Solidarity implies a readiness for collective

different models operating at the European sphere, and some normative assessments for future developments of solidarity in Europe, are the main concerns of European academic debate. I will just point out some approaches specifically referred to free movement of persons.

Several scholars have been involved in analysing to what extent free movement of persons, and in particular, of citizens, interacts with European solidarity. Some distinguish,¹⁷⁹ for example, two main uses of the principle of solidarity by the ECJ. On the one hand, the Court uses this principle negatively, as a way of defending national social welfare policies against erosions that could be produced by the single market, and hence, protecting EU citizens that have not exercised free movement.¹⁸⁰ When used positively, the principle of solidarity consists of imposing the obligations over the member states to extend benefits to migrant EU citizens who have exercised their right to move and reside freely within the Community under Art. 18 EC. Concerning this later use, Barnard claims, the degree of solidarity is dependent on the degree of integration on the host state. This would be reflected both in the ECJ's case law and in the Directive on citizen's rights¹⁸¹ that codifies an important part of the former. Thus, 'the longer migrants reside in the member state, the greater the number of benefits they receive on equal terms with nationals and this is justified in the name of integration and solidarity'.¹⁸² These three categories of residents are: 1) long-term residents (for a continuous period of more than 5 years), as was the case in *Martínez Sala*, fully assimilated to nationals of the host state, and covered by the principle of 'national' solidarity; 2) medium-term

action and a will to institutionalise that collective action through the establishment of rights and citizenship'. S. Stjernø, *Solidarity in Europe. The History of an Idea*, Cambridge: Cambridge University Press, 2005, p. 2.

¹⁷⁸ Somek decomposes solidarity in three main categories: solidarity as identification, solidarity as transcendence and, following Durkheim, solidarity as interpenetration (both mechanical and organic). A. Somek, 'Solidarity Decomposed: Being and Time in European Citizenship' (2007) 32(6) *European Law Review*, at p. 787.

¹⁷⁹ C. Barnard, 'EU Citizenship and the Principle of Solidarity' in E. Spaventa and M. Dougan (eds) *Social Welfare and EU Law*, Oxford, Hart Publishing, 2005, at p. 157ff.

¹⁸⁰ One way of doing that is, i.e., not applying the competition rules to social security schemes: 'the concept of an undertaking within the meaning of Arts 85 and 86 of the Treaty does not encompass organizations charged with the management of social security schemes of the kind referred to in the judgments of the national court.' Joint cases C-159/91 and C-160/91, *Christian Poucet v Assurances Générales de France and Caisse Mutuelle Régionale du Languedoc-Roussillon* [1993] ECR I-637, par. 20.

¹⁸¹ Directive 2004/38, *supra*, note 130.

¹⁸² Barnard, *supra*, note 179, p. 166.

residents (residing more than 3 months), as in *Grzelczyk*, where the equal treatment with nationals of the host state is based on a principle of 'transnational' solidarity,¹⁸³ limited to certain benefits or periods; 3) just-arrived migrants (residing less than 3 months), as in *Collins*, that can benefit from a limited equal treatment in the host state.

Similarly, it has been stated that the European solidarity model is a category-based type, since the level of social protection varies according to the basis of entitlement of the migrant which correspond to the normative criteria of degree of integration just mentioned.¹⁸⁴ As a general rule, it is still the economic function of the worker within the common market which justifies full access to social rights, that is, it follows the logic of reciprocal exchange or commutative solidarity between the contribution to the production by the worker and his socio-economic integration in the host society. This is so, even when the general solidarity logic of those social benefits is a redistributive or asymmetrical one.¹⁸⁵

On the other hand, it has been argued, that a different solidarity model is the one brought forward by the case law extending to economically inactive European citizens cross-border access to welfare benefits. This new model, focused on the citizen as such and not on his economic role in the common market, is the result of the joint interpretation of the citizenship provisions and non-discriminating treatment by the Court, which confers autonomous entitlement to welfare rights. Full access to social citizenship rights, together with supranational coordination rules, would further reflect a tendency towards a de-territorialisation of social security systems.¹⁸⁶

¹⁸³ This transnational solidarity implies that national taxpayers pay their taxes to help the provision of benefits for nationals in need and for migrant EU citizens in temporary need. Somek opposes to consider this transnational solidarity as an extension and a transmitter of national solidarity, even when this transnational solidarity remains indeterminate. Union citizenship, he further argues, alters the shape of, and even opposes to, national solidarity. Somek, *supra*, note 178, at pp. 787, 792 and 805.

¹⁸⁴ S. Giubboni, 'Free Movement of Persons and European Solidarity' (2007) 13 *European Law Journal*, at pp. 362-3.

¹⁸⁵ M. Ferrera, 'Towards an 'Open' Social Citizenship? The New Boundaries of Welfare in the European Union' in G.d. Búrca (ed.), *EU Law and the Welfare State. In Search of Solidarity*, Oxford, Oxford University Press, 2005, at p. 31.

¹⁸⁶ D. S. Martinsen, 'Social Security Regulation in the EU: The De-Territorialization of Welfare?' in G.d. Búrca (ed) *EU Law and the Welfare State. In Search of Solidarity*, Oxford: Oxford University Press, 2005. See also Giubboni, *supra*, note 184, at p. 361.

The judicial definition of the scope of social solidarity, which according to AG Fenelly 'envisages the inherently uncommercial act of involuntary subsidisation of one social group by another',¹⁸⁷ is an ongoing and inconclusive task. In some cases, the Court precisely extends national solidarity on the basis of the degree of integration of the migrant worker or citizen in the host member state, or of the existence of a real and effective link between the migrant and the society of that state. In other cases, it seems that the Court is more flexible in assessing whether or not there is a sufficient degree of integration, and gives priority to the non-discrimination rule or to the non-obstruction of the freedom. In both cases, however, the extension of solidarity rights implies that national redistribution of social resources is being determined, to some extent, by judicial supranational decisions, or what is the same, that part of national resources covering social welfare rights¹⁸⁸ is being judicially distributed at the European sphere.

These challenges and ideas are implicit as well in recent cases. As AG Maduro clearly points, even if it is true that

[N]o member state is under an obligation to subsidise the academic or other educational institutions of another member state [...] this is not a valid reason for interfering with the exercise of the fundamental freedoms guaranteed by the Treaty. It is one thing for a member state to be under no obligation to subsidise certain activities in another member state; it is quite another to deny certain financial benefits to its own nationals or nationals of another member state merely by virtue of the fact that they have exercised their rights of free movement. In a project such as the European Union, and, notably, as a consequence of the exercise of rights under the Treaty

¹⁸⁷ Opinion AG Fenelly in Case C-70/95, *Sodemare SA, Anni Azzurri Holding SpA and Anni Azzurri Rezzato Srl v Regione Lombardia* [1997] ECR I-3395, par. 29.

¹⁸⁸ The Court has recognised that a certain national welfare systems is structured around the principle of solidarity, when ruling that a national 'system of social welfare, whose implementation is in principle entrusted to the public authorities, is based on the principle of solidarity, as reflected by the fact that it is designed as a matter of priority to assist those who are in a state of need owing to insufficient family income, total or partial lack of independence or the risk of being marginalized, and only then, within the limits imposed by the capacity of the establishments and resources available, to assist other persons who are, however, required to bear the costs thereof, to an extent commensurate with their financial means, in accordance with scales determined by reference to family income'. Case C-70/95, *Sodemare*, supra, note 187, par. 29.

provisions on free movement, it is inevitable that some of the resources of member states will also benefit individuals or institutions of other member states. As the Court explained in *Grzelczyk*, there should be 'a certain degree of financial solidarity between nationals of a host member state and nationals of other member states'. The idea underlying this approach is that although national governments retain exclusive jurisdiction to regulate areas such as social security or educational policy, they cannot restrict the exercise of the rights guaranteed by the Treaty in order to ensure that the relevant funds and resources are enjoyed only by their own nationals.¹⁸⁹

Concluding remarks

To conclude, I will point out briefly some reflections. The broad construction of free movement of persons has led to: 1) the erosion of competences of the member states to control the access and residence within their territory and their welfare systems, and the progressive concentration of competences at the supranational level; 2) the redefinition of the provision of public goods and of the redistribution of economic national resources at European level;¹⁹⁰ and 3) the transit from a community of workers – migrant economic agents expected to integrate the host society as a necessary means for realising the common market – to a community of citizens, not bound to an economic rationale, that share common rights to move and reside.

From a democratic point of view, the judicial distribution of national solidarity that results from the enhanced protection of economic freedoms generates some legitimacy problems. In concrete terms, the increase in the number of receivers of non-contributory benefits has to be covered by national budgets, which means that if the former does not come hand in hand with an increase of tax revenue, there is a risk

¹⁸⁹ Case C-281/06, Opinion delivered on the case *Hans-Dieter Jundt and Hedwig Jundt v Finanzamt Offenburg* [2007] ECR n.y.r., par. 19. In the same sense, even when 'social policy is, in the current state of Community law, a matter for the member states, who have a wide discretion in exercising their powers in that respect [...] that wide discretion cannot have the effect of undermining the rights granted to individuals by the provisions of the EC Treaty in which their fundamental freedoms are enshrined'. Case C-213/05, *Wendy Geven v Land Nordrhein-Westfalen* [2007] ECR I-6347, par. 27 [author's emphasis]

¹⁹⁰ R. White refers to the problem of allocation of national resources in his concluding remark of his article 'Free Movement, Equal Treatment, and Citizenship of the Union' (2005) 54(4) *International and Comparative Law Quarterly*, at pp. 904-5.

that the social security standards decrease, since member states with a rising number of non-economically active migrants would not be able to afford the financial burden of providing benefits for complying with the equality of treatment.¹⁹¹ These economic reasons have justified some of the cautious case law, stating that excessive burden on national social security schemes could seriously erode welfare states, being the underpinning claims that not all social solidarity among strangers is feasible or desired.

The dilemma involved in constructing a more human but less social Europe¹⁹² – in other words, of entitling more individuals to social rights, but decreasing their quality – can be understood as a part of a larger problem that arises from the lack of coordination of market-making and market-correcting competences, and of the inadequately defined relations between economic freedoms and the desired levels of social rights.¹⁹³ As it has been pointed out by some scholars, it seems to be necessary to take a step forward towards a political construction of a specifically European sphere of redistributive solidarity, or of supranational form of welfare.¹⁹⁴ In developing this task, further levels of Europeanisation should also take into account a more comprehensive understanding of the mutual influences of decision-making among different areas of political economy.

¹⁹¹ Besson and Utzinger, *supra*, note 5, at p. 589, who fear a *social levelling-down* in member states due the increasing number of social benefits attached to EU citizenship, with the possible negative consequences of reduction of social benefits or expulsion of non-national job seekers from the territory.

¹⁹² I borrowed this expression from Menéndez, *supra*, note 168.

¹⁹³ These correspond to the procedural and substantive dimensions of social deficit as put forward by Menéndez, *supra*, note 171.

¹⁹⁴ Giubboni, *supra*, note 184, at pp. 374-5. In the same sense, see *supra*, note 176.

Chapter 4

Free movement of capital as the deep economic constitution of the EU

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Introduction

The purpose of this chapter is to describe the dynamics of the law on free movement of capital and to find out which of the three strategies of the RECON project is the most suitable to explain how capital flows are conceived in the European Union from a democratic perspective. In order to achieve both aims, the evolution of the European legal regime on movement of capital will be reconstructed, particularly focusing on the European Court of Justice's (ECJ) case law - not just describing the legal regime it shapes, but also explaining the influence or impact of its decisions on the democratic structure of the European Union. The reconstruction covers the period from the democratically legitimated postwar consensus on the need to control capital flows to the consecutive provisions proning to the current free movement of capital. Consequently, it departs from the Bretton Woods postwar regime, in which capital control was essential to the economic order (section one). Further, the first stage in the case law of the Court on capital movements (1980s) will be described, in which control contrary to other community freedoms were considered illegal or, in other words, in which the free movement of capital was just a complement of the common market (section two). This regime changed when capital flows were not only

fully liberalised but constitutionalised in the 1990s (section three). Finally, the free movement of capital was not only constitutionalised, but considered part of the economic freedoms which prevail over other European constitutional principles (section four). This chapter puts each stage of the evolution of the European legal regime on movement of capital into context, and inserts a critical evaluation of the Court's case law from the democratic perspective.

Bretton Woods as an expression of the initial wide social consensus on the control of capital flows

The point of departure of the analysis of the different legal regimes that have ruled the movement of capital in Europe must be located immediately after the World War II. At that moment, the human, social and political devastation which resulted from the conflict were so close that a wide consensus about how society should work and what should be its foundation could be forged.¹ The responses to the challenges posed by the nineteenth century *laissez-faire* economic system were identified as one of the main causes of the social and moral breakdown before war.² Therefore, during the postwar years a new social agreement about how economy and society should interrelate was achieved, considering that economic efficiency should be subordinated to other socio-political aims. In other terms, and applying the categories described by Polanyi,³ the new economic order to arise should be 'embedded' in society and not independent to it.

Once this consensus was transferred to politics, it gave rise to new strategies based on the conviction about the need to somehow control markets. Thus, in the national sphere it explains the emergence of

¹ Cf. T. Judt, *Postwar. A History of Europe Since 1945*, Penguin, London, 2005 (particularly chapters one and three).

² 'Nineteenth-century civilisation was not destroyed by the external or internal attack of barbarians; its vitality was not sapped by the devastations of World War I or by the revolt of a socialist proletariat or a fascist lower middle class. Its failure was not the outcome of some alleged laws of economics such as that of the falling rate of profit or of underconsumption or overproduction. It disintegrated as a result of an entirely different set of causes: the measures which society adopted in order not to be, in its turn, annihilated by the action of the self-regulating market'. K. Polanyi, *The Great Transformation. The Political and Economic Origins of Our Time*, Beacon Press, Boston, 1944, at p. 257. In sum, '[t]he congenital weakness of nineteenth-century society was not that it was industrial but that it was a market society'. *Ibid.* at p. 258.

³ Polanyi, *supra*, note 2.

social planning, or what is now well-known as 'welfare state'. What is relevant to here is that social planning meant that the state needed to manage economic resources enough to carry out the purposes of such a policy. Therefore, governments were compelled to retain control over the different tools through which national economic policy could be managed, specifically assuring the autonomy of its monetary policy, fixing exchange rates with other currencies and controlling capital flows.⁴ Because of their world scale, in order to achieve the goals referred to exchange rates and avoiding capital mobility, a wide-scope agreement of international scope was required. That agreement was achieved at the Bretton Woods Conference, its main aim being fixing exchange rates in connection with a gold standard.

Two remarks should be made about the system designed at Bretton Woods. First, to what refers to capital movements, the agreement not only allowed but fostered national controls over them, either by cooperative controls between states or by national exchange controls to search for and prevent illicit capital flows. In this respect it was 'a dramatic rejection of the liberal financial policies that had been prominent before 1931'.⁵ The second remark refers to the relationship between the economic order foreseen at Bretton Woods and democracy. Since all states participating in the Conference were able to retain their monetary autonomy,⁶ and since that autonomy gave

⁴ On the importance of the relation between these three elements, see R. A. Mundell, *International Economics*, Macmillan, New York, 1968 (particularly chapters 15 to 17). Mundell maintained that only two out of these three conditions - capital mobility, fixed exchange rates and monetary policy autonomy - can be met at any one time.

⁵ E. Helleiner, *States and the Reemergence of Global Finance. From Bretton Woods to the 1990s*, Cornell University Press, Ithaca, 1994, at p. 25. For a more detailed account of the growing support for capital controls after the international financial crisis of 1931 see *idem*, at pp. 26-33.

⁶ However, retaining monetary independence was not completely risk-free for states: 'Controls made it possible for national authorities to defend their pegged exchange rates against speculative attacks not prompted by significant divergences in economic policy. Firms and brokers still could find ways of spiriting domestic currency out of the country, through over- and under-invoicing and the operation of leads and lags, but the need to circumvent controls meant that there was expense involved. There had to be a reasonable expectation that a devaluation would follow in finite time for this to be worthwhile. Minor policy divergences that led to the modest overvaluation of a currency might not provide sufficient motivation. This in turn gave national authorities some leeway to utilise their monetary independence'. B. Eichengreen, 'The Bretton Woods system: Paradise Lost', in B. Eichengreen and M.

expression to a general will based on the abovementioned social consensus about the embeddedness of the economic order, the agreement resulting from Bretton Woods was perceived as democratically legitimated. Indeed, the political and economic theory which inspired the agreement was widely accepted, at least because it looked for promoting international commerce while guaranteeing national economic policy autonomy.⁷ Therefore, it proposed to respect liberal postulates 'embedding' the economic issues in the political order; in short, it proposed an 'embedded liberalism'.⁸

The birth of several European Treaties prompting integration during the 1950s was not alien to these ideas. Indeed, the design that underlied the signature of the Treaty on the European Coal and Steel Community (ECSC), by which member states pooled some sectoral policies under the authority of an independent agency with executive powers, transferred the idea of planning politics to the European sphere. Some years later, the Treaty on the European Economic Community (EEC) established the foundations of a common market in which factors of production could freely move as a way to guarantee growth by means of fostering commerce, while avoiding disturbances to national welfare politics. In this design it was possible to follow the trace of embedded liberalism theories. Therefore, the legal regime on capital flows it foresaw allowed a limited

Flandreau (eds), *The Gold Standard in Theory and History*, Routledge: London, 1997, at p. 226.

⁷ On the foundations of Keynes' political view on the issue see J. Kirshner, 'Keynes, Capital Mobility and the Crisis of Embedded Liberalism', (1999) 6 *Review of International Political Economy*, 313-337 (especially at pp. 317-321).

⁸ It was Ruggie who labelled the concept this way. For him, the essence of the embedded liberalism compromise was that 'unlike the economic nationalism of the thirties, it would be multilateral in character; [and] unlike the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism'. J. G. Ruggie, 'International Regimes, Transactions and Changes: Embedded Liberalism in the Postwar Economic Order'(1982) 36 *International Organization*, 379-415, at p. 393. In short: 'Embedded liberalism refers to the idea that Bretton Woods was liberal in the sense of encouraging international transactions, but its liberalism was tempered by or 'embedded' within a larger social context of goals beyond those of economic efficiency. It stands in contrast to the laissez-faire approach of the nineteenth century, which minimised government intervention and gave primacy to market rationality despite effects on national unemployment and other domestic conditions'. K. R. McNamara, *The Currency of Ideas. Monetary Politics in the European Union*, Ithaca, Cornell University Press, 1998, at p. 54.

liberalisation of movements.⁹ As a matter of fact, during the first two decades of the European integration process the free movement of capital was the common market freedom which received least attention. A whole chapter of the Treaty of Rome (the fourth of the third title, first part – Arts 67 to 73) was dedicated to it, establishing the obligation to ‘progressively abolish (...) all restrictions on the movement of capital belonging to persons resident in member states and any discrimination based on the nationality or on the place of residence of the parties or on the place such capital is invested’ (Art. 67.1 EEC Treaty). member states also included a ‘stand still’ clause, committing themselves ‘to avoid introducing within the Community any new exchange restrictions on the movement of capital and current payments connected with such movements, and shall endeavour not to make existing rules more restrictive’ (Art. 71 EEC Treaty). This legal framework was completed with two Directives implementing Art. 67 EEC Treaty,¹⁰ which distinguished three kind of regimes applicable to money transfers: the complete liberalisation of the cases included in lists A and B of the Directive, the allowance to keep the *status quo* for cases foreseen in list C, and the prohibition of the liberalisation of cases enumerated in list D.¹¹

What this regime meant was that in the long term there would be a *limited* liberalisation of capital flows *between member states*. This depicts a global scenario in which during three decades international capital movements were restricted, and which coexisted with a small area of six countries where some flows (gradually they were expected to be more) were allowed within their frontiers. One may think that because of economic efficiency reasons the natural further step

⁹ ‘As regards capital movement, the Treaty contains only one obligation: the freeing of current payments on capital movements (Art. 67, par. 2). The ultimate goal is stated so generally as to lend itself to any number of interpretations’. L. N. Lindberg, *The Political Dynamics of European Economic Integration*, Stanford, Stanford University Press, 1963, at p. 19.

¹⁰ First Council Directive of May 11, 1960 for the implementation of Art. 67 EEC, J.O. 1960, 921 and J.O. 1962, 2435; and Second Council Directive 63/21/EEC of December 18, 1962 adding to and amending the First Directive, J.O. 1963, 62. (For the English texts see O.J., Special Edition, 1959-1962, 49 and 1963-1964, 5). The Directives were amended by Art. 29 of the 1972 Act of Accession (see O.J. 1972 L73/94) and by Directive 85/583/EEC on transactions in shares in unit trusts (O.J. 1985 L372/39).

¹¹ A complete analysis of the legal regime foreseen in the capital Directives can be found in S. Mohamed, *European Community Law in the Free Movement of Capital and the EMU*, Stockholm, Kluwer Law International, 1999 (particularly at pp. 67-79).

towards integration in Europe would be to completely liberalise capital flows and to establish a common monetary policy. But that step was not necessary since, in order to avoid the negative effects that the liberalisation of some capital movements could produce on national balances of payments, the Treaties also included some provisions on monetary issues, by which the partners promised to co-ordinate their policies in monetary matters 'to the full extent necessary for the functioning of the Common Market' (Part III, Title II, Chapter 2 - Arts 104 to 109).¹²

As a result of the tight control member states exercised over capital flows in application of the Bretton Woods agreement and the (more permissive) regime of the EC Treaty, individuals accepted that capital's natural tendency to flow towards locations where more economic efficiency could be achieved, was limited to national borders (the Six's frontiers in well defined cases). Indeed, during these years the relevance of the free movement of capital by respect to the rest of the whole *Aquis Communautaire*, and to the other economic freedoms in particular, was scarce. This explains why the ECJ was not asked to solve a sole case on the matter until the end of the 1970s.

The first stage (the 1980s): the free movement of capital as a complement to the common market

From the end of the 1970s and for almost a decade, the ECJ had to deal with the first cases on capital movements. Its case law started to develop the foundations of the fourth community freedom: the free movement of capital. As explained, until then it needed not to be fully established because it was part of an overall international socio-political and economic design of which capital controls were an important part. But the end of the Bretton Woods exchange regime and, more importantly, of the social agreement it represented, on the one hand, and the consolidation of the other community freedoms, essentially based on the renewed interest in the completion of the common market and on the active role played by the Court, on the

¹² 'Why take formal steps to enhance capital mobility when equilibrating capital movements have already begun to play a salient role in the process of payments correction? As in any endeavour, it seems fortunate to be able to succeed without really trying'. B. J. Cohen, 'The Euro-Dollar, the Common Market, and Currency Unification', (1963) 18 *Journal of Finance*, 605-621, at p. 613.

other hand, changed the relevance of the free movement of capital for the European Communities.

In the first place, it should be noted that in the international level the breakdown of the exchange regime designed in Bretton Woods made capital controls connected to it not (so) necessary. Keynesian ideas were still important, but neoliberals became more and more influential in western societies,¹³ their point of view radically opposed to capital controls.¹⁴ As a result of these events, liberalisation of capital flows in the international scene was feasible for the first time in many decades. However, in the European scenario a slightly different play was on the stage. Even before the end of the Bretton Woods regime, member states have decided to maintain stable their exchange rates (at least to a certain degree) by preventing exchange fluctuations of more than 2,25 per cent in relation to the US dollar in order to achieve in the medium term an Economic and Monetary Union.¹⁵ The European 'currency snake', as the system was known, and its sequel, the 'snake in the tunnel', both failed, but the consolidation and improvement of this framework gave finally rise to the establishment of the European Monetary System in 1979. As a

¹³ '[The neoliberal] movement remained on the margins of both policy and academic influence until the troubled years of the 1970s. At that point it began to move centre-stage, particularly in the US and Britain, nurtured in various well-financed think-tanks (offshoots of the Mont Pelerin Society, such as the Institute of Economic Affairs in London and the Heritage Foundation in Washington), as well as through its growing influence within the academy, particularly at the University of Chicago, where Milton Friedman dominated. Neoliberal theory gained in academic respectability by the award of the Nobel Prize in economics to Hayek in 1974 and Friedman in 1976'. D. Harvey, *A Brief History of Neoliberalism*, Oxford, Oxford University Press, 2005, at p. 22. Harvey describes in detail how neoliberal ideas took root and were finally implemented in pp. 43-63.

¹⁴ 'The chief danger, however, would threaten from renewed attempts by governments to control the international movements of currency and capital. It is a power which at present is the most serious threat not only to a working international economy but also to personal freedom; and it will remain a threat so long as governments have the physical power to enforce such controls. It is to be hoped that people will gradually recognise this threat to their personal freedom and that they will make the complete prohibition of such measures an entrenched constitutional provision'. F. A. Hayek, *Denationalisation of Money*, London, Institute of Economic Affairs, 1976, at p. 125.

¹⁵ See Plan Barre of February 1969 and the Werner Report of 1970. The latter document entailed the 'total and irreversible mutual convertibility free from fluctuations in rates and with immutable parity rates, or preferably they will be replaced by a sole Community currency'.

result, in that decade the relevance of capital controls declined in Europe, but not as much as in the international level.

The other reason which explains why capital flows acquired a new dimension during the second half of the 1970s decade is referred to the development of the common market in Europe. Being money transfers across national borders inherent to any economic activity foreseen in the EEC Treaty, the free movement of capital appeared to be closely related to any other community freedom. In other words, when the case law of the European Court of Justice consolidated the other economic freedoms, movements of capital acquired a new dimension and became by this very reason an important issue. As a result, since this moment the Court had to deal with some cases related to these movements.

In that respect, in the *Casati*¹⁶ ruling the European Court of Justice identified one of the first problems the free movement of capital had to face to: as have been said, inasmuch as the money transferred is a mean of payment it is very closely related to the other community freedoms,¹⁷ but money transfers are also intimately connected with the monetary and political economy of the member states since they have a potential impact on them (mainly over their balance of payments).¹⁸ Should then a money transfer be considered a mean of payment and, therefore, a part of the other well-established community freedoms? Or should it be considered a capital movement by itself, what permits to apply the exceptions the Treaty provides in case of imbalance on the balance of payments of a member state? Thus, it is vital to decide which dimension prevails: considering money transfers as means of payment, which means that the rules of the pertinent freedom should be applied, or as capital movements, which permits free movement of capital provisions to be applied.¹⁹

But before answering this question, it should be noted that this problem will not be relevant at all if the Treaty provisions about the

¹⁶ Case 203/80 *Criminal proceedings against Guerrino Casati* [1981] ECR 2595.

¹⁷ *Casati*, *supra*, note 16, par. 8.

¹⁸ *Casati*, *supra*, note 16, par. 9.

¹⁹ A comment on this ruling in M. Petersen, 'Capital Movements and Payments Under the EEC Treaty after *Casati*', (1982) 7 *European Law Review*, 167-182; and in J. - V. Louis, 'Free Movement of Capital in the Community: the *Casati* Judgment', (1982)

¹⁹ *Common Market Law Review*, 443-452.

free movement of capital were directly applicable (as were many articles related to the other community freedoms). This legal issue, which has an extraordinary repercussion on the configuration of the freedom as well as on the empirical results of the common market, was dealt with in the above-mentioned *Casati* ruling. In *Casati* the Court decided that norms on the free movement of capital (and specifically Art. 71 EEC Treaty) did not have direct effect because the obligation to liberalise capital movements is limited 'to the extent necessary to ensure the proper functioning of the common market', an assessment which is a matter for the Council.²⁰ This reasoning was still coherent with the social agreement and the original economic structure the Treaties were based on: if political autonomy of member states was to be assured in the fixed exchange rates environment provided by Bretton Woods, capital flows must be under control. In addition, the Court stated that the expiration of the transitional period did not mean that restrictions on the exportation of bank notes (Art. 67.1 EEC Treaty) were abolished – what in fact means that national restrictions to the free movement of capital may be valid for community law if they are justified enough.

Two main ideas inspire these statements and the *Casati* ruling itself. First of all, that *member states retained the competences over decisions about the material scope of the free movement of capital*. Indeed, in 1979 the United Kingdom liberalised the movements of capital under Thatcher's mandate.²¹ This decision pushed the remaining European governments towards liberalisation, because maintaining national controls would have discouraged inflows. But beyond the particular power relations it entailed, what this situation made crystal clear was that the decisions about movements of capital were still under national competence. Precisely, the view of the free movement of capital the Court expressed in the *Casati* ruling was that the Council had the power to decide to what extent the liberalisation of capital movements was needed. Therefore, when looking at it through the lenses of the tripartite scheme, the *Casati* ruling supports the renationalising strategy. This conception of the free movement of

²⁰ *Casati*, *supra*, note 16, par. 11.

²¹ The abolition of Britain's forty-year-old system of exchange controls in October 1979 is labeled as 'dramatic' by Helleiner. He also states that 'the government is reported to have destroyed the British Treasury's files on exchange controls to prevent any future government from reimposing them'. E. Helleiner, *supra*, note 5, at p. 150.

capital has been consistently reaffirmed by the Court in its case law of the 1980s. Indeed, it has also stated that the provisions of the Directive implementing Art. 67 EEC Treaty did not restrict the right of member states to prevent infringements of their laws and regulations (*Brugnoni and Ruffinengo*).²² Therefore, the member states were not only allowed to determine the scope of the free movement of capital by deciding to what extent it was necessary for a proper functioning of the common market (as was ruled in *Casati*), but they also could limit that scope if national measures for the surveillance of their balance of payments or their type of currency were needed (Art. 108 EEC Treaty). This means that not only the market-correcting norms, but also the market-making ones were subject to the will of the States (here 'the will of the States' should not be understood as a common will, but as the will of each member state, since particular measures reducing the scope of the free movement of capital in each member state were allowed). In sum, one can conclude that the strategy of renationalisation²³ was the one which inspired the free movement of capital during this first stage.

The second main idea which hides behind the reasoning of the Court in *Casati* is that *the free movement of capital had a subsidiary role in respect of the other freedoms* which compound the common market: it shall be granted just to the extent it is needed for their functioning. This conception of the free movement of capital implied the need to open a new jurisdictional pattern in order to determine to which field a money transfer was related, since depending on the decision to attribute it to one freedom or another, the legal consequences would be radically different.²⁴ If a money transfer was considered a

²² Case 157/85 *Luigi Brugnoni and Roberto Ruffinengo v. Cassa di risparmio di Genova e Imperia* [1986] ECR 2013.

²³ Or even more strictly speaking, the *national* strategy: competences were neither devolved to the member states nor renationalised, because they have not ever been attributed to other fore than the national one. In addition, if both market-making and market-correcting norms were competence of the national level (i.e. just Treaty norms were supranational, and their content referred to national authorities) it seems to us that this nomenclature is accurate.

²⁴ 'In the past the Court has opted to regard the movement of capital as subsidiary to the other freedoms. Broadly speaking this meant that the provisions on movement of capital were applicable only where a transfer of money or capital did *not* constitute a payment in connection with the movement of goods or services. In this way the Court prevented the other freedoms being affected by the operation of the rules on movement of capital and thus avoided possible cumulative application. In its case law the Court has as far as possible avoided this cumulative or parallel application

movement of capital, the legal regime will be mainly subjected to the will of the member states, as shown, while if it was considered a mean of payment of an economic transaction related to any other freedom the legal regime will substantially change (at least because of the direct effect of the provisions regulating those freedoms). Therefore, the important question which is yet to be answered is: to which legal regime a money transfer yields to?

As a matter of fact this issue was dealt with in what should be considered the cornerstone of the case law of the European Court of Justice during this first stage. In the *Luisi and Carbone* case,²⁵ by means of a preliminary ruling procedure, the Court was asked about the distinction between the notions of 'current payment' (Art. 106 EEC Treaty) and 'movement of capital' (Art. 67 EEC Treaty). During this procedure the Court was also inquired about under which circumstances national controls should be allowed in order to identify movements of capital in the form of current payments. The legal problem was, thus, to consider the crossing of a border with some money in cash as part of the free movement of capital (regime which allows member states to retain some powers in order to control their balance of payments) or to consider it as a mean of payment (Art. 106.3 EEC Treaty). In this particular case the facts which gave rise to the legal conflict were related to the free provision of services, but under some special features: this was the first time a money transfer was attached to a movement from the part of the user instead of from the part of the provider of the service.²⁶

The option supported by Italy and France, which were very interested in defending their balance of payments because of the economic difficulties they were suffering, was that these transfers of

by classifying the transaction or act restricted by a given national measure as a movement of capital, movement of goods, movement of persons or provision of services.' A. Landsmeer, 'Movement of Capital and Other Freedoms', (2001) 28 *Legal Issues of Economic Integration*, 57-69, at p. 57.

²⁵ Joined cases 286/82 and 26/83 *Graziana Luisi and Giuseppe Carbone v. Ministero del Tesoro* [1984] ECR 377.

²⁶ Several comments were published about this ruling. See J.-V. Louis, 'Free Movement of Tourists and Freedom of Payments in the Community: The Luisi-Carbone Judgment', (1984) 21 *Common Market Law Review*, 625-637; J.-C. Séché, 'Libre prestation des services et allocations de devises aux touristes', (1984) 20 *Cahiers de droit européen*, 706-713; and R. Smits, 'The End of Claustrophobia: European Court Requires Free Travel Payments', (1984) 9 *European Law Review*, 192-202.

money should be considered as part of the free movement of capital, which will allow them to apply national norms in order to protect their fiscal interests. They alleged that in order to consider a transfer of money as part of the free movement of services, it was demanded that both parts of the economic transaction were identified.²⁷ From their point of view, a service offered in an indiscriminate way in a member state to users in general, just at their disposal if they move to the place where the supplier is, should not be considered a service. In order to support this conception of the free provision of services, they quote Advocate General Trabucchi's opinion in *Watson and Belman*,²⁸ who said that the Treaty just makes explicit reference to the suppliers of the service and not to the users. Therefore, according to his opinion, a transfer of money could never be considered as part of the free provision of services.

Advocate General Mancini's opinion in *Luisi and Carbone* radically differed from this view. He argued that in economic sectors like tourism it is inherently assumed that the user must move in order to receive the service. In the fields of teaching and health it is also evident that teachers and doctors should not move throughout the common market, since their economic activity makes sense (i.e. allows them to increase their economic benefits) only if they are placed on a permanent location. To arrive at these conclusions Mancini seems to insert his arguments to an overall analysis of the consequences of the legal problem these money transfers posed, instead of merely resigning himself to elaborate a reductionist reasoning just focused on the particular legal regime to which the free provision of services is subjected. This strategy allowed him to reveal to the member states supporting the arguments against his case that the economic impact of their view would be noticeable if applied on a broader scale (tourism was a very important economic sector precisely for France and Italy, of which their balance of payments would be on an even worse situation if incomes related to it were not

²⁷ The facts of the *Luisi and Carbone* case identified the two Italians which wanted to cross the Italian border with money in cash, but not the service provider. Luisi and Carbone alleged the money transfer was necessary for paying some services (language courses, chirurgic interventions, hotel stays...), but without specifying who the provider was. They labeled those economic activities in abstract: 'tourism', 'health', etc.

²⁸ Case 118/75 *Criminal proceedings against Lynne Watson and Alessandro Belmann* [1976] ECR 1185.

at their disposal). But, in addition to those general reasons about how the common market should be conceived, legal arguments of Advocate General Mancini were solid too: he particularly invoked that the 1961 program for the liberalisation of the movement of services included both dimensions of tourism (service provider's and user's displacements) among the fields to be liberalised, which means that the transfer of bank notes inherent to them should be considered part of the free movement of services instead of attached to the free movement of capital. This categorisation was also maintained in the capital Directives.²⁹ In addition, the Act of Accession of Greece maintained the restrictions over the transfers of foreign money by tourists, a temporal derogation which meant that the general regime was the liberalisation of those movements.

The Court finally ruled that those money transfers should be considered part of the free provision of services. Thus, it reduced the scope of the free movement of capital by considering that it starts just where the limits of the free provision of services end. In other words, the Court ruled that the scope of the free movement of capital depended on the extent of the other community freedoms, and that it was hence subjected to the particular variations their limits could undergo. However, member states were allowed to retain the power to verify that transfers of foreign currency purportedly intended for liberalised payments were not actually used for unauthorised movements of capital. Therefore, if not rendering illusory the freedoms established by the common market, member states could control those movements in order to protect their balance of payments and their currency type. It seems that the Court had born in mind Mancini's view over the need to assess the consequences for the whole common market system when allowing those controls, which permitted to solve the underlying conflict between the commitment to liberalise the movements of capital and the need to control the economic consequences they may mean for the member states.

Observing the *Luisi and Carbone* ruling from a broader perspective, particularly from the one which connects democracy with economic policy decisions, it seems clear that what was in dispute in that case were the specific limits of the movement of capital as it has been

²⁹ See *supra*, note 10.

established in the original Treaties, and not how the relationship between the political and the economic order was designed in them. Therefore, neither the member states' arguments nor the Advocate General's ones questioned the validity of the Community's legal regime on movements of capital, but just its scope. As a result, during the 1980s embedded liberal politics were still perceived as legitimate in the courtrooms; however, that perception did not reflect the deep changes that meanwhile were taking place in the major European governments - not only in the British, but also in the German, Dutch and Danish ones. As a token of these changes it can be argued that in a very short period of time the recently elected socialist government of the most reluctant member state to neoliberal ideas, France,³⁰ was forced to give up its expansionary fiscal policy and its embedded liberal framework of thought in order to adopt neoliberal solutions to its serious economic problems, particularly liberalising capital movements.³¹

However, instead of interpreting political wills, the courtrooms remained attentive to the still unchanged legal framework. Therefore, the case law in *Luisi and Carbone* was sustained and expanded by the European Court of Justice in its *Lambert* ruling,³² in which it allowed national norms to control how transfers of foreign money were exchanged into national currency. In order to protect national balances of payment, it was argued, means of payment related to

³⁰ 'The French government tightened its controls on outflows of capital first in May 1981, then again in March 1982, and by March 1983 the regulations were rewritten as restrictively as possible. Importers and exporters were not allowed forward exchange transactions, foreign travel allowances were further reduced, personal credit cards could not be used abroad, and the infamous *carnet de change*, a booklet in which the French were to record their foreign exchange transactions, was introduced'. R. Abdelal, *Capital Rules. The Construction of Global Finance*, Cambridge, Harvard University Press, 2007, at p. 58.

³¹ Soon the French socialist government was convinced that capital controls were counterproductive since they constrained the middle classes most of all, while the rich circumvented them with impunity. Therefore, 'Mitterrand and the socialists reversed course in the spring of 1983. The *tournant*, the Mitterrand U-turn, was an admission of defeat: capital had won the battle of wills and ideologies'. R. Abdelal, *supra*, note 30, at p. 59. On the reasons of this change, see also Helleiner, *supra*, note 5, at 140-145; V. A. Schmidt, *From State to Market? The Transformation of French Business and Government*, Cambridge, Cambridge University Press, 1996, 94-130; and M. Loriaux, *France After Hegemony. International Change and Financial Reform*, Ithaca, Cornell University Press, 1991, chapter 8.

³² Case 308/86 *Criminal proceedings against R. Lambert* [1988] ECR 4369.

liberalised economic transactions must comply with the regulated exchange market. If they could resort to the free exchange market, some benefits could then be obtained from the legal regime foreseen exclusively for capital movements. In other words, it would be possible to take advantage at the same time from both the liberalised regime of the money transfers related to community freedoms and of the free exchange market related to capital movements. Hence, in this ruling the Court continued to allow national measures to supervise that movements of capital did not take place in the form of means of payment. Therefore, with it the Court consolidated the clear distinction it had established in *Luisi and Carbone* between the legal regimes related on the one hand to the common market freedoms, and on the other hand to movements of capital. While the Court then stated that national measures were allowed in order to control that a movement of capital did not take place under the appearance of a mean of payment, now it avoids that the exchange regime of the former (free exchange market) could be applied to the latter, what would constitute a *de facto* broadening of the scope of the free movement of capital.

Summarising what have been the main arguments of the Court when deciding about the free movement of capital during this first stage of its case law, it should be noted that, despite the neoliberal turn in economic politics of most of European governments during the 1980s, it has still followed the drafting of the Treaties to a tee. While in other economic freedoms it has decided to broaden their scope in the supranational level, this has not been the case in the movements of capital field, in which member states clearly stated that they should be liberalised just in the extent they were needed to the proper functioning of the common market. In contrast to the other community freedoms, of which Treaty provisions have been declared directly applicable, free movement of capital remained a national issue when they were not part of the common market. In fact, member states were allowed to control common market transactions in order to avoid illegal movements of capital. Therefore, while decisions about community freedoms were supported by arguments installed on the federal strategy, decisions about movements of capital were based on renationalising arguments. The case law of the Court adopting this kind of arguments in order to restrict the scope of the free movement of capital was also consolidated, in what refers to

the Directive implementing Art. 67 EEC Treaty, in rulings *Alan East*³³ and *Van Eycke*.³⁴

The second stage (the 1990s) The constitutionalisation of the free movement of capital

The second stage in the case law of the ECJ about the free movement of capital corresponds to the decade of 1990. As has been said above, the Court interpreted the original Treaties as giving the member states free hand to determine through directives the content of the freedom. What happened during the 1980s was that the political will of the member states changed as a result of the French radical turn in economic policy.³⁵ The consequences of French socialists' U-turn were also visible in the international scene, Chavranski and Camdessus respectively directing the OECD and the IMF,³⁶ but its deepest impact was on the European scene, where Delors relaunched the integration project by fixing 1993 as the deadline to complete an Internal Market. In fact, immediately after the signature of the Single European Act (SEA) the Commission decided to foster the free movement of capital not only as the suitable reply to the competitive pressures from abroad (particularly from the United States' liberalised market), but also as the indispensable step towards the achievement of its next medium-term political objective: the Economic and Monetary Union (EMU).³⁷ As a result of all these events, and after rough

³³ Case 143/86 *John Richard Alan East and others (Margetts and Addenbrooke) v. Thomas Cuddy and Winifred Cuddy* [1988] ECR 625.

³⁴ Case 267/86 *Pascal Van Eycke v. ASPA NV* [1988] ECR 4769.

³⁵ '[W]hat changed in Europe between the early 1980s - when an initiative to rewrite the rules of European finance failed despite having the United Kingdom, Germany, and the Netherlands enthusiastically in favour - and the late 1980s, when the institutional foundations of European finance were fundamentally recast? The question relates not only to the history of European integration, but also to the emergence of global capital markets. The answer is deceptively simple: France changed'. Abdelal, *supra*, note 30, at p. 57.

³⁶ On the influence of French socialists in the politics of capital liberalisation, see R. Abdelal, 'Writing the Rules of Global Finance: France, Europe, and Capital Liberalization', (2006) 13 *Review of International Political Economy*, 1-27.

³⁷ As Helleiner explains it, Delors 'hoped that the removal of capital controls would force European governments to move to closer monetary cooperation if they wanted to preserve stable exchange rates and regain some degree of control over monetary policy in the new open financial environment. Indeed, only two weeks after the Council of Ministers approved the capital liberalisation directive, it set up the Delors Committee to study 'concrete steps' to achieve economic and monetary union. Delors

negotiations,³⁸ it was possible to achieve a unanimous decision in the Council of Ministers adopting a new legal regime which liberalised all capital flows in the European Community (Directive 88/361).³⁹

However, the conflict about the freedom was still far from being closed. It is true that the free movement of capital was achieved when the Directive came into force on 1 July 1990, but two controversial issues still remained unsolved: on the one hand, during the negotiations of the Directive some voices expressed their concern about the liberalisation of capital movements without taking a number of measures which could avoid some related negative consequences for national economies;⁴⁰ on the other hand, some countries (in particular Germany) considered that the scope of the

also hoped that financial liberalisation might encourage Germany and Britain, both of which favoured the removal of capital controls, to become more enthusiastic about EMU. Germany had in fact refused to discuss EMU until France and another Community member abolished their controls'. Helleiner, *supra*, note 5, at p. 159.

³⁸ 'The directive's acceptance was sealed by two important decisions. First, Delors had made it clear that the issue of capital controls could be raised only after European central bank governors agreed in September 1987 to strengthen intervention measures within the EMS. Without the promise of expanded credit facilities, many countries for which capital controls had been necessary to maintain the parity of their currencies within the EMS would have been wary of accepting a commitment to the freedom of capital movements. The second decision concerned the question of tax evasion [...] French Finance Minister Bérégovoy, supported by Denmark, had threatened to obstruct the approval of the capital liberalisation directive unless other members agreed to introduce a community-wide withholding tax aiming at preventing tax evasion. Only after the Community agreed in June 1988 to study the withholding tax proposal did he back down. In the resulting discussions, strong opposition by Britain and Luxembourg (and eventually West Germany) prevented agreement on a withholding tax, and the French were forced to accept a more limited scheme in which national tax authorities would cooperate in antifraud investigations'. Helleiner, *supra*, note 5, at p. 158.

³⁹ Council Directive 88/361/EEC of 24 June 1988 for the implementation of Art. 67 of the Treaty, O.J. 1988, L 178/5.

⁴⁰ 'In its Opinion, the Economic and Social Committee suggested that liberalisation ought to be accompanied by efforts in such important fields as harmonising the operating rules for financial services and stock markets, the rules governing the solvency and stability of financial institutions, and tax harmonisation. Furthermore, they stated that liberalisation could not be achieved without stabilisation of exchange rates, noting that unstable exchange rates and sudden fluctuations pose a considerable danger for the economies of the various member states, and concluding that it was becoming more and more difficult to conduct a co-ordinated Community policy, with floating exchange rate and fixed parity currencies coexisting side by side'. J. Usher, 'Monetary Movements and the Internal Market', in N. N. Shuibhne (ed.), *Regulating the Internal Market*, Cheltenham, Edward Elgar, 2006, at p. 187.

liberalisation of capital flows should go beyond the European Community's borders instead of being delimited by them. Therefore, the two latent conflicts which remained unsolved referred to the *overall design of the economic policy*, and to the *particular scope of the freedom*.

It was just a matter of time for both issues to reemerge, and they did so when the EMU provisions were negotiated at Maastricht. To what refers to the overall design of the economic policy, two conflicting models were discussed.⁴¹ On the one hand, there were some countries, led by France, which supported the idea of an economic government at the European level, while on the other hand were other member states which preferred the economy not to be decided by politicians. Instead, they agreed with the ordoliberal ideas which have succeeded in Germany's postwar economic recovery and granted economic stability since then.⁴² Consequently, this cleavage between the radically opposed economic policy trends was also present when the scope of the freedom was debated. Those supporting the role of the state were consistent with their own view when considering that the free movement of capital should be limited to the Community members, while ordoliberals defended the *erga omnes* effect of the freedom.

The negotiations ended with an agreement on both issues: due to the economic puissance of their economy, without which European economic integration was not possible, German leaders could subordinate their acceptance of EMU to the adoption of their successful economic model in the Community.⁴³ Therefore, despite some coordination at the political level that was agreed upon, the economic policy design was consistent with the ordoliberal paradigm (its institutional expression an independent European Central Bank)

⁴¹ These models have long influenced politics in Europe. Indeed, they constitute a clear cleavage between member states. A comparative analysis in A. Labrousse and J. D. Weisz (eds), *Institutional Economics in France and Germany. German Ordoliberalism Versus the French Regulation School*, Berlin, Springer, 2001.

⁴² A revision of the ordoliberal influence in the postwar Germany in C. Joerges, 'What is Left of the European Economic Constitution? A Melancholic Eulogy', (2005) 30 *European Law Review*, 461-489.

⁴³ On the negotiation of EMU see K. Dyson and K. Featherstone, *The Road to Maastricht. Negotiating Economic and Monetary Union*, Oxford, Oxford University Press, 1999; C. Mazzucelli, *France and Germany at Maastricht. Politics and negotiations to create the European Union*, New York, Garland Publishing, 1997, Chapter IV.

and the *erga omnes* effect of the free movement of capital was included in the Treaties. As a result of all these events, during the 1990s a new legal regime for capital movements was approved, consisting first in their liberalisation between the member states, as was described on the Directive 88/361, and later by a re-formulation of the content of the Treaties through the Maastricht agreements. It is extremely important to note that the Maastricht Treaty was the definite moment in order to establish the final conditions under which a complete free movement of capital has been achieved in the European Union, and also that it implied a change on the constitutional status of the freedom: it was a matter not to be decided by the Council of Ministers, but by States on an international agreement. This explains why this legal regime has not been modified since then – apart from the minor fact that the Amsterdam Treaty changed article numbers. From then on, the main provision regulating movements of capital is Art. 56 EC (ex Art. 73B EC), of which its two sections literally state:

1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between member states and between member states and third countries shall be prohibited.
2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between member states and between member states and third countries shall be prohibited.'

This provision thus liberalised all movements of capital between member states and even between member states and third countries. However, restrictions to the latter movements which existed by national or community law prior to 1994 and referred to direct investments were allowed to be maintained (Art. 57.1 EC). The second paragraph of the same article describes the procedure the European institutions must respect when regulating movements of capital between member states and third countries related to direct investments: qualified majority is the standard procedure, but unanimity is required if any restriction to the liberalisation is to be established (Art. 57.2 EC). Nevertheless, member states still retain some competences which, once exercised, may restrict the free movement of capital. These limited cases just constitute exceptions to

the freedom (Art. 58 EC) that for the first time seemed to put the legal regime of movement of capital on a level with all the other European Union's economic freedoms. For instance, member states are now allowed to apply provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested. They are also allowed to adopt measures in order to avoid infringements to their legal order. All these provisions substantially changed the legal regime to which movements of capital were subjected. Therefore, the case law interpreting those provisions and the scope of the freedom they foresee also changed. In this sense, as important as its new content (institutional design, liberalisation and *erga omnes* effect) was the legal status it deserved, what has been referred to as *constitutionalisation*. The relevance the freedom then acquired depended not only on its inclusion in the Treaties (which one could label as *formal* constitutionalisation), but also on the direct effect doctrine (*material* constitutionalisation), which main consequence was a new scope for the free capital movements. The analysis of the case law of the European Court of Justice on the matter will prove vital to understand which conception of the European Union hides behind this new regime.

Material constitutionalisation of the free movement of capital: the direct effect doctrine

A substantial change on the legal effects of the new provisions regulating the free movement of capital occurred during the 1990s: the freedom was solidly consolidated by recognising direct effect of articles one and four of the Directive 88/361 and of the provisions of the Treaty. Since this recognition, the general presumption is that all transfers of capital throughout the borders of the member states (*Bordessa*)⁴⁴ and, importantly, between member states and third countries (*Sanz de Lera*)⁴⁵ are allowed. It is clear to everybody that the consequences of recognising direct effect to the main provisions of the regime which regulates capital movements go beyond the legal field, but the repercussion on it is extremely large. Examining first the strictly legal consequences of these rulings one must notice that since

⁴⁴ Joined cases C- 358/93 and C-416/93 *Criminal proceedings against Aldo Bordessa and Vicente Mari Mellado and Concepción Barbero Maestre* [1995] ECR I-00361.

⁴⁵ Joined cases C-163/94, C-165/94 and C-250/94 *Criminal proceedings against Lucas Emilio Sanz de Lera, Raimundo Díaz Jiménez and Figen Kapanoglu* [1995] ECR I-04821.

the direct effect of the provisions on capital movements is declared, a new legal issue emerges: should community economic freedoms be respected separately, or are they a unique framework? In other words, should a money transfer comply with the capital movement provisions, or with all the economic freedoms granted by EU law? In the *Svensson* ruling, the Court decided that a national measure was contrary both to the free movement of capital and to the freedom to provide services. It replied to the question thus applying cumulatively all community provisions. Advocates General Tesouro and Mischo were clearly opposed to this decision and suggested, in *Safir*⁴⁶ and *Ambry*⁴⁷ respectively, that the Court should first decide about which is the applicable legal regime, and then analyse if the particular measure infringes it. But the Court took no notice of those opinions of Advocates General and declared in *Konle* that both the freedom of establishment and the provisions on capital movements were applicable.⁴⁸ This cumulative application of the economic freedoms implies not only that the provisions on movement of capitals are no more subsidiary to the other freedoms, but also that the supranational economic freedoms are conceived as a whole and that they thus constitute an entire block that must always be respected.⁴⁹ This conception lays the foundations of the new constitutional status of the economic freedoms generally, and of the free movement of capitals in particular, as will be seen below.

But the consequences of declaring the direct effect of provisions on the free movement of capital are even wider. To what refers to the margin of maneuver of member states when restricting the freedom, one must bear in mind that it was reduced since the Maastricht Treaty established a new framework for movements of capital in which capital flows should be as free as possible. In addition, in the same Treaty the foundations of EMU were laid, so the previous allowance of national measures in order to protect national economic interests and member states' balance of payments were not so

⁴⁶ Case C-118/96 *Jessica Safir v. Skattemyndigheten i Dalarnas Län* [1998] ECR I-1897.

⁴⁷ Case C-410/96 *Criminal proceedings against André Ambry* [1998] ECR I-7875.

⁴⁸ Case C-302/97 *Klaus Konle v. Republik Österreich* [1999] ECR I-03099 (par. 22).

⁴⁹ A more detailed account of the relationship between the free movement of capital and the other community freedoms can be found in S. Peers, 'Free Movement of Capital: Learning Lessons or Slipping on Spilt Milk?', in C. Bernard and J. Scott (eds), *The Law of the Single European Market. Unpacking the Premises*, Oxford, Hart Publishing, 2002, especially pp. 337-340.

necessary. Therefore, in *Bordessa* and *Sanz de Lera* the Court stated that prior authorisation from the administrative authorities in this sense is not compatible with the Treaty provisions, and just declarations are allowed (declarations which may be object of subsequent checking in order to protect those economic interests). However, these rulings have been clarified by the Court, which has stated first that Art. 56 EC does not preclude a system of prior authorisation if the protection of public policy or public security is at risk (*Konle*);⁵⁰ and later that because of the extremely mobile money transfers are, a prior declaration may prove ineffective (*Église de Scientiologie*).⁵¹ The condition it imposes in order to validate a national system of prior authorisation is thus that the norm by virtue of which it exists is accurate enough in order to assure legal certainty among citizens (and economic operators must also be added). It is important to note to this respect that the Court has not made a legal reasoning adapting the free movement of goods case law on national controls⁵² to the field of movements of capital, as Advocate General Saggio suggested in his opinion,⁵³ but that it just appealed to the principle of legal certainty in order to assess the validity of a transnational investment. For legal scholars it goes without saying that adapting the free movement of goods case law on national controls to the field of movements of capital would have increased legal certainty, as it would have made explicit the criteria required for a national measure to be valid. But the Court preferred to retain some power and resorted to a legal principle which its limits it is the sole legitimated to determine. Therefore, adopting this strategy the Court paradoxically restraints legal certainty by retaining the final decision about the legality of capital movements.

One of the arguments used by Saggio when scrutinising the member states' regimes of prior authorisation is especially important: he has

⁵⁰ *Konle*, *supra*, note 48.

⁵¹ Case C-54/99 *Association Église de Scientiologie de Paris and Scientiologie International Reserves Trust v. French Republic* [2000] ECR I-1335.

⁵² Case C-367/89 *Criminal proceedings against Richardt* [1991] ECR I-4621. In fact, the *Bordessa* and *Sanz de Lera* rulings were the translation to the free movement of capital regime of a consolidated case law in other freedoms. They thus put all the community freedoms on the same level. This conclusion was evident already when the ruling took place, as shows up the case comment of M. Jarvis, 'Free Movement of Capital Comes of Age', (1995) 20 *European Law Review*, at 514-521.

⁵³ Opinion of Advocate General Saggio (par. 16) in *Église de Scientiologie*, *supra*, note 51.

argued that what national authorities were protecting with those regimes were not their national interests, but a common one, since the benefits of the stability of both the public policy and public security are shared among all member states. Therefore, exceptions to the common freedom of capital movements (community of market risks) would be based on the (multilevel) protection of a common interest (community of social insurance). One can find some features of a federalist strategy in this reasoning, mainly in what refers to the existence of a common public policy and a common public security which deserves to be protected from both national and supranational level. However, the Court did not assume Advocate General's opinion and it seemed to persist in considering nationally-based all exceptions to the free movement of capital, what fits better in the renationalising strategy.

Be it as it may, the *Bordessa* and *Sanz de Lera* rulings not only widened the scope of the free movement of capital (as was designed by Member States in the Maastricht Treaty), but they also restricted the scope of the control that the national authorities can exercise in order to protect their economies. As a result of these two rulings, and in accordance with the abovementioned ones, the free movement of capital was given during these years a material constitutional status (since it prevails over any other norm).⁵⁴

Consequences of the material constitutionalisation of the free movement of capital: its new scope

As a consequence of the liberalising regime and of the material constitutionalisation of the freedom, in this period the main trend in the case law of the European Court of Justice was to determine the new scope of the free movement of capital. It is obvious that as a result of its constitutionalisation the scope of the freedom should broaden, but there were also cases in which it was limited. In this sense, the result is an extremely important feature of the legal regime,

⁵⁴ Several institutions have posed a question mark after the new constitutional status of the free movement of capital, and even have rebelled against the new dimension the freedom acquires with this new interpretation of the Court. On the difficulties of the Spanish Supreme Court in order to accept the *Bordessa* ruling and its consequences for penal law, see A. Fernández Tomás, 'Libre circulación de capitales, control de cambios y delitos monetarios: la solución a unas discrepancias entre el Tribunal de Luxemburgo y el Tribunal Supremo español', (1997) 1 *Revista de Derecho Comunitario Europeo*, 175-193.

at least to what refers to the case law, that the Court retained the competence over the decision of what is a movement of capital. In fact, since neither the Directive nor the Treaties gave any definition of what constitutes a movement of capital, the scope of the freedom was widened by considering some fields included on its material content. In this sense, bank loans (*Svensson*)⁵⁵ and mortgages over real estate investments (*Trummer and Mayer*)⁵⁶ were declared part of the content of the freedom. In relation to this legal technique, one must pay attention to the reasoning by which the Court considers the latter field as part of the money transfers which were liberalised. As a matter of fact, when determining the material scope of the Treaty provisions, in the *Trummer and Mayer* case it resorted to the Annex I of the Directive 88/361, which enumerated on an open list different categories of capital movement to which the Directive was applicable. Mortgages were not included on that list, but the Court stated that because of their inextricably linkage with capital movements they should be considered under the legal regime of the free movement of capital. In addition, it stated that the prohibition to express the mortgage on a foreign currency, as was foreseen in the Austrian law under review, should be interpreted as a restriction to the freedom, since it could make less attractive an investment. Therefore, the *Trummer and Mayer* ruling may be summarised by highlighting the three main points of its reasoning. In this case the Court decided (a) to use the Annex of a secondary law which was not in force in order to interpret the content of a Treaty provision;⁵⁷ (b) to broaden the scope of the concept 'movement of capital' on a case by case basis (since the 'close connection' criterion has not been precisely defined);⁵⁸ and (c) to consider against the free movement of capital any restriction which could make less attractive an investment.⁵⁹

To what refers to the resort to the Annex I of the Directive not in force any more in order to interpret the concept of capital movement in the Treaty, as legal scholars it is important to consider this at least as a

⁵⁵ Case C-484/93 *Peter Svensson et Lena Gustavsson v. Ministre du Logement et de l'Urbanisme* [1995] ECR I-03955.

⁵⁶ Case C-222/97 *Manfred Trummer and Peter Mayer* [1999] ECR I-01661.

⁵⁷ *Trummer and Mayer*, *supra*, note 56 (par. 21).

⁵⁸ *Trummer and Mayer*, *supra*, note 56 (par. 24).

⁵⁹ *Trummer and Mayer*, *supra*, note 56 (par. 26).

strange reasoning.⁶⁰ If the content of that Directive have been transferred to the Treaties without any reference to its Annex, the straight interpretation should be that it was not in the member states' mind to include its content in the Treaty. However, the Court decided that the correct way to give content to the concept of movement of capital was not by delimiting it on its own decisions, but by interpreting member states' will precisely as they had previously defined it in that annex. Hence, the existence of a supranational law liberalising the movements of capital shows that a federal strategy has been adopted when redesigning the policy, but the argument the Court uses when defining the content of that supranational law is a renationalising one, since it takes into account what was the common denominator of member states opinions on the issue. Surprisingly, the combination of both strategies seems not to be an isolated case but a constant in the new free movement of capital regime, as will be seen later.⁶¹

The decision of the Court to refer to the annex of the Directive instead of stating a concrete judicial definition of movement of capital may be founded on very different grounds,⁶² but it is beyond any doubt that

⁶⁰ 'An indicative nomenclature of capital movements is annexed to the Directive and is divided under thirteen headings (direct investments, property investments, etc.). The Nomenclature remains relevant today even though the Treaty provision on which the Directive itself was based is no longer in force. The Court accepted in *Trummer and Mayer* that insofar as Art. 73b EC carried over in substance the contents of Art. 1 of the Third Directive, that nomenclature retained the indicative value it had for the Directive'. L. Flynn, 'Coming of Age: the Free Movement of Capital Case Law 1993-2002', (2002) 39 *Common Market Law Review*, 773-805, at p. 776.

⁶¹ Indeed, this strategy matches up with the one adopted in Art. 57.2 EC referred to the material scope of the movement of capital with third countries, since the procedure to regulate that movements differs depending on the content of the regulation: if it respects liberalisation then qualified majority is enough to pass the norm, but if it implies a restriction to the liberalisation unanimity is required. The adoption of the federal or the renationalising strategy depends thus on the content of the norm to be passed.

⁶² Perhaps the most acceptable explanation is Landsmeer's one: 'The reason why the Court does not formulate a definition and uses a relatively old directive that dates from before the second phase (EMU, 1 January 1994, and therefore before the new Treaty provisions of Arts 56-60 EC), could be explained by the difficulties which a general definition could create. A generally formulated definition would easily affect the other freedoms. For instance, the buying of real estate in one of the member states could affect the freedom of establishment or the freedom of services. These kinds of transactions will however also affect the movement of capital. By using the Directive, the influence of capital movements on the other freedoms will be restricted to the

it confers on the Court a broad margin of appraisal, since as long as the legislator does not define the content of 'capital movement' the Court will retain the competence over the interpretation of the concept. But this margin is also broadened by virtue of the Court's decision to determine the relevance of a case for the free movement of capital depending on its link to it. This case by case approach allows the Court to gradually determine the limits of the scope of what is under the regime of the freedom of capital movements.

Finally, to what refers to the decision of considering any reduction of an investment's attractiveness a restriction to the free movement of capital, one should note that this reasoning broadens the scope of the freedom. The supranational provision allowing capital movements will thus be reinforced, since member states will unlikely achieve to pass a norm which does not affect the freedom. This interpretation of what a restriction to the free movement of capital is, linking it to the attractiveness of a transaction, is a stricter one in comparison with how restrictions to any other community freedom have been interpreted until then.⁶³ This allows us to consider the free movement of capital as the widest community freedom – at least to what refers to the margin of the member states not only in order to limit it, but also to not interfere in it.

The Court also broadened the scope of the free movement of capital by means of restricting the extent to which member states could limit the scope of free movement of capital when exercising a competence which remains theirs, namely, the power to tax. Despite Art. 58 EC permitted, as already shown, national norms referred to tax law to restrict the movement of capital, in some cases national provisions were considered against the community freedom since they created a discrimination depending on the place a company which pay

transactions 'enumerated' in the Directive. Besides, by using the Annex of the Directive, the Court can decide on a case by case basis whether the capital provisions apply'. A. Landsmeer, 'Capital Movements: On the Interpretation of Article 73B of the EC Treaty', (2000) 27 *Legal Issues of Economic Integration*, 195-200, at pp. 198-199.

⁶³ 'The above-mentioned conclusion is however less spectacular then it appears at first impression. Compared to other kinds of transactions, Capital is much more sensitive to barriers and certain kinds of regulations. A very small change in interest rates for instance is often enough to transfer capital streams. This is due to the fact that developments in technology have made capital much more volatile compared to goods and services'. Landsmeer, *supra*, note 62, at p. 199.

dividends to natural persons is placed (*Verkooijen*),⁶⁴ or since they were not justified enough in order to allow a violation of the Treaty norms (*Sandoz*).⁶⁵ This legal technique, thus, limits the member state's margin of manoeuvre, and as a consequence of that contributes to reinforce the supranational freedom.

However, during the second stage of the Court's case law there were also some rulings limiting the scope of the free movement of capital. The cases in which the Court decided to stop the expansion of its scope were basically related to issues in which a conflict between the supranational economic constitution,⁶⁶ based on the economic freedoms (community of market risks), and the nationally based welfare politics (community of social insurance), took place. In fact, despite this new constitutional status achieved by the free movement of capital, in all cases in which there existed a collision between the supranational economic freedoms and the national welfare policies, the Court ruled that member state's competences on these issues prevailed over community provisions. This was what happened when norms protecting national culture conditioned the transfer of money from one country to another (*Veronica*),⁶⁷ or when a prior authorisation was required in order to acquire a property which would constitute a second residence (*Konle*).⁶⁸ In the latter case the Court considered the national norms as valid only under very restricted conditions, particularly referred to the achievement of a certain level of protection of an economic activity or of a permanent population residing in a very well delimited area. The Court has ratified this case law on several occasions,⁶⁹ but despite its reasoning

⁶⁴ Case C-35/98 *Staatssecretaris van Financiën v. B. G. M. Verkooijen* [2000] ECR I-4071.

⁶⁵ Case C-439/97 *Sandoz GmbH v. Finanzlandesdirektion für Wien, Niederösterreich and Burgenland* [1999] ECR I-07041.

⁶⁶ On the notion of 'economic constitution' see Joerges, *supra*, note 42. It is discussed if this concept is applicable to the European Union: see M. E. Streit and W. Mussler, 'The Economic Constitution of the European Community: From Rome to Maastricht', (1995) 1 *European Law Journal*, 5-30, and the debates in the same volume.

⁶⁷ Case C-148/91 *Vereniging Veronica Omroep Organisatie v. Commissariaat voor de Media* [1993] ECR 487.

⁶⁸ *Konle*, *supra*, note 48.

⁶⁹ See Case C-355/97, *Beck and Bergdorf* [1999] ECR I-4977 and Case C-300/01, *Doris Salzmann* [2003] ECR I-4899. The *Bordessa* and *Sanz de Lera* case law on the legality of prior notification regimes instead of prior authorization ones applied to the field of the acquisition of second residences can be found in Joined Cases C-515/99, C-519/99 to C-524/99 and C-526/99 to C-540/99 *Reisch and Others* [2002] ECR I-2157 and in Case C-452/01 *Margarethe Ospelt* [2003] ECR I-9743.

resorted to economic arguments, a non-economic dimension underlies in all this saga of rulings on this issue.⁷⁰ In addition, the foundations of those decisions were grounded on time-limited provisions included in Accession Treaties (mainly in the Austrian one), so one cannot consider this as a general exception to the free movement of capital legal regime, but just an isolated and temporary one. In any case, the most clear example of the limit that national competences over welfare policies suppose for the expansion of the scope of the free movement of capital is the Court's ruling in *French Republic v. Commission*,⁷¹ in which a non-legally binding document of the Commission was annulled since it dealt with the pension funding problems, what is considered to be a national problem. The Court stated that the competences over these issues were clearly national and the European Union had not any say on it. Completing this case law, the well-established principle of procedural autonomy of the member states was also considered a limit of the scope of the freedom (*Fenocchio*).⁷² In sum, from this case law it can be said that renationalising arguments were predominant when the Court aimed at limiting the scope of the free movement of capital.

⁷⁰ 'EU law sees property in neutral terms as 'real estate', and its sale and purchase as a straightforward contractual bargain, barriers to which constitute an interference with an efficient single market. Land must be alienable to residents from other member states: there must be no discrimination, in national land ownership law, between nationals and non-resident aliens. With a number of the new member states, the most widely expressed (because least controversial) objections to opening up their property markets in this way were phrased using a similar market-based logic. The fear expressed was that relative differences in land values and wealth as between the old and new member states would lead to acquisition of significant areas of land by foreigners. To prevent this from occurring could not be regarded as discriminatory because equality involves the idea of treating like cases alike. And since foreigners and nationals are not in a like position as regards their wealth, treating them differently is not discriminatory. [...] However, in relation to derogations from the single market *acquis*, this tells only half the story. Relative wealth differentials do not of themselves account for the Protocols, since Denmark negotiated an opt-out relating to second homes in the Maastricht Treaty despite its relative wealth, as indeed have other member states, such as Austria in its Accession Treaty. The missing part of the story is cultural rather than economic'. C. Hilson, 'The Unpatriotism of the Economic Constitution? Rights to Free Movement and their Impact on national and European Identity', (2008) 14 *European Law Journal*, 186-202, at p. 195.

⁷¹ Case C-57/95 *French Republic v. Commission of the European Communities* [1997] ECR I-01627.

⁷² Case C-412/97 *ED Srl v. Italo Fenocchio* [1999] ECR I-03845.

Assessment of the Court's case law

What can be inferred from the legal regime on the free movement of capital during this second stage of the Court's case law on the issue? First of all that the new formula by which the freedom is regulated (Art. 56 EC) maintains the distinction between movements of capital (first section) and means of payments (second section), despite their legal regimes were from then on exactly the same. This means that the *Luisi and Carbone* ruling loses some effect, since the distinction among both categories has no relevance any more. And this is so by equating the current payments' legal regime to the capital movements' one,⁷³ which means that the latter's has widened its material scope because of the legislator's will.

The second conclusion is that despite the fact that the federal strategy guides the drafting of the new articles of the Treaty, when delimiting the scope of the free movement of capital (widening it) as well as when determining its exceptions (both broadening and restricting that scope) the Court adopts a renationalising strategy. In its reasoning respecting national points of view over sensitive issues is still an important feature, maybe in order to legitimate as much as possible its rulings.

Finally and foremost, the new regime on capital movements and the case law recognising the direct effect of its provisions settled a constitutionally protected freedom in which national economic interests were not as relevant for the European Union as they previously were. This radical change can be explained because of the inclusion in the Maastricht Treaty of EMU provisions. As a consequence of all that, the new regime permits all money transfers across national borders inside the European Union, and even between member states and third countries. What should also be noted is that whereas before this new regime free movement of capital and the other economic freedoms coexisted and each money transfer should be considered a capital movement or attached to one of the other freedoms, after it all money transfers are considered part

⁷³ 'The distinction between capital and current payments was accepted in *Luisi and Carbone*, in which the Court referred to the existence of different Treaty provisions dealing with each of these notions. However, the significance of any difference between capital movements and current payments has diminished since that judgment was delivered, as the decision to combine the rules on both in a single chapter of the Treaty shows'. Flynn, *supra*, note 60, at p. 776.

of the free movement of capital.⁷⁴ Therefore, this new regime widens the scope of the free movement of capital beyond what its ancient limits were. In addition, the interrelation among community freedoms has been strengthened and it now forms a solid block of law which must be respected. Cumulative application of economic provisions shows up how much they have been reinforced. As shown, the sole reasons which the Court accepted in order to forbid those movements are now referred to the protection of the competences, the cultural interests or the welfare policies of member states. Interestingly enough, this means that for the Court, national interests rather than collective interests – as Advocate General Saggio suggested in *Église de Scientiologie* – were still the sole valid reason to limit the freedom. In addition, the controls taken in order to protect those national interests should be implemented without disturbing the correct functioning of the freedoms, so prior authorisations should be changed for mere declarations. This scheme shows that the new conception lying behind the free movement of capital is closer than before to the federal strategy (based on a distribution of competences) rather than to the renationalising one, as it once was. Free movement of capital has become a constitutional-type rule which must be observed even by national legislators.

Last but not least, it should be noted that instead of establishing a clear set of norms which would allow citizens to be sure of what the legal regime allows them (or not) to do, the Court has decided to retain as much power over capital movements' decisions as it can. This strategy from the part of the Court has had as a consequence that particulars had to resort to judges in order to solve their uncertainties, what has increased the number of cases the European Court of Justice has to deal with.

⁷⁴ This has been made clear by the Court in its saga of rulings on the acquisition of second residences. As Hilson puts it, 'EU laws on free movement of capital require there to be no discrimination, as between nationals and non-national EU citizens, in their ability to purchase real property. While earlier, discrimination-based case law on property acquisition was based on other freedoms including establishment (Case 182/83, *Fearon* [1984] ECR 3677; Case 305/87, *Commission v Greece* [1989] ECR 1461), the Court's more recent case law has focused, increasingly exclusively, on capital'. (Hilson, *supra*, note 70, at p. 194,, note 58).

The fourth stage (the 2000s) Beyond the consolidation of the paradigm

During the decade of 1990, while EMU was being build up and the case law on the free movement of capital quickly developed, member states were pushed to think about privatising what had been their public companies, usually providing public services to their citizens. Confronted with that decision, in many cases very unpopular, national governments included in the articles of association of those privatised companies some clauses which allow them, in one way or another, to retain a substantive power over the most relevant decisions a company may take. These provisions have been eagerly denounced by the Commission and have finally given rise to a new saga of decisions of the Court, known as the 'golden shares' rulings. It is not the aim of this paper to scrutinise the legal winding paths of these rulings, but to assess to which of the three conceptions of the European Union the Court is more close to when it decided in these cases. Therefore, the focus will be on the main arguments and major trends of this case law instead of analysing them in detail.

First of all, one must note that the first ruling of the golden shares saga (*Commission v. Italy*),⁷⁵ which took place in 2000, did not imply any relevant feature since the Italian Republic admitted its liability, and neither its legal service nor the Advocate General developed a strong legal reasoning. Very different was the second step of the saga, which comprised three different rulings (*Commission v. Portugal*; *Commission v. France*; and *Commission v. Belgium*).⁷⁶ Despite the different decision the Court adopted in the Belgium case - the sole one of the entire saga in which the Court considered a golden share clause justified - what is relevant is the arguments of the Advocate General Ruíz-Jarabo Colomer. In his opinion, Colomer considers that the provisions which the Commission denounced were part of the system of property ownership each member state is allowed to decide about by virtue of Art. 295 EC. Therefore, he holds that they always comply with the Treaty provisions. The sole infringement of community law he considers that may take place is referred to how those national norms are implemented, since for instance they may

⁷⁵ Case C-58/99 *Commission v. Italian Republic* [2000] ECR I-3811.

⁷⁶ Case C-367/98 *Commission v. Portuguese Republic* [2002] ECR I-4731; Case C-483/99 *Commission v. French Republic* [2002] ECR I-4781; and Case C-503/99 *Commission v. Kingdom of Belgium* [2002] ERC I-4809.

provoke discriminations between nationals and non-nationals, but not to the norms themselves, which are valid since the Treaty explicitly mentions that it does not prejudge the ownership system of each member state.⁷⁷ Colomer supported this opinion with convincing arguments, pointing out that the Art. 295 EC is located in the sixth part of the Treaty ('General and final provisions'), from what it should be deduced that it inspires the rest of articles of the Treaty. He also highlights that this provision is literally based on the Schuman Declaration, hence it has an influence on the European integration process itself. But despite all these arguments, the Court did not take into account Colomer's opinion and considered that the free movement of capital regime was the applicable one.⁷⁸ It not only did not accept that by virtue of Art. 295 EC those national regimes were respectful with community law, but basing its reasoning on the 'close connection' concept,⁷⁹ it also decided that it was the free movement of capital and not the freedom of establishment which should be applied to the case.

The third step in the 'golden shares' saga came with two more rulings (*Commission v. Spain* and *Commission v. United Kingdom*).⁸⁰ What should be highlighted to this respect is not only the Court's decisions, but also Advocate General Colomer's reaction to the prior judgment in the abovementioned cases. He put his finger on the sore spot by insisting on the point of view which he had expressed in his previous

⁷⁷ 'The Advocate General was able to conclude that Art. 295 EC implied that the privatisation measures did not have to be considered as being incompatible *per se* with the EC Treaty but were covered by a presumption of legitimacy by virtue of Art. 295 EC. Only if the *exercise* of the powers infringed the EC Treaty rules would there be a cause of complaint. The Advocate General singles out the non-discrimination Treaty clause (Art. 12 EC) and the competition rules (Arts 81, 82 and 86 EC), *not* the free movement rules as the legal basis for an infringement complaint'. E. Szyszczak, 'Golden Shares and Market Governance', (2002) 29 *Legal Issues of Economic Integration*, 255-284, at p. 267.

⁷⁸ This interpretation has been supported also by some legal scholars. See V. Kronenberger, 'The Rise of the "Golden" Age of Free Movement of Capital: A Comment on the *Golden Shares* Judgements of the Court of Justice of the European Communities', (2003) 4 *European Business Organization Law Review*, 115-136, particularly at pp. 126-127; M. Urrea Curren, 'El regimen de autorizaciones administrativas previas en las empresas privatizadas', (2003) 15 *Revista de Derecho Comunitario Europeo*, 683-697, at p. 694.

⁷⁹ *Trumer and Mayer*, *supra*, note 56.

⁸⁰ Case C-463/00 *Commission v. Kingdom of Spain* [2003] ECR I-4581; and Case C-98/01 *Commission v. United Kingdom of Great Britain and Northern Ireland* [2003] ECR I-4641.

opinion. There are three main points in which he disagrees with the Court. First, he considers that the will to control a privatised company is just (very) incidentally related to the free movement of capital and therefore that, in the last case, freedom of establishment and not of movements of capital should be applied. This means that for the first time an Advocate General questioned the main contribution of the *Trummer and Mayer* ruling to the case law on capital movements: the resorting to the secondary law in order to interpret the Treaties. Secondly, to what refers to Art. 295 EC, Colomer accuses the Court of remaining silent in the previous rulings on a vital decision which determines substantially the way national governments can exercise some control over extremely important economic sectors. And finally, he also questions the different solution the Court gave to the French and the Belgium case, since the sole difference among them was the economic sector affected (an oil company in the French case, energy pipelines in the Belgium one).

Unfortunately, the opinion of the Advocate General had not an echo on the member states' pleas before the Court. Perhaps a strong defense of their respective systems of property ownership by the part of national governments would have forced the Court, at least, to argue against the applicability of Art. 295 EC, but since both Spain and United Kingdom almost did not make any reference to the issue, the Court could pass by over it without clearly giving a serious reasoning. What it has done, indeed, was crossing the fence of what member states have decided to be the playground. Once the free movement of capital was given a constitutional status, the Court, instead of interpreting its provisions on the basis of the member states will as specified in Directives or in the Treaty, has for the first time felt free to determine the content of the freedom by itself. In what seems a serious step, in its ruling it subordinated Art. 295 EC to the economic fundamental freedoms.⁸¹ This means that the economic design explicitly described by member states in the Treaties is no more valid. With its rulings the Court has designed itself a new economic order in which the main parameter of validity are the economic freedoms, thus widening the scope of the free movement of capital. Due to its consideration of the community freedoms as the main constitutional principles, one could label this new economic order as 'constitutionalised liberalism'.

⁸¹ *Commission v. Kingdom of Spain*, *supra*, note 80, par. 67.

The last steps in the continuous saga of the golden shares rulings are still mere confirmations of what the Court established until that moment. Obviously, all of them have a particular feature which makes them interesting from a legal point of view, since the Court has refined its case law always widening the scope of the now almighty economic freedoms. Hence, the Court has decided that public companies established in other member states are also susceptible to be dissuaded of acquiring shares from a privatised company because of the existence of a golden share clause (*Commission v. Italy* and *Commission v. Spain*).⁸² It also ruled that even when golden shares are not created by legislation but within the framework of domestic company law, Art. 56 EC is applicable. In such situations the Court considers that the member state concerned acts not as a private shareholder but as a public authority whose actions fall within the scope of application of Art. 56 EC (*Commission v. Netherlands*).⁸³ The scope of the free movement of capital has also been broadened recently by virtue of the recognition that even a genuine public regulation, which only provides for normal rules of company law and which by any means mention the State as the beneficiary of these rules, could constitute a restriction to the freedom (*Commission v. Germany*).⁸⁴

Summing up what is until now the last stage in the Court's case law on the free movement of capital, a clear conclusion arises: the Treaty provisions on the field have acquired a constitutional status because of the direction the Court has driven its rulings to. To this respect it resulted decisive the abovementioned statement of the Court on the *Commission v. Spain* ruling,⁸⁵ putting on top of the hierarchical legal

⁸² Case C-174/04 *Commission v. Italian Republic* [2005] ECR I-4933; and Case C-274/06 *Commission v. Kingdom of Spain*, not yet reported.

⁸³ Joined Cases C-282 and C-283/04 *Commission v. Kingdom of the Netherlands* [2006] ECR I-9141.

⁸⁴ Case C-112/05 *Commission v. Federal Republic of Germany* [2007] ECR I-8995. On his comment of the ruling, Ringe poses a subtle and interesting question: what would had happened if the German *Land* had sold its share on the company? Will the same law still constitute an infringement of Art. 56 EC? See W.G. Ringe, 'Comment on the Case C-112/05 *Commission v. Germany*', (2008) *Common Market Law Review*, 45: 537-544 (p. 542-543). The issues raised by this judgement are deeply examined by P. Zumbansen and D. Saam, 'The ECJ, Volkswagen and European Corporate Law: Reshaping the European Varieties of Capitalism', (2007) 8 *German Law Journal*, 1027-1051.

⁸⁵ *Commission v. Kingdom of Spain*, *supra*, note 80.

pyramid of the EU law the economic freedoms (described by the Court as 'fundamental freedoms'), even above the general provisions which rule the European integration. This statement supposes the end of the long road that has brought the free movement of capital from being a subordinated freedom to become the most prominent element of a supranational economic constitution. This travel began with the decision to consider that all economic transaction can constitute a capital movement if it is merely indirectly linked with the open list of the Annex I to the Directive (*Trummer and Mayer*). A second step further was made when all reduction in the attractiveness of a transaction may be considered a restriction⁸⁶ (*Trummer and Mayer*). Then, cumulative application of the provisions of the different economic freedoms allowed the settlement of a constitutional block of norms (*Konle*). All these decisions paved the way for the subsequent recognising of an economic constitution by the saga of golden shares rulings (particularly the *Commission v. Spain* one) which was the last step in this fast evolution of the case law on the free movement of capital.

Conclusions

The main conclusion of the review of the case law of the Court on the free movement of capital through the analytic glass of the three models, is that the arguments employed in the rulings were more federal as more developed was the case law. During the first stage the Court, when taking its decisions, always was aware of what the member states would have agreed if they were on its place (renationalising strategy). During the second stage, capital movements were liberalised, but the Court still resorted to the renationalisation strategy when deciding upon the scope both of the

⁸⁶ '[S]uch a wide view of the concept of restriction could lead to a conflict with the system of allocation of powers set out in the EC Treaty, with the extension of Community competences to matters which should be left to the regulatory autonomy of the member states. [...] [S]uch an expansive view could lead to a possible abuse of the Treaty provisions by economic operators challenging any national measure limiting their commercial freedom in any way. The latter danger echoes the situation that prevailed in the field of the free movement of goods prior to the ruling in *Keck*, when all sorts of fanciful attempts were made by traders to invoke Art. 28 EC in order to challenge national measures, the effect of which on intra-Community trade was often, to say the least, rather far-fetched'. A. Looijestijn-Clearie, 'All That Glitters Is Not Gold: European Court of Justice Strikes Down Golden Shares in Two Dutch Companies', (2007) 8 *European Business Organization Law Review*, 429-453, at pp. 447-448.

concept of capital movement and of the restrictions to the free movement (renationalising strategy combined with a structural federal strategy). Finally, during the third stage the Court adopted a completely federal approach when establishing and consolidating the new economic constitution.

What is remarkable is the absence of cosmopolitan arguments in the reasoning of the Court. How can it be explained? One should bear in mind that the Court always interprets and refers to community law, that is, to supranational law. Since the cosmopolitan strategy is founded in the premise that national legal regimes coexist and in the idea that a common law is not the solution to the European problems (implicitly assuming that there is not a clear division of competences), one must assume that cosmopolitan arguments are not frequent in the Court's case law referred to the free movement of capital (and to the other fields of research based on the analysis of its jurisprudence: free movement of persons, state liability, and tax law). This can be argued to be understood as a bias in the research results, so the findings should be incorporated to those which resulted from the analysis of other areas of the economic policy (such as the broad economic policy guidelines, or the labour law) in order to obtain the complete panorama of how the economic policy is conceived in the European Union. But, as a result of this bias, all jurisdictional decisions restricting the scope of the free movement of capital could be easily equated to the renationalisation strategy; and all rulings widening that scope could be related to the federal one.

It has also been described the economic design to which the free movement of capital related in each period. In order to understand the importance of capital controls it is vital to assess the whole picture. Therefore, each time the economic design has changed, the freedom has done so. As a result, it is clear that the evolution in the strategy adopted by the Court has a direct correlation with how the economic order is designed. While renationalising arguments are the base of the rulings, 'embedded liberalism' or, at least at some point, a neo/ordoliberal design inspires the economy. However, the 'golden shares' saga implies a major change in this scheme, since it reverses how things happened until then. Now it has been the Court who modified the economic order with its case law: since economic freedoms are supreme principles which prevail even over national measures very indirectly related to capital flows, a 'constitutionalised

liberalism' has been founded in the EU. This kind of decisions can only be based on a federal strategy.

However, a new step in the evolution of the EU economic order as well as in the Court's jurisprudence seems to be close, since the current economic crises has pushed member states to think about restoring some capital controls – at least to what refers to tax heavens. It never has been put an end to the debate on capital controls,⁸⁷ but now it seems that it will reemerge. A new step in the Court's rulings can be foreseen, and further research on the issue will be needed.

Table 4.1: The evolution of the legal regime on capital movement

	Economic Design	Legal Regime	Case law	Model of EU democracy
1960 – 1970	Embedded liberalism	Directives	No	Renationalisation
1980	Embedded liberalism	Directives	Limited scope (no direct effect)	Renationalisation
1990	Neo/ Ordoliberalism	Treaties (Maastricht)	Wider scope Direct effect and constitutionalisation	Renationalisation Federal
2000	'Constitutionalised' liberalism	Treaties (Maastricht)	Absolute scope Constitutional principle	Federal

⁸⁷ See B. J. Cohen, *Global Monetary Governance*, Routledge: London, 2008 (p. 193 and ss.); B. Eichengreen, *Capital Flows and Crises*, MIT Press: Cambridge, 2003 (Chapter 10); G. G. Schulze, *The Political Economy of Capital Controls*, Cambridge University Press: Cambridge, 2000 (Chapter 8); or L. Alfaro, 'Capital Controls: A Political Economy Approach,' (2004) 12 *Review of International Economics*, 571-90.

Chapter 5

The unencumbered European taxpayer as the product of the transformation of personal taxes by the judicial empowerment of 'market forces'

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[P]lus des droits pour chacun [...] c'est moins de pouvoir pour tous.¹

Introduction

Tax systems have played a fundamental role in the drawing and reproduction of national economic borders in Europe (and elsewhere). We know well that European integration was intended to re-configure and re-draw these borders, and, to a rather large extent, it has succeeded in doing so (indeed, in many aspects, the single market is a reality). Notwithstanding this, public discourse, and even academic discourse, is based upon the premise that taxes remain one of the few competences firmly in the hands of the member states. Once again, we are confronted with the claim that national taxation powers have been left untouched (and should be left untouched) in the process; or to put it differently, the power to tax is (and *should be*)

¹M. Gauchet, *La Démocratie d'une crise à l'autre*, Nantes, Editions Cécile Defaut, 2007.

the last refuge of national sovereignty.² But if taxes were a key instrument in creating and reproducing economic borders, how could

² See, for example, U. Di Fabio, 'Some remarks on the allocation of competences between the European Union and its member states', (2002) 39 *Common Market Law Review*, pp. 1289-1301, especially at p. 295: 'when looking at the distinctive features of the respective community, the decision as to the burden of charges, tax policy, and the responsibility concerning income and expenses must remain with the national parliaments'; and A. Moravcsik, 'In Defence of the Democratic Deficit. Reassessing Legitimacy in the European Union', (2002) 40 *Journal of Common Market Studies*, pp. 603-24, available at <<http://www.princeton.edu/~amoravcs/library/deficit.pdf>>, at p. 607: 'Much is thereby excluded from the EU policy agenda. Absent concerns include taxation and the setting of fiscal priorities, social welfare provision, defence and police powers, education policy, cultural policy, non-economic civic litigation, direct cultural promotion and regulation, the funding of civilian infrastructure, and most other regulatory policies unrelated to cross-border economic activity. Certainly, the EU has made modest inroads into many of these areas, but only in limited areas directly related to cross-border flows.' More surprising are the confusing claims made by some tax specialists, such as B. Terra and P. Wattel in *European Tax Law*, London, Kluwer Law International, 1997, at p. 3, such as 'the further the harmonization process and, therefore, loss of national freedom of policy in the field of *indirect taxation progresses*, the more the member states will feel the need to defend their remaining tax sovereignty, that is sovereignty in the field of *direct taxation* [...] Finally, we observe that a genuine *European tax* hardly exists as such. There is no tax levied at Community level by a Community tax authority'. We can find statements of national politicians galore repeating the same core idea. Among which, consider the common position of several member states transmitted to the Laeken Convention: 'Contribution by Mr Peter Hain (UK), Ms Lena Hjelm-Wallen (Sweden), Ms Danuta Hübner (Poland), Mr Ivan Korcok (Slovak Republic), Mr Dick Roche (Ireland) Mr Tunne Kelam, Mr Rein Lang; member of the Convention - Mr Henrik Hololei, Mr Bobby McDonagh, Ms Ana Palacio, Mr Robert Zile, Mr Pat Carey, Mr Kenneth Kvist, Mr Urmas Reinsalu, Lord Tomlinson, Mrs Liina Tonisson; alternate member of the Convention: 'Articles III.59 and III.60 in the draft EU constitutional treaty', DOC CONV 782/03, available at: <<http://register.consilium.eu.int/pdf/en/03/cv00/cv00782en03.pdf>>, where it can be read: 'We believe that taxation questions are, both historically and in the contemporary world, of profound sensitivity and touch very directly on the relationship of the citizen to the State. One of the key components of a State's sovereignty is its capacity to fully express the preferences of its citizens on taxation, delivered through democratic control and accountability [...]. We believe therefore that the right to determine taxation issues should continue to be held at national level. Unanimity on taxation matters in the Council ensures this'. See, also, the recent statement (June 2007) of the Slovak Christian Democratic Party on tax sovereignty, where it is (wrongly) claimed that 'the sole authority of the Slovak Republic to decide on the personal income tax and corporate taxes', and requires the government to oppose and reject 'any legally binding acts and other acts of the European Communities and European Union that might concern the harmonisation of such taxes, of their tax base, structure or system or against any motion to set a new (European) tax'. The document is available (in Slovak) at: <<http://www.konzervativizmus.sk/article.php?1114>>. The official position paper of the British

Europe have achieved its present level of economic integration? Call it the tax paradox of European integration.

This chapter dissolves this (merely apparent) paradox by showing that the redrawing of economic borders has, indeed, resulted in a dramatic transformation of national tax systems. A detailed account of the constitutional, legislative and collecting tax powers of the European Union (including a list of secondary Community law on the matter) proves that the real question is not how national tax competence remains intact despite the re-drawing of economic borders,³ but, indeed, why some politicians and some scholars claim that this is the case. More seriously, the key question is not whether taxes have become Europeanised, but how; and, indeed it is this how which explains how the transformation of national tax systems may be the best kept secret of integration. But the persistence of the (inaccurate) characterisation of taxation as a national competence is not so much a smokescreen, as a revelation of the silent and opaque ways in which national tax systems have been transformed as economic integration has proceeded; especially with regard to personal taxes. After all, indirect or *ad rem* taxes have been openly and deeply Europeanised. Many of them are collected by the member states according to a legislative framework established in Community law (this is the case of external customs duties and more famously, of Value Added Taxation and, to a lesser extent, of the core set of

government concerning the negotiations of the 2007 IGC contains similar claims. The introduction by Gordon Brown, then Prime Minister, is very revealing: 'The Mandate for the new amending Treaty meets these red lines. It ensures that our existing labour and social legislation remains intact; protects our common law system, police and judicial processes, as well as our tax and social security systems; and preserves our independent foreign and defence policy. In addition, the Treaty will make clear for the first time that national security remains a matter for member states'. The text is available at <http://www.fco.gov.uk/Files/kfile/CM7174_Reform_Treaty.pdf>. See, also, the speech by then Foreign Minister David Miliband to the College of Europe 'Europe 2030: Model Power, Not Superpower' on 15 November 2007: 'Open markets, subsidiarity, better regulation and enlargement are now far more part of the conventional vocabulary of European debate than a United States of Europe, *centralised taxation* or a common industrial policy. The truth is that the EU has enlarged, remodelled and opened up. It is not and is not going to become a superstate'. Available at <<http://www.brugesgroup.com/MilibandBrugesSpeech.pdf>>.

³ An account of the division of tax powers and its constitutional implications can be found in A. Menéndez, 'The Purse of the Polity' in E. O. Eriksen (ed.), *Making the European Polity*, London, Routledge, 2004.

excises). But indirect taxes, as we will see in the first, are not politically crucial, contrary to what is the case with personal taxes, the true *sinews of democratic power*. Both the definition and collection of personal taxes have been *formally* left in the hands of the legislatures of the member states. Leaving aside minor inroads in savings taxation, the Commission has failed to persuade the Council of Ministers of the need to approve secondary Community law dealing with corporate income tax (with personal income tax being taboo to an even larger extent). And still, the re-definition of the scope of economic freedoms led by the European Court of Justice and the Commission in the early 1980s, and partially endorsed in the Single European Act, the 1988 Directive on the Free Movement of Capital, and the Treaty of Maastricht, has unleashed dynamics in which the Court of Justice has progressively brought national personal taxes under the review of 'European constitutionality'. If this can be said, in legal terms, to have expanded the breadth and scope of economic freedoms, in political terms, it has structurally empowered certain economic actors (mainly the multinational corporations doing business *across* borders, but also other transnational economic actors) *vis-à-vis* the member states. The loss of effective taxing capabilities at national level is bound *not* to be repaired at supranational level as long as it is accepted that the adoption of directives or regulations on tax matters requires a unanimous vote in the Council of Ministers.⁴ This has resulted in the assignment of formal constitutional power over personal taxes to the supranational level, while disempowering all public institutions when it comes to defining the terms under which personal taxes are collected. In competence terms, Community (constitutional) law (with the ECJ as its mouthpiece) frames the validity of national personal taxes, whereas the member states (and eventually regions) remain the sole legislator bound to be incapable of actually legislating *but* in the same direction as the European wind blows. This propels a distinctive dynamic in which what has not been agreed politically (the harmonisation or co-ordination of personal tax laws) is happening by stealth (as adaptation to the constitutional framework established by the ECJ, case by case, only formally leaves much of a margin of discretion to national legislatures). As a result, the collective and multilateral character of tax law, its central role in the realization of both distributive justice and a whole series of macro-

⁴ See Art. 116 of the Treaty on the functioning of the European Union.

and micro-economic goals, has been challenged and contested. The image of the solidaristic taxpayer, who sees tax law as the institutional way of determining what one owes to other fellow members in society, an image which keeps on underpinning national constitutional law, runs the risk of being replaced by the role model of the unencumbered taxpayer, the 'rational' economic agent for which the single market is a boon, and who regards taxes in general as a cost, at best consideration, for the goods and services provided by the state.⁵ The *distributive* consequences of this peculiar process of Europeanisation are far from being in line with the tax principles enshrined in national constitutional laws (and thus, in the constitutional traditions common to the member states). This invites a series of questions concerning the consequences that this has for the overall democratic legitimacy of the European Union, and whether it could be said that this development relies on any conception of the European Union as a legitimate polity. However, because material transformation proceeds under the formal appearance of the stability and resilience of national tax sovereignty, the process has slipped under the radar of public discourse, and thus contributes to the maintenance of the (mistaken) belief that personal taxes remain a national competence.

This chapter aims to flesh out the argument that has just been summarised. Firstly, it reconstructs the key legal component in the transformation of personal taxes in Europe, namely, the case law of the European Court of Justice. This is done in sections III to VI of the chapter, by means of distinguishing different periods in the evolution of the case law of the Court, and describing, in a systematic fashion, the key content of the decisions of the Luxembourg judges, and considering some of the key elements of the political and socio-economic context in which they were rendered. Secondly, I assess the implications of the peculiar path of Europeanisation followed in the case of personal taxes. In the conclusions, attention is paid to the implications that this has for the democratic legitimacy of the European Union. I stress the major risks involved in this *opaque integration through stealth*, a risk of which some Advocates General, and, more recently, the ECJ itself, seem to have become partially

⁵ On the question of what kind of person would find Community law as it stands legitimate, I cannot but refer to A. Somek, *Individualism*, Oxford, Oxford University Press, 2008.

aware. But before doing this, I undertake two ancillary, but very necessary, tasks. The first section sets the analytical framework of the chapter. In it, I establish the criteria for distinguishing *personal* from *ad rem* taxes, differentiate the different aspects of the power to tax, and clarify the substance and the structure of the review of the European constitutionality of national laws, including personal tax laws. The second section describes the fundamental constitutional decisions enshrined in the founding Treaties of the Communities, upon the basis of which the jurisprudence of the Court claims to have evolved. In particular, attention is paid to the delicate balance between market integration and national tax-policy autonomy, which was at the heart of the 'common market' integration project. Paying attention to the socio-economic blueprint of the founding Treaties reveals that any claim which refers back to the 'socio-economic' constitution of the European Union and presents it as a single, coherent and persistent vision fails to take into account that there have been, and there remain, several competing visions of economic integration, and, consequently, of the shape of the Union as a polity, and of European constitutional law as the key means of social integration in Europe.⁶

Analytical foundations

The three faces of the power to tax, the difference between personal and *ad rem* taxes, and the review of European constitutionality of tax laws

This section presents three sets of analytical distinctions necessary to make normative sense of European tax law. The first analytical issue regards the disaggregation of the 'power to tax' into the three differentiated processes of decision-making through which any tax is shaped in modern constitutional polities, namely: (1) constitutional tax power; (2) legislative tax power; and (3) executive tax power

⁶ The self-restraint which prevailed until the Single European Act was congenial to both functional and social-democratic understandings of the Communities. The moderate review of constitutionality undertaken between 1986 and 1995 could be interpreted as either the judicial anticipation of a social-democratic and federal view, or the surfacing of a neo-liberal understanding of the single market. The deep review of constitutionality practiced between 1995 and 2005 leaned towards a neo-liberal understanding. The soul-search which the ECJ started in 2005 points to a correction of the neo-liberal views by a recognition of the remaining sovereignty of the European Union, and thus an odd combination of neo-liberal federalism with inter-governmental realism.

(which concern the collection and monitoring of taxation). The second set of analytical questions concerns the differentiation between personal and *ad rem* taxes. The third sub-section considers the foundations and mechanics of the review of European constitutionality of national laws, and in particular, of national personal tax laws.

The three faces of the power to tax

As I have already argued elsewhere,⁷ the levying of any tax money is the result of a process defined in at least three differentiated steps, corresponding to three different aspects of the power to tax:⁸

1. The constitutional framing of the tax system, or the definition of the procedural and substantive principles according to which taxes should be collected, some of which are the general constitutional principles governing the use of public power, while others are specific to the exercise of taxing powers (in post-war Europe, the typical principles were those of generality of taxation and of progressiveness in the distribution of the tax burden).
2. The legislative definition of each concrete tax figure, or the power through which each tax figure is defined, specifying the elements needed to calculate the concrete tax liability of taxpayers and the variables relevant for the effective collection of taxes.⁹
3. The administrative collection of each specific tax debt, either upon the basis of self-assessments submitted by taxpayers, or assessments made by tax authorities; this power usually goes hand in hand with that of monitoring compliance with tax obligations.

⁷ See *supra*, note 2.

⁸ The power to tax tends to be reduced to the power to levy concrete tax claims, i.e., to 'cash in' taxes. Indeed, this is at the source of the claim that European integration has barely affected national tax systems.

⁹ Typically, the regulatory framework of each tax figure is established in two sub-steps. Legislative procedures are employed to define the core elements of each tax (the tax base, the tax rate and the elements defining the spatial and temporal variables of the tax), while details are turned into concrete rules by means of regulatory procedures enshrined in statutory instruments typically authored by executive organs.

In a complex political order, such dimensions of the power to tax are normally not only differentiated in legal and political terms, but each power is entrusted to different decision-making processes (and in federal or quasi-federal states, to different levels of government). Moreover, the lines of allocation of such powers may vary depending upon the concrete tax figure in consideration. The common claim that the third dimension is the one in which most power is wielded (which would justify the tendency to collapse the power to tax with the power to collect a specific tax) is inaccurate. Certainly, 'cashing in' taxes leads to empowerment through the actual control of economic resources (even if there is a legal mandate to transfer them to another level of government or to employ them in very specific ways); however, the first and second dimensions lead to empowerment, to the extent that they limit, and can eventually severely constrain, the exercise of the administrative, 'cashing-in' power, and thus result in the assignment of structural influence on the shape of the tax system. It is a less visible tax power, but no less influential.

Indeed, this three-fold distinction makes it possible to distinguish three relevant levels in the analysis of European taxation. The exercise of any tax power in Europe is structured by constitutional principles (those enshrined in each national constitutional tradition *and* the four economic freedoms as yardstick of European constitutionality). This entails that some tax alternatives, which may have been politically, economically and legally possible under the national constitutional order, are now off-limits. In addition, legislative tax powers have been transferred from the regional and national levels of government to the Union, either through the harmonisation or the co-ordination of national tax norms.¹⁰ Finally, the Union has a modest, but far from insignificant, power to collect taxes. However, as already mentioned in the introduction, and as will be considered in more detail *infra*, the review of the validity of national tax norms by reference to the four economic freedoms entails the assignment, or appropriation, of constitutional tax powers by the

¹⁰ Although both developments tend to be regarded as a constraining factor of the power of national and regional governments to decide the design of their own tax systems, more frequently than not they have had the opposite effect. I consider this in 'Another View of the Democratic Deficit: No Taxation without representation', in Y. Meny, C. Joerges and J. H. H. Weiler (eds), *What Kind of Constitution for What Kind of Polity? Responses to Joschka Fischer*, Harvard Law School and European University Institute, 2000.

supranational level of government - but not the transfer of legislative or collecting powers to it - because even if such decisions are *formally possible*, they are procedurally almost *impossible* given the requirement of a unanimous decision in a Council of Ministers, where the member states have clear and contrasting interests. As long as some member states believe that they win because of the lack of European legislative action, and as long it is accepted that no legislation can be passed unless it is unanimous, the present division of competences is bound to be stable.

Personal and *ad rem* taxes

The most popular classification of taxes is based upon the distinction of direct and indirect taxes, whereby taxes are distinguished by whether the final bearer of the tax pays it directly, or whether it is paid by a third party, which then translates the economic burden to the final taxpayers.¹¹ It is not fully unreasonable to assume that the persistent popularity of the distinction is not unrelated to the fact that it was enshrined in the most influential national constitution of all, the US Constitution (expressly, in its Art. I).¹² Notwithstanding this, such a distinction tends not only to be fuzzy (as the constitutional history of the United States themselves proves),¹³ but is also highly ambiguous (as rendered evident by the unending discussions on the shifting of the tax burden in the economic literature).¹⁴

¹¹ The classical locus is perhaps J. S. Mill, *Principles of Political Economy*, Book V, Chapter 3, par. 1 (now at p. 825 of volume III of the complete works edited by J. M. Robson, published in Toronto by University of Toronto Press and Routledge and Kegan Paul, 1965).

¹² See Art. I, par. 9, four: 'No Capitation, or other direct, Tax shall be laid, unless in proportion to the Census or Enumeration herein before directed to be taken'.

¹³ The original meaning of the text seems not to have been the one which was assigned to it by the judgment of the Supreme Court in the famous *Pollock* case (157 US 429 (1895) [available at: <<http://laws.findlaw.com/us/157/429.html>>], which prompted the even more famous Sixteenth Amendment. On this, see B. Ackerman, 'Taxation and the Constitution', (1999) 99 *Columbia Law Review*, pp. 1-58.

¹⁴ While the shifting of the tax burden has been discussed since taxes have been collected, it became a central economic question with the protracted debate between Seligman and Edgeworth. An account of the debate, exploring its wider impact on the 'mathematical' turn of economics (and its actual transformation from political economy into economics) in L. Moss, 'The Seligman-Edgeworth Debate about the Analysis of Tax Incidence: The Advent of Mathematical Economics, 1892-1910', (2003) 35 *History of Political Economy*, pp. 205-40. On the transformation of political economy into economics, see D. Milonakis and B. Fine, *From Political Economy to Economics*, London, Routledge, 2009. On the post-war debate, see D. Fullerton and G. E. Metcalf (eds), *The Distribution of Tax Burdens*, Cheltenham, Edward Elgar, 2003 (the

For all these reasons, it seems to me that it is necessary to reconsider the very criteria according to which taxes are differentiated and distinguished. This seems to me to be particularly so if the distinction is to be rendered functional in the context of European integration. In this regard, it must be noticed that the reference to direct and indirect taxes enshrined in the Protocol on Privileges and Immunities, or in the 77/799 Directive seems to me to have been guided by two considerations.¹⁵

The first one corresponds to what connection there is between tax liability and the ability of the taxpayer to pay. Direct taxes would be those where tax liability is directly and immediately graduated by reference to one or several dimensions of the economic wealth or income of the taxpayer; in brief, it is her ability to pay. Indirect taxes would be those where tax liability is calculated by reference to fully objective and impersonal factors, independent of the wealth or income of the taxpayer. The clearer and more obvious connection between the ideal of distributive justice and the way in which personal taxation is collected implies that the Europeanisation of personal taxes has wider democratic consequences. Indeed, personal taxes do involve, even if not always explicitly considered, key decisions which draw the line between those who are to be regarded as members of the political community, and those who are to be considered as alien.¹⁶

The second one, anchored into the history and the present process of European integration, concerns the impact that different types of taxes have on cross-border economic activities. In this regard, the competitive impact of *ad rem* taxes over cross-border economic

introduction was published as NBER Working Paper 8978/2002, available at: <<http://ase.tufts.edu/econ/papers/200201.pdf>>.

¹⁵ See, also, the judgments in cases C-287/94, *Frederiksen* [1996] ECR I-10485, C-199/05, *European Community v Belgian State* [2006] ECR I-10485 or C-437/04, *Commission v Belgium*, [2007] ECR I-2513.

¹⁶ In this regard, personal taxation has always been more flexible than formal citizenship law, as foreigners who deploy their economic activities mainly or mostly within the territory of the state tend to be treated as if they were nationals. Indeed, the key membership criterion is not that of citizenship, but that of residence. It is important to notice that the consolidation of European states as Social *Rechtsstaats* has also implied the mirror extension of the definition of 'tax citizenship' on what concerns access to welfare benefits. This reveals the key connection between personal taxes and the equation of fundamental socio-economic rights and obligations.

activities is much more direct and obvious than that of *personal taxes*. Indeed, *ad rem* taxes are the means of choice to limit the opening of the national market to foreign goods and services (through customs duties or internal sale taxes). This is why the removal of *access* obstacles to national common markets focuses on *ad rem* taxes, as the latter directly and immediately alter the very terms in which goods and services are sold in each national market. And while there is no doubt that personal taxes may have an effect on cross-border competition, such an effect is less obvious and immediate because personal (or even corporate) decisions are never taken exclusively upon the basis of tax levels.¹⁷ Indeed, differences in personal taxes may be sustainable if economic integration consists in opening national markets to non-national economic actors (as, indeed, was the case in the 'common market' stage of European integration; on that, see the introductory chapter to this section).

To distinguish the specific way in which the distinction between direct and indirect taxes is understood in the chapter from the vague distinction between the two in history and in other legal systems, I

¹⁷ Under such circumstances, different levels of personal taxation may not have a direct and clear impact upon the prices of goods or services. Different personal tax structures may co-exist, provided that there is a direct relationship between the level of taxation and the level of provision of public goods. However, this pre-supposes a capacity to monitor capital flows, because, otherwise, the cognitive basis of personal taxation is quickly undermined. On tax competition, the neo-liberal classical reference is J. Buchanan and G. Brennan, *The Power to Tax. Analytical Foundations of a Fiscal Constitution*, Cambridge, Cambridge University Press, 1980, now volume 9 of the complete works of J. Buchanan, Indianapolis, Liberty Fund, 2000; see, especially, at p. 216: 'independently. But the point here is not the traditional one to the effect that jurisdictions should be responsible for both the tax and expenditure decisions in order to ensure some proper balancing of the two sides of the account, as driven by some cost-benefit public-choice model of electoral choice. Our point is the quite different one to the effect that tax competition among separate units rather than tax collusion is an objective to be sought in its own right.' See, also, W. Oates, 'Fiscal Competition and the EU: Contrasting Perspectives', (2002) 31 *Regional Science and Urban Economics*, pp. 133-45. For a wider view of the problem, see R. Avi Yonah, 'Globalization, Tax Competition and The Fiscal Crisis of the Welfare State', (2000) 113 *Harvard Law Review*, pp 1573-1676, and, id., *International Tax as International Law. An Analysis of the International Tax Regime*, Cambridge, Cambridge University Press, 2007, especially chapter 10. See also D. Swank, *Global Capital, Political Institutions and Policy Change in Developed Welfare States*, Cambridge, Cambridge University Press, 2002, in particular, Chapter 7. On the inertial effect of the national institutional structure (limiting the race to the bottom effect), see S. Basinger and M. Hallerberg, 'Remodeling Competition for Capital: How Domestic Politics Erases the Race to the Bottom', (2004) 98 *American Political Science Review*, pp. 261-76.

will refer to direct taxes as personal taxes, and to indirect taxes as *ad rem* taxes hereafter.

The review of European constitutionality of national laws

The founding Treaties of the European Communities assigned the task of ensuring that 'in the interpretation and application of this Treaty *the law* is observed' to the European Court of Justice.¹⁸ The reference to the 'law', instead of a more modest and circumspect reference to the 'Treaty' or to 'this Treaty' played a major role in the constitutional transformation that European Community law underwent in the 1960s, 1970s and 1980s, and, in particular, its 'constitutionalisation'.¹⁹

Indeed, a key part of this transformation was the construction of the founding Treaties of the Communities *as if* they contained the key elements of the constitution of the European Union. The affirmation of the constitutional dignity and value of European Community law was reflected in the affirmation of the structural principles of primacy and direct effect, and in the transformation of judicial procedures before the Court of Justice into potential occasions to review the extent to which national legislatures observed the 'higher law', i.e., Community law. Even if the Court of Justice had a limited power to declare national laws invalid, only indirectly recognised in infringement proceedings, it transformed its rulings (and, in particular, the preliminary rulings requested by national courts) into occasions to undertake a review of the European constitutionality of national laws.

In operational terms, this review is structured in two prongs, concerning (1) whether the national law infringes one (or, more exceptionally, several) of the economic freedoms; and (2) whether there are overriding public interests which would render such a breach justifiable.²⁰

¹⁸ Art. 164 in the original numbering of the Treaty Establishing a European Community.

¹⁹ E. Stein, 'Lawyers, Judges, and the Making of a Transnational Constitution', (1981) 75 *American Journal of International Law*, pp. 1-27; G. F. Mancini, 'The Making of a Constitution for Europe', (1989) 26 *Common Market Law Review*, pp. 595-614; J. H. H. Weiler, 'The Transformation of Europe', (1991) 100 *Yale Law Journal*, pp. 2403-2483.

²⁰ The test had been developed by the Court within the context of its case law on free movement of persons, where the leading cases were (and keep on being) 8/74

In the first prong of the test, the Court determines whether or not the national law has breached *prima facie* one of the economic freedoms. As considered in the general introduction to this section, the case law of the Court has extended to enlarge the breadth and scope of economic freedoms, identifying the breaching act first as a direct discrimination upon the basis of nationality, later with an indirect discrimination upon the basis of nationality, and finally expanding the concept to the placing 'obstacles' to the exercise of economic freedoms. As will be stressed in the rest of this chapter, and was already indicated in the introduction to this section, the expansion of the breadth and scope of economic freedoms as a yardstick of European constitutionality is far from being inconsequential in both legal-dogmatic and normative terms. In particular, review of European constitutionality by reference to discrimination implies a substantive *renvoi*, so to say, to national constitutional law; while the concept of 'obstacle' to an economic freedom pre-supposes a self-standing, transcendental definition of the economic freedom, necessarily autonomous, when not contradictory, with the conception in national constitutional law.

The second prong of the test concerns the possible justifications for the infringement. Since its pioneering judgment in *Cassis de Dijon*,²¹ the Court has been ready to consider not only the explicit justifications defining each economic freedom enshrined into the specific Treaty provisions, but also 'rule of reason' exceptions. Or to use the very terminology of the Court 'overriding requirements relating to the public interest', provided that the national law is adequate to realise a constitutional principle recognised by Community law, and is necessary to such a purpose (or, tantamount to the same thing, there is no alternative national law which could realise the same objective while curtailing, to a lesser extent, the economic freedom in question).²² As we will see, the concrete consistency and scope of application of such interests has been a core

Dassonville v Procureur du Roi, [1974] ECR 837 and 120/78, *Rewe Zentral* (*Cassis de Dijon*), [1979] ECR 649. See J. H. H. Weiler, 'The Constitution of the Common Market Place: Text and Context in the Evolution of the Free Movement of Goods', in P. Craig and G. de Búrca (eds), *The Evolution of EU Law*, Oxford, Oxford University Press, 1999, pp. 349-76, and M. Maduro, *We the Court*, Oxford, Hart Publishing, 1998.

²¹ Case 120/78, [1979] ECR 649.

²² On the proportionality test, the locus classicus is R. Alexy, *The Theory of Constitutional Rights*, Oxford, Oxford University Press, 2002.

theme in the development of the case law of the ECJ on personal taxation.

Tax constitutional choices in the founding treaties of the Communities

In this section, I consider the fundamental tax constitutional choices enshrined in the three founding Treaties of the European Union.²³ My main claim is that tax integration was aimed to render feasible the opening up of national markets to economic goods and agents from all other member states (by means of a complete customs *union* and a *common* market)²⁴ while maintaining intact the power of member states to design coherent tax systems capable of supporting the democratically-decided mixture of economic, social and welfare policies. This double imperative explains, (1) the fundamental distinction between *ad rem* and personal taxes implicit in the Treaty of Paris and explicit in the Treaties of Rome; and (2) the transfer of constitutional, legislative and, in some cases, even tax-collecting powers regarding *ad rem* taxes to the Union, while leaving essentially intact the national competence to define, shape and collect personal taxes. While the former were regarded as constitutive of the common market, the latter were regarded as being so intrinsically connected with the overall socio-economic design as to require the systematic and explicit reconsideration of the final socio-economic constitution of the European polity by political decision-making processes before being transformed and subject to European constitutional principles and secondary norms. In this regard, the largely forgotten, but decisive conflict over the concept of discriminatory pricing in the Treaty of Paris is highly revealing with regard to the original tax constitution of the European Union.

²³ I followed a well-established Convention by considering both the 1951 Treaty of Paris (Treaty establishing the Coal and Steel Community) and the 1957 Treaties of Rome (Treaties establishing the European Economic Community and the Euroatom) as the founding Treaties of the Communities. The three documents are generally regarded as containing a good deal of the *material constitution* of the European Union, or, at the very least, they are constructed as if they were, indeed, the key component of the said material constitution of the Union.

²⁴ On the notion of common market, especially as distinct from that of single market, see the general introductory chapter to this section of the report).

The Treaty of Paris

As has already been stressed in the introduction to this chapter, the reform of national tax systems was regarded as a necessary step in European integration, given their central role in drawing national economic borders. Given that the founding Treaties were premised on the assumption that economic integration was to propel political and social integration, it should be no surprise that *what kind of tax integration was necessary to achieve economic and political integration* was a paramount concern in the negotiations leading to all three Treaties, and in the first debates concerning the very idea of economic integration within the Coal and Steel Community, once it had already been established.

The Treaty of Paris in 1951 constituted the European Coal and Steel Community (The Treaty is hereafter referred as TECSC, and the Coal and Steel Community as the ECSC). The ECSC was defined as a 'common market' in coal and steel. It was to be achieved through a combination of measures, some implying the derogation and amendment of national laws, others the drafting of new, common supranational norms. In the usual jargon of European studies, the Coal and Steel Community implied both measures of negative and positive integration.²⁵ The specific institutional and substantive implications of such a blueprint were rather less defined than is sometimes assumed.²⁶

There were two main tax-relevant provisions enshrined in the Treaty of Paris. First, Art. 4 laid down a negative constitutional principle, which declared any import or export duty burdening coal and steel in

²⁵ The Treaty which established the European Coal and Steel Community (hereafter TECSC) has been rightly characterised as a 'rule-based' Treaty, made up of specific norms framing the action of the supranational administration (the High Authority) at the core of the new supranational organisation. On the relationship between the positive integrative measures contemplated in the TECSC and the socio-economic model underpinning the Treaty, see S. Giubboni, *Social Rights and Market Freedom in the European Constitution: A Labour Law Perspective*, Cambridge, Cambridge University Press, 2005.

²⁶ Indeed, the creation of a common market was regarded as fully compatible with the fact that the coal industry was fully nationalised in France, and so heavily regulated in Belgium as to deprive private property of much of its core meaning in Belgium. See, also, the revealing literal tenor of the original Art. 222 TEC: 'This Treaty shall in no way prejudice the rules in member states governing the system of private ownership', (now included in Art. 345 TEC).

trade between member states of the ECSC to be contrary to the new Treaty.²⁷ Second, Articles 60 and 64 enshrined another negative constitutional principle, ruling out 'discriminatory' pricing in coal and steel, essentially banning different prices depending on the nationality of the buyer (or eventually seller). While the first provision was rather clear-cut, the second was much wider, and thus, its actual implementation was likely to be controversial. And, indeed, it was. As we will see in the next sub-section, it was not obvious whether or, indeed, how this provision would apply to taxes applied to imported goods or taxes re-imbursed at the border to exported goods (given that both of them had a direct and immediate effect upon the price to be paid by the consumer of the goods).

Applying the Paris Treaty

Indeed, the concept of 'price discrimination' proved to be enormously controversial since the very day in which the common market for coal, iron-ore and scrap started to be operative.²⁸ German coal producers had been resorting to differentiated pricing practices, charging one price to national buyers and another to foreign clients. While there was no doubt that the Treaty required that this double pricing practice be brought to an end, it was far less obvious whether the restitution of turnover taxes at the border (and their eventual deduction from the 'exporting' price) was, or was not, compatible with a common market in which prices were not to be discriminatory upon the basis of nationality.

There were two contrasting views on the matter, which not only reflected different sets of economic interests, but were also underpinned by different conceptions of what the coal and steel common market was about.

²⁷ The legal and economic relevance of the Article was rather limited, given that most member states did not charge any duties on coal and steel products, Italy being the exception. Special arrangements allowed Italians to keep on charging duties, although they were to be phased out at increasing speed, and to have been fully abolished by 1958 (see Art. 27 of the Convention on Transitional Provisions). However, it did not mandate the full harmonisation of tariffs applicable to products from third countries, although Art. 72 empowered the Council to fix minimum and maximum tariffs, and Art. 74 granted the High Authority the competence to intervene if the rates at which customs duties were fixed facilitated dumping practices. On the actual practice in the first years of the ECSC, E. Haas, *The Uniting of Europe*, Stanford, Stanford University Press, 1958, at p. 103.

²⁸ The date was 13 February 1953.

Firstly, there were those who claimed that non-discriminatory pricing required that both nationally produced and imported goods should bear an equal sales tax burden (i.e., they should be subject to taxation in the country of sale, not in that of origin). This required creating the conditions under which goods were exported 'free of national taxes' (either by exempting the product or the industry from taxation in the country of origin, or by re-imbursing the sales taxes paid before exportation), and under which they were subject to the full weight of national sale taxes in the country of destination (typically by means of an equalising tax calculated by reference to the taxes that the same goods would have borne had they been produced domestically). This reflected the standard principle in international tax law²⁹ and suited the interests of producers with higher national tax levels quite well (i.e., French producers). It pre-supposed that the European common market was about *opening each and every national market* to European, but non-national, economic actors by means of getting rid of all national measures which created a discriminatory burden on non-national or non-resident economic actors. Barring further political decisions, the common market was composed of six markets made common. In tax terms, this implied drawing a clear-cut distinction between *ad rem* taxes (which were to be Europeanised in order to render possible the porosity of national markets) and personal taxes (which were not to be directly affected by the common market stage of integration). This distinction, when considered together with the institutional and substantive design of European integration, made it possible for national political processes to take autonomous decisions on the shape and configuration of their national personal taxes, and thus, followed different choices on the concrete shape of their socio-economic constitution.³⁰ This first conception must be regarded as the

²⁹ For the principles applied in international trade law, and in the Belgian-Luxembourgish and the Benelux communities, see J. M. Hostert, 'The Court of Justice of the European Communities and the Interpretation of the Tax Provisions of the Rome Treaty', (1966-67) 43 *British Yearbook of International Law*, pp. 147-176.

³⁰ Some observers stress that this created the conditions for sheer nationalistic protectionism. See for example the very revealing editorial of the *Luxemburger Wort*, of 9 July 1952, at p. 7, available at <<http://www.ena.lu?lang=2&doc=1125>>: 'In spite of this, the cracks in the system are too numerous to prevent the loopholes that Governments strive to uncover in order to get around the ban against undermining competition in the coal and steel industry, and through this, to benefit their own national enterprises. The ideal arena for these manipulations is the tax system. Coal and steel manufacturers, while coming under supranational jurisdiction in production and sales, continue to be subject to taxes and national duties. The impact

midwife (and temporary stand-in) of a federal European Community, under which market Communitarisation will come hand in hand with the harmonisation of the whole set of socio-economic regulations, including taxes, wage policies and social insurance mechanisms. For the time being, market integration could be reconciled with autonomous socio-economic decision-making on the part of the member states because the latter continued to control the key means by which they drew their economic borders.

Secondly, there were those who claimed that non-discriminatory pricing required that the practices of the restitution and equalisation of taxes at the border be abandoned *in toto*. While, in abstract, the said practices may be compatible with economic integration, in actual practice, equalisation and restitution could not but lead to discrimination against non-nationals, distorting competition and negatively affecting national consumers. The reason why any border adjustment of taxes was necessarily problematical was that it was impossible to determine in an objective manner the tax burden that a product should bear. Endorsing this second position implied turning national tax systems into a key part of the competitiveness equation (indeed, because German producers were subject to a lighter tax burden than their French counterparts, they tended to favour this second conception). But besides short-term economic interests, this position entailed a vision of the common market as a fully integrated economic area. While member states would retain the formal power to define and shape their tax systems, the very fact that the competitiveness of national producers would be affected by the overall level of taxation within their jurisdiction would create major economic pressure to adjust national tax systems so as to ameliorate the competitiveness of national producers. This view of the common market as, indeed, a single market with no substantive economic borders was appealing to both 'ordo-liberals', as it promised to result in a market-led adjustment of national tax and regulatory frameworks,³¹ and to social-democratic federalists, who hoped the

of this, whether directly or indirectly related to the tax burden, obviously influences the competitive capacities of the industries in question.'

³¹ The German Chancellor of the Exchequer, then Prime Minister, Ludwig Erhard subscribed to this view. On Erhard's 'social market economy', see A. Nicholls, *Freedom with Responsibility: Social Market Economy in Germany, 1918-1963*, Oxford, Clarendon Press, 1994. On the relationship between ordo-liberalism and the economic aspects of the constitution of the European Communities, see C. Joerges,

economic dynamics would generate the momentum to undertake a thorough Europeanisation of national tax systems (including personal taxes).³²

After political and technical consultations (including the Tinbergen Report drafted by experts with a political background),³³ the first option was the one ultimately favoured. As just hinted at, this entailed endorsing a very concrete conception of what economic integration was about, under which national personal taxes were not to be Europeanised except through political decisions enshrined in primary and secondary Community law. A major legacy of the decision was the clear-cut distinction between personal taxes (income and corporate taxes) and *ad rem* taxes (turnover taxation and excises).³⁴ The latter (*ad rem*) was said to be generally passed on to the

'What is Left of the European Economic Constitution? A Melancholic Eulogy', (2005) 30 *European Law Review*, pp. 461-489.

³² Having said that, it is too facile to conclude that this position was a kind of advocacy of the single market of the 1980s. The relative structural affinity of national tax and welfare systems ensured that applying such a conception would not have resulted in a race to the bottom in 1953, 1957 or for that purpose 1965. However, it is clear that it would have implied favouring tax integration as a necessary but unplanned consequence of the realisation of the principle of non-discrimination on pricing. See R. Regul and W. Renner, *Finances and Taxes in European Integration*, Amsterdam, International Bureau of Fiscal Documentation, 1966, pp. 88-97; Haas, *supra*, note 27, at p. 60ff.

³³ See 'Report on the problems raised by the different turnover tax systems applied within the common market: report prepared by the committee of experts set up under Order no. 1-53 of the High Authority, dated Mar. 5, 1953', document 1057-53 of the High Authority, usually referred as the Tinbergen Report. ('Rapport sur les problèmes posés par les taxes sur le chiffre d'affaires dans le marché commun établi par la commission d'experts instituée par la Haute Autorité, of the High Authority'). Tinbergen was, at the time, the chairman of the Dutch planning authority. It is, perhaps, not fully groundless to assume that the President of the High Authority had been re-assured by the issue being decided by such a committee under such leadership, instead of the issue landing on the Court of Justice, where Jacques Rueff, when not whispering in De Gaulle's ears, did actually sit.

³⁴ The distinction was first hinted at in the above-mentioned Tinbergen Report, p. 24. The High Authority conveyed a committee (the so-called Tinbergen committee) which claimed that the conflict could be solved by means of adhering to the view that differences in the burden of general taxes (i.e., corporate or personal income taxes) could be compensated through the exchange rate, while differences in turnover taxes could not (as they were not unlikely to be borne by the consumer at the end of the day). This left the question of how a levelled playing field was to be established open. While it was generally agreed that any proper solution would require coherence across the board (the same system being applied in all member states and to all products, not only coal and steel), it preferred overall a system based

consumer; thus, different levels of national taxation had the clear potential of affecting competitiveness within the common market, given their marginal salience in prices. The former (personal taxes) were not directly reflected in consumer prices, or, at least, not fully and evenly. Thus, although they obviously had an incidence over the overall competitiveness of the economic agents of each member state, their potential impact would be mediated by the exchange rate of the national currency in the mid- and long-run, and by the accompanying public services funded with personal taxes.

This provided a rationale for the system of restitution and equalisation of turnover taxation at the border, which the High Authority added should not result in the unjust enrichment of exporters. In operational terms, adding to the market price the taxes or levies which the exporters were exempted from or restituted – at the border was prohibited.³⁵ Moreover, the practice of restitution and equalisation at the border was intrinsically problematical given the impossibility of establishing, in an objective manner, the amount of taxes that a product bore in a multi-phase turnover tax system. Limiting the restitution to the last phase before exportation was a reasonable option under such circumstances;³⁶ but a deeper and

upon compensation at the frontier limited to the amount paid in the last phase of the turnover tax.

³⁵ Art. 5 of Decision 30/1953, of 2 May 1953, JO of 04.02.1953, p. 109. See, in particular, Art. 5: '[I]t shall be a prohibited practice within the meaning of Art. 60 (1) of the Treaty to include in the price charged to the purchaser the amount of any taxes or charges in respect of which the seller is entitled to exemption or drawback.'

³⁶ The confinement of restitution to the last phase was bound to be conflictive, precisely because French exporters were bound to get higher refunds given that France started applying VAT on April 1954 (and thus the refund of the last phase was a full refund only in the French case). On the introduction of VAT in France, see F. M. B. Lynch, 'Funding the Modern State: The Introduction of the Value Added Tax in France', EUI Working Paper History Department 97/2, Florence, European University Institute. It is, perhaps, pertinent to stress that VAT was the final result of several innovative practices with turnover taxation, fully systematised in 1954. On the French context, see the European Parliament, Directorate Generale for Research, 'Options for a Definitive VAT System', Working Paper of the European Parliament, Economic Affairs Series, 9/1995, available at <http://www.europarl.europa.eu/workingpapers/econ/pdf/e5en_en.pdf>, at p. 2. More generally, see K. K. Sullivan, *The Tax on Value Added*, New York, Columbia University Press, 1965; R. W. Lindholm, 'The Value Added Tax: A Short Review of the Literature', (1970) 8 *Journal of Economic Literature*, pp. 1178-1189; and A. Schenk and O. Oldman, *Value Added Tax, A Comparative Approach*, Cambridge, Cambridge University Press, 2007, Chapter 1.

wider harmonisation of the system of national turnover tax was called for,³⁷ and would, indeed, take place sooner, rather than later.

The Treaties of Rome

The learning process on the effects of internal taxes unleashed by the actual implementation of the TECSC goes a long way to account for the decision to single out taxes and tax laws as a means of choice in order to establish the 'general' common market foreseen in the Treaty Establishing the European Economic Community (The Treaty is hereafter referred as TEC; the Community as the EEC).

Thus, with the TEC, we find an explicit mandate to transfer substantial constitutional, legislative and collecting tax powers³⁸ from the member states to the European Union. In particular, the first step towards the realisation of the common market was to be the creation of an economic space³⁹ by means of the abolition of tariff⁴⁰ and non-tariff obstacles between member states, hand in hand with the substitution of national borders for a new common economic border *vis-à-vis* non-member states.⁴¹ At the heart of this endeavour was the

³⁷ This clearly illustrated the limits of 'sectorial' integration and the structural 'spillover' mechanisms embedded in the very definition of the ECSC. Indeed, the obstacles stemming from the design of multi-phase turnover taxes could not be met by means of reforming turnover taxation exclusively for coal and steel, but unavoidably resulted in an encompassing reform of turnover taxation as such. On the limits of sectorial integration, see Haas, *supra*, note 27, at pp.103-110.

³⁸ The creation of a common economic space rendered inevitable a degree of Europeanisation of national tax systems; similarly, it made the transferral of some collecting tax powers to the Communities almost inevitable certainty. The TEC and the EURATOM assigned legislative tax powers to the standard Community decision-making process, thus requiring a proposal by the Commission and unanimous agreement between the national representatives in the Council of Ministers. The tax collecting powers transferred to the High Authority under the TECSC, powers framed by the text of the Treaty itself, which fixed the essential elements of the levies to be imposed. As just stated, the TEC conditioned the accrual of collecting tax powers to the Economic Community to what, materially speaking, was a reform of the Treaty itself.

³⁹ The common market was to be in full compliance with the international obligations assumed by member states under the international trade framework. See the original tenor of Art. TEC 234.

⁴⁰ The concept of customs union, as defined in Art. XXIV of GATT, was paradigmatically defined by J. Viner in *The Customs Union Issue*, New York, Carnegie Endowment for Peace, 1950. See, also, B. A. Belassa, *Trade Liberalization among Industrial Countries, Objectives and Alternatives*, New York, McGraw Hill, 1967.

⁴¹ This had two main concrete implications: a) *that no customs duties could be levied on account of goods or services moving within the European Community*; this required not

establishment of a customs union among member states. By definition, the customs union required the transfer of practically all substantial powers over customs duties from the member states to the European Communities.⁴² Consequently, the legislative power actually to establish the tariff duties applicable on the external borders of the Communities was to be assigned to supranational decision-making processes if the same duty was to be applicable equally and homogeneously in all member states.⁴³

But as the ECSC 'tax crisis' illustrated, the objectives pursued through the customs union could only be fully realised if the member states were precluded from translating the protectionist strategies usually rendered effective through customs duties into the language of internal taxes.⁴⁴ Thus, the Treaties affirmed a sweeping interdiction of discriminatory internal taxation,⁴⁵ which was immediately regarded

only the progressive abolition of such duties (Arts 9 and 13 TEC on what concerns imports, further spell out in Arts 14 and 15; and Art. 16 regarding exports) but also that duties could only be decreased not increased once the Treaty entered into force (Art. 12 TEC); as is well-known, Articles 30 to 36 of the TEC dealt with quantitative restrictions and measures having an equivalent effect. If such provisions are now regarded as the core of the principle of free movement of goods it is because a) the customs union has been fully and successfully established; and b) that a common external tariff would be established (Art. 19 TEC). Art. 18 TEC ensures the compatibility of the creation of the Economic Community with the international trade framework by affirming - as an objective of the Community - that it must contribute to the overall reduction of trade barriers; and Art. 233 TEC ensures compatibility with the Benelux customs union.

⁴² As will be seen in the next paragraphs, the fact that the duties continued to be collected by what, formally speaking, are national agents not only hides this transfer of power, but also limits it, as the procedural norms which govern the actual process of collection of the tax are national ones.

⁴³ The very idea of a customs union requires the fixing of common supranational constitutional principles barring the collection of customs duties when goods or services move from one member state to another, and pooling in common the power to fix the duties applicable to goods and services from third states. As will be seen in detail below, it was almost inevitable that the transfer of constitutional and legislative tax powers will end up being accompanied by the transfer of collecting powers, as the economic dynamics unleashed will highlight the communal nature of the ensuing proceedings.

⁴⁴ Indeed, member states have tended to claim that suspect taxes collected at the border were not customs duties or equivalent measures, but really internal taxes, and thus exempt from the prohibition laid down in the original text of the EEC Treaty in Art. 9.

⁴⁵ The first two sections of Art. 95 established a broad prohibition of internal taxation which discriminated against products from other member states, while Art. 96 prohibited member states from restituting tax to exporters in excess of what they

as an 'indispensable foundation of the common market'.⁴⁶ As had been learnt in the early days of the ECSC, it was obvious that sales taxes on goods and services were the most likely means of choice to manipulate market conditions in favour of national producers and products, and thus the Treaty mandated the harmonisation of 'turnover taxes, excise duties and other forms of indirect taxation' so as to realise the 'interest of the common market'.⁴⁷ Equalisation practices were explicitly foreseen, as an intermediate step in the 'fusion' of national markets.⁴⁸

In contrast, the Treaties did only contained a rather limited reference to personal taxes, specifically, a mandate to conclude a multilateral treaty to avoid the double taxation of physical and legal persons.⁴⁹

The definition of the general European will on tax matters as the unanimous aggregation of national general wills (as expressed by national governments) reflected both the particular procedure through which the European Communities were established (neither mere Treaty-making nor standard constitution-making, but the *tertium genus* constitutional synthesis)⁵⁰ and the sheer complexity of the decisions affecting the general structure and shape of tax systems. Integration through taxation was not to be mere integration through de-taxation, or, to put it differently, positive, not negative integration, was to be the main driving force in the creation of a common market through the Europeanisation of national tax systems.⁵¹

have actually paid, in order to avoid the cover subsidy of exports. Art. 98 further limited such restitutions to indirect taxation, thus excluding repayments on account of corporate income tax or other forms of direct taxation)

⁴⁶ Judgment in Case 57/65 *Lütticke*, [1966] ECR 205, at p. 210.

⁴⁷ Art. 99 TEC in the original numbering.

⁴⁸ See 'Rapport des chefs de delegation aux Ministres des Affaires Etrangères', (the so-called Spaak Report), Comité Intergouvernemental créé par la conférence de Messine, available at: <http://aei.pitt.edu/996/01/Spaak_report_french.pdf>, at p. 13; on the need of positive and gradual action, see pp. 14-5.

⁴⁹ Art. 220 TEC in its original numbering.

⁵⁰ See my 'The European Democratic Challenge', (2009) 15 *European Law Journal*, pp. 277-308.

⁵¹ What was required was thus positive normative integration, not purely economic integration, or a mixture of negative integration and benign neglect leading to the undirected adjustment of national normative frameworks to the (partial) lifting and re-drawing of economic borders.

The requirement of unanimous agreement among national governments was thus not so much a reflection of serious doubts about the convenience of establishing a supranational tax system, but of the need for complex balancing and active political judgement before taking such decisions. The derivative democratic legitimacy of supranational tax norms did not prejudge the shape of decision-making rules on the future (once the system had been put into place).

In general terms, this explains why *the formal competence bases* of the European Communities on tax matters did basically concern *ad rem personal taxes*. This did not entail that *personal taxes* could not be Europeanised, but that any step in that direction should be undertaken after *explicit political decision-making*, which was required to take the complex factual and normative nature of tax systems as a whole properly into account.

In constitutional terms, this entailed that, once the customs union was completed, constitutional Community law would have an incidence on the shape of *ad rem taxes*, in particular, requiring them not to be discriminatory upon the basis of nationality when applied to the goods (and, more generally, economic agents or services) from other member states. Community law was not to impinge on the substance of national constitutional tax law, but merely required equal tax treatment to Community non-nationals, and to Community non-national goods and services. Until the necessary political decisions had been taken, personal taxes would remain a national competence, also in constitutional terms.

In legislative terms, Europeanisation basically concerned 'access inhibiting norms', and, paramountly, national customs duties (soon abolished in intra-Community trade) and national 'cascade' turnover taxes. The repeal of national tax norms came hand in hand with the rewriting of new tax norms at supranational level. The national customs code was progressively replaced by a common, later a single, European customs code; and purely national 'turnover' taxes were fully replaced by a Europeanised common VAT system, in which European law set the definition of the tax base and the upper and lower limits of the tax rates. Thus, the common market was characterised by the framing of national tax systems by the principle of no tax discrimination on the basis of nationality, which was

basically considered to extend national constitutional standards to (Community) non-nationals.

From the foundation of the Communities to the Single European Act: legislative successes and failures and judicial self-restraint

The first period in the evolution of European tax law was characterised by three features: (1) a considerable, albeit protracted success in establishing a European legislative framework for the collection of the key *ad rem* taxes in all member states; (2) a persistent failure to push economic and political integration beyond the common market stage, despite several major policy initiatives by the Commission (and, intermittently, by the majority, but not all, of national governments meeting in Council), which was paradigmatically exemplified in the failure to Europeanise national statutes defining personal taxes; and (3) the limited breadth and scope of European constitutional law on tax matters, affirmed and extended by the ECJ with regard to *ad rem* taxes, but not even regarded as imaginable on what concerned personal taxes.

The Europeanisation of national legislation on *ad rem* taxes

The completion of the customs union in the 1960s and the prospect of entering into a wider economic and monetary union drove the two major tax legislative successes of the European Communities. The harmonisation of customs duties and the replacement of the variegated systems of turnover taxation by a basically – even albeit not fully harmonised Value Added Tax.

The harmonisation of customs duties was relatively quick and allowed the Communities to complete the fourth and final stage of the ‘common market’ schedule eighteen months ahead of time.⁵² Some pending issues were left unsolved, most of which resulted from

⁵² Member states agreed to a concrete calendar of reductions of internal duties, synchronised with the progressive convergence of the external tariff of member states. Reductions proceeded in earnest, and both the elimination of tariffs within the Community and the establishment of a common external tariff had been achieved one year and a half ahead of the initial schedule, that is, by 1 July 1968. Much less substantial achievements can be registered on what concerned the Europeanisation of national customs legislation other than tariffs, besides non-binding recommendations issued by the Commission, part of which dealt with transitory norms applicable to the rolling back of national tariffs.

the fact that the Europeanised duties were administered, collected and monitored by national tax agents.

It was more laborious to replace national systems of turnover taxation with a new and essentially common system of Value Added Taxation. First, Value Added Tax was generalised in 1967, replacing national turnover taxes. But the degree of divergence in national legislation remained considerable, and, consequently, there was a major potential for conflict. Although it was far from easy to turn the widespread consensus on the desirability of moving in the French direction (i.e., the substitution of national tax systems for the 'French' Value Added Tax) into specific common norms, the disagreements focused on the specific contents of the norms, the timing of the reforms and the contents of the transitional norms, and not so much on the desirability of establishing common norms or even on their general shape (although strong views were held – and continue to be held – on whether the EU VAT should be based upon an origin or destination model).⁵³ The further harmonisation of VAT was only

⁵³ As already indicated, experience from the TECSC goes a long way to explain the specific provisions on turnover taxation contained in the TEC. Its provisions affirmed both the principle of non-discrimination of internal taxation *vis-à-vis* the products from other member states and the principle of capping the restitution of taxes on exportation to the amounts borne during production. The Commission put its hands to work on implementing the mandate contained in Art. 99 TEC, which prescribed the introduction of a turnover tax system and of restitution/equalising practices compatible with the common market. Upon the basis of comprehensive reports produced by committees of tax experts (and, above all, the 'Rapport du Comité Fiscal et Financier', the so-called Neumark Report, Luxembourg, Commission of the European Communities, 1962, on file with the author), the Commission tabled proposals to substitute the multi-phase taxes in force in five of the six member states for a value added tax similar to the one applied in France since 1954. Although the tax experts had favoured 'full harmonisation' (i.e., a common definition of the tax base and the setting of the same VAT rates in all member states) as the necessary precondition for 'full' market integration, the Commission opted for a rather gradualist approach. Its proposals were circumscribed to the definition of the mechanics of the new tax, leaving ample discretion to member states on the definition of the tax bases and the tax rates. The first proposal of 1962 aimed at harmonising national sales taxes in several steps (the ultimate objective being, as suggested by the Neumark Report, the 'abolition of all tax frontiers'). For the immediate future, the Commission suggested the introduction of a non-cumulative sales tax chosen by each member state, to be followed by a harmonised value added tax. The major economic and budgetary implications of such transformations led the Commission to leave the Substantive content of subsequent steps open. See the preliminary recitals of the November proposal: 'Whereas the aim of the common system of added-value taxation must be to secure neutrality of effect on competition inasmuch as within

undertaken in the 1970s, and was considerably helped by the final resolution of the conflict with regard to granting the European Union an autonomous tax base (through the system of own resources rendered possible by some minor Treaty Amendments in 1970 and 1975).⁵⁴ The perspective of VAT becoming an own resource of the Union supported further harmonisation of the definition of the tax base and a certain degree of co-ordination on tax rates.

each country the same goods will be taxed at the same rate irrespective of the number of stages in their production and distribution, and in international trade the amount of tax imposed will be known, so that it will be possible to fix an exact figure for compensation. Whereas it is hardly possible at present to indicate by what time the necessary conditions for attaining the ultimate objective, which is the abolition of all tax frontiers, can be fulfilled.' Draft Directive for the harmonisation among member states of turnover tax legislation, Supplement to Bulletin of the EEC, 12/1962, available at <http://aei.pitt.edu/6875/01/4080_1.pdf>. The text was re-drafted to take account of several amendments proposed by the European Parliament and the Social and Economic Committee, and re-submitted in June 1964. One year later, at the same time that it tabled its proposals on granting the EEC tax collecting powers to fund the Common Agricultural Policy, the Commission put forward the proposal of a second Directive concerning the forms and method of the common VAT. See Proposal for a second Council Directive for the harmonisation among member states of turnover tax legislation, concerning the form and the methods of application of the common system of taxation on value added tax, Supplement to Bulletin of the EEC, 5/1965, available at <http://aei.pitt.edu/6881/01/4086_1.pdf>. Not only were the proposals not immediately acted upon, but many member states increased the amounts paid to exporters in *lieu* of the taxes borne during the production phase. Paradoxically, the fact that France had substituted its traditional turnover taxes by a Value Added Tax in 1954 contributed to unleashing this trend. The fact that French exporters paid turnover tax through VAT was regarded as being to their advantage, as they were guaranteed to have the whole amount of the indirect taxes borne during production restituted (thanks to the transparency achieved by VAT). Under pressure from national producers, several member states increased the amount of taxes repaid on exportation as they complied with their obligation to reduce customs duties to 'compensate' for the benefits that VAT provided to French exporters. The Commission then proposed a standstill of the restitution/equalising practices, but to no avail. This resulted in re-focusing all efforts on the introduction of a new turnover tax. Five years after its first proposal, and scarcely two after the empty chair crisis, the first two VAT directives were approved.

⁵⁴ See A. Menéndez, 'Taxing Europe', (2004) 10 *Columbia Journal of European Law*, pp. 297-338.

The persistent resilience of national economic borders and the failure of the agenda of harmonisation of personal taxation

As already indicated, the constitutional decisions taken in the Treaties assumed that the Europeanisation of personal taxes was not automatic, and would have to be decided politically within the context of further political and social integration. However, the Treaties did not exclude further tax integration. It was well understood, from the inception of the Communities, that, as soon as customs duties and *ad rem* taxes were transformed so that they were no longer an obvious means of protectionism, the member states would be pressed and tempted to attain such objectives through other means, and personal taxes would be a means of choice.

Upon such a basis, the Commission was very active in its programme of harmonisation of European taxation. Backed by the majority of national governments, the Commission put forward several proposals for the Europeanisation of national personal taxation. The decisions taken by the High Authority of the ECSC, and, in particular, the legislative proposals put forward by the Commission of the European Communities in the 1960s and 1970s in development of the blueprint contained in the Treaties were clearly animated by a 'federal' vision of the European tax system. The studies conducted on behalf of the Commission and its specific proposals were underpinned by the view that European integration could only be sustainable if a comprehensive tax framework was agreed upon by the Council of Ministers and enshrined into Community regulations and directives, allowing the embedding of the emergent common market to have the characteristic lines of the embedded national markets. This is, indeed, well reflected in the breadth, scope and conclusions of the Neumark Report of 1962, which comprised recommendations not only on turnover taxation, but also on corporate and personal income tax.⁵⁵ However, not much was

⁵⁵ *Supra*, note 51. In the comprehensive report, the committee constructed its mandate as a general question about the economic and political requirements for the establishment of a functional common market, upholding the (then dominant) view that markets could only operate if properly embedded in their societal context. Thus, the report defines the 'common market' as requiring conditions analogous to 'internal markets', which, in turn, requires factors other than the strict set of norms regulating economic activities to be considered. Firstly, the report assumes a systemic view of taxation and expenditure, highlighting the 'productive' role of public

achieved in legislative terms. Leaving aside the directive on capital duty, the Commission did not see any of its initiatives bear legislative fruit. It did not even have much success on what concerned the network of double taxation bilateral treaties which Art. 220 TEC encouraged member states to sign. By the time the four stages of the common market were completed, many of the pre-existing Treaties were still to be amended so as to be brought in line with the new reality of European integration, and one out of the fifteen was yet to be negotiated and ratified.⁵⁶

expenditure, and consequently, framing, in rather specific terms, the tension between market integration and disparate levels of national taxation. Secondly, it affirms that the stability and efficiency of the common market cannot be ensured by mere negative integration, but requires 'positive' policies, in particular, social policy. See, also, Segre Report of 1966. Thus, even if the committee understood the terms of reference of its report as covering the achievement of conditions similar to those of an internal market (thus, including the suppression of tax borders, both physical and legal; p. 7), it considered that the internal market was not merely a matter of negative freedoms, but that it could not but be underpinned by positive policies of a social and re-distributive character; p. 3 of the report: 'Les buts économiques et sociaux poursuivis sur le plan national seraient ainsi transposés sur le plan du marché commun.'; and p. 12, where a uniform social and economic policy are considered to be pre-conditions for turning national markets into a single market. Moreover, the report refers back to the general objectives set in the EEC Treaty; and, on p. 7, warns of the negative effect that tax discrimination would have upon the objective of establishing a common market. Third, the report stresses the need to combine an ideal blueprint of the European tax system with concrete steps through which it should be brought about, and the importance of temporary measures in the latter case, to avoid tax integration resulting in serious disruption of the economic and social tissue. This explains why the report sustained the need for a profound transformation of national tax systems. Even if, structurally speaking, both the taxation and expenditure systems were sufficiently similar as to allow economic integration, disparities on the concrete design of specific tax figures recommended introducing major changes. The report contains clear advice in favour of the harmonisation of turnover taxation and excise duties, as well as favouring the re-negotiation of bilateral double taxation conventions (which, as we already indicated, were directly covered by the provisions of the Treaty). It also calls for the prompt harmonisation of the tax treatment of cross-border capital income and of taxes relating to the transfer of capital, as well as the co-ordination of the national norms governing personal and corporate income taxation, land taxes, taxes on net wealth, and even inheritance taxes and death duties. Thus, it contains arguments in favour of the adoption of a universal single income tax in all member states, based not only upon arguments of tax fairness, but also of tax transparency, judged to be essential in a common market in which individuals may obtain income from economic activities taxed in different member states (at p. 33).

⁵⁶ U. Anschütz, 'Harmonization of Direct Taxes in the European Economic Community', (1972) 13 *Harvard International Law Journal*, pp. 1-52.

While the EEC Treaty contained a clear and relatively detailed blueprint for the opening of national markets, which was defined in the introductory chapter to the first section of this report, as the common market stage of European integration, this founding text also established wider economic and political integration as a less specific, but not less important, aim of the process of integration. Indeed, the lack of specificity of the Treaties of Rome is, in itself, good evidence of the close connection that was assumed to exist beyond further economic integration and political integration, the latter only being possible if substantive constitutional decisions were adopted.

These initiatives reveal that the majoritarian view was one which supported the transformation of the European tax system by reference to the national tax model. In particular, there was general acceptance that complete economic integration could not be achieved without a considerable degree of approximation of the national personal tax statutes through both framing European legislation and the partial transfer of tax collecting powers to the European Union. At the same time, it was assumed that the transfer of tax and spending powers to the supranational level, the harmonisation of national tax norms, and the partial integration of national tax administrations was absolutely essential to maintain the capacity of European public institutions at all levels of government to fund public goods, re-distribute resources and steer the economy at the macro-economic level. This jingled quite well with the conception of taxes as a means of social integration and macro-economic management which underpinned the tax systems of every member state at the time of the foundation of the Communities (a conception which, as was seen, was closely related to the advocacy of a mixed economy⁵⁷ and the view of the state as a mature welfare state⁵⁸).

⁵⁷ And, in particular, the active use of macro-economic pulls and levers to ensure stable and sustained growth resulting in full employment and a rising standard of living. See J. M. Keynes, *General Theory of Employment, Interest and Money*, London, MacMillan, 1936, and R. Musgrave, *The Theory of Public Finance*, New York, McGraw-Hill, 1959.

⁵⁸ On the welfare state, see S. Rokkan, 'Dimensions of State Formation and Nation Building', in C. Tilly (ed.), *The Formation of National States in Western Europe*, Princeton, Princeton University Press, 1974, pp. 562-600; A. de Swann, *In Care of the State*, Oxford, Blackwell, 1984.

The limited role of the ECJ: constitutional Court on *ad rem* taxes; fully self-restrained on personal taxes

During the first two decades of European integration, the European Court of Justice played a modest role as the guardian of the European constitutionality of national tax norms.

On the one hand, it affirmed itself as the defender of the communitarisation of national markets by means of reviewing the constitutionality of national tax norms which created obstacles to the free movement of goods, essentially customs duties, turnover taxes and other *ad rem* taxes. In doing so, the Court relied on the central normative role assigned to the free movement of goods in the founding Treaties (to this day, the free movement of goods is not only the first common policy, but is regulated in a separate chapter from other economic freedoms) and on the clear-cut character of the specific provisions contained in the Treaties (especially, the original Art. 9). With such arguments in hand, it overcame the reluctance of national judges even to consider the review of any tax norm by reference to constitutional principles.

On the other hand, it exerted the utmost self-restraint on what concerned national personal taxes.⁵⁹ This was partially due to the lack of incoming cases to the Court. The Commission failed to bring infringement procedures concerning national personal income taxes, and national courts failed to pose preliminary questions concerning these issues. However, it is not too adventurous to assume that the Court did intentionally avoid 'inviting' preliminary requests on the matter, something which it could have easily done by either offering an encompassing construction of the breadth and scope of the old Art. 95 of the Treaty, or by means of *obiter dicta* which might have been interpreted as an indication of its willingness to review the European constitutionality of national personal taxes in structurally similar ways to its consideration of domestic taxes which burden

⁵⁹ The only exceptions are less than a handful of cases concerning personal taxes requested from public employees at the service of the Commission. But, in such cases, what was at stake was not the compatibility of national taxes with Community law as such, but only with the Protocol on the privileges and immunities of the European Communities. See Cases 6/60, *Humblet*, [1960] ECR 1129; 7/74, *R. Ch. Brouerius van Nidek*, [1974] ECR 757 and 208/80, *Lord Bruce of Donington*, [1981] ECR 2205. And, of course, the case law on the Capital Duty Directive, to the extent that the latter may be regarded as a form of direct corporate taxation.

imported goods in a discriminatory manner. After all, the Court had made it clear in its early jurisprudence that the key provisions enshrining the free movement of persons and the freedom of establishment had direct effect since the completion of the fourth stage of the common market in mid-1968, exactly in the same way as the free movement of goods did. But notwithstanding this, probably under the spell of the 'Tinbergen' dispute, it still did not invite any exploration of whether Art. 95 could be so constructed as to cover personal taxes.

As a result, self-restraint left it open as to whether national personal tax norms were, or were not, framed by European constitutional principles pending their harmonisation through secondary Community law, and, in the eventual case that this was so, whether the European yardstick of constitutionality was to be defined by reference to the four economic freedoms, or whether it should be constructed by reference *also* to 'common national tax constitutional principles'. What, throughout this period, seemed to be accepted was that the judges were not empowered to set aside national tax norms even if they were in conflict with national constitutional provisions.

Self-restraint and the unwillingness to review the constitutionality of national tax norms reflected not only a certain idea of the legitimacy of the Court of Justice itself, but also seemed to imply that the Court endorsed the view that the democratic legitimacy of the Union could only originate in national political processes, and then be transferred to the supranational level. In the area of *ad rem* taxes, the Treaties did contain clear-cut decisions which were to be implemented by the Communities as the loyal servants of the collective democratic will of the member states. Because this was so, the Court could step into the role of the guardian of the rights of transnational citizens. But in the area of personal taxes, the Treaties did not contain such clear cut-decisions, but only contained procedural norms which left the decisions on how to Europeanise personal taxes in the hands of the Council of Ministers as a collective Community actor, or to the member states as international actors.

Opening national personal tax laws to review of European constitutionality in the context of the Single Market

The opening of the 'European constitutional season' of personal tax law was a direct consequence of the transformation which the European Communities underwent in the first half of the 1980s, as the achievement of the 'single market' came to be regarded as the great objective of integration. Given that this has already been covered in the introductory chapter to this section of the report, it should suffice now to remind the reader that the several political, economic and social crises which overlapped in the 1970s and shattered the confidence in the post-war socio-economic consensus and not only hampered the ongoing plans to realise economic and political integration, but also seemed to put at risk all previous achievements of the Communities, in particular, the customs union and the common market.⁶⁰ Aiming at a single market in which the four economic freedoms were realised to their full potential looked like an attractive idea across the growing political divide between 'old-fashioned' Christian and Social-Democrats and the emerging neo-liberals.

Personal taxes had been targeted once and again by the Commission as key obstacles on the road both to preserve the realisations of the 'customs union' and to realise the 'internal market'. In the aftermath of *Cassis de Dijon*, and given the deadlock characteristic of the law-making process, it was only natural that the Commission would try its hand at bringing infringement proceedings before the Court of Justice.⁶¹ This led to the *Avoir Fiscal* ruling in January 1986,⁶² days after the final text of the Single European Act⁶³ had been agreed upon, and days before it was formally signed.⁶⁴

⁶⁰ On the history of the single market, see (despite its interpretative shortcomings), G. Grin, *The Battle of the Single European Market*, London, Kegan Paul, 2003.

⁶¹ The 1985 White Paper of the Commission highlighted supranational tax legislation as a key means to achieving the single market. See 'Completing the Internal Market. White Paper of the Commission to the European Council (Milan, 28-29 June 1985)', COM (85) 310 final, 14 June 1985, available at <http://aei.pitt.edu/1113/01/internal_market_wp_COM_85_310.pdf>.

⁶² Case 270/83, *Commission v France (Avoir Fiscal)*, [1986] ECR 273.

⁶³ On the Single European Act, a nuanced contemporary assessment can be found in J. Lodge, 'The Single European Act: Towards a New European Dynamism?', (1986) 24 *Journal of Common Market Studies*, pp. 203-36. On the negotiation of the SEA, the

Affirming the principle of the review of European constitutionality of national personal tax norms

While the substantive parts of the ruling in *Avoir Fiscal* are very important and continue to be the law in force, its utmost importance derives from the fact that the Court affirmed that personal tax laws could be found to be in conflict with the basic principles of Community law, i.e., the (then) three economic freedoms.⁶⁵ This implied, under the terms considered in Section I, affirming that the review of the European constitutionality of national legislation extended to personal tax norms. Consequently, each and every national personal tax norm became the potential object of a review of European constitutionality, with first three, and then four, economic freedoms operating as the yardsticks of its constitutionality (the fourth being the free movement of capital, which only became a fully-fledged economic freedom after the entry into force of Directive 88/361 on 1 July 1990).⁶⁶

Avoir Fiscal concerned the compatibility of the tax credits granted by French law to shareholders with a view to reducing the cumulative economic effects of corporate and personal income taxes when

standard reference is A. Moravcsik, *The Choice for Europe*, Ithaca, Cornell University Press, 1998. The ideological background is studied in G. Grin, *The Battle for the Single Market*, London, Kegan Paul, 2003.

⁶⁴ The fact that the member state against which the Commission had brought infringement proceedings was France, the country in which the advocates of a full exit from the single market strategy had been close to victory around 1983, is likely not to have been fully co-incidental. On the very well-known infighting on European policy of/in the early Mitterrand Presidency, see K. Dyson and K. Featherstone, *The Road to Maastricht*, Oxford, Oxford University Press, 1999, Chapter 4.

⁶⁵ In retrospective, it could be claimed that the Court had already made some hints at the opening of a new line of jurisprudence in Case 15/81, *Gaston Schul*, [1982] ECR 1409. The latter was, strictly speaking, a VAT case. But in some *obiter dicta*, the Court actually re-constructed the scope of European constitutional norms; while, until then, the said principles were believed to frame 'turnover' and other indirect taxes exclusively, the Court seemed to have re-interpreted them as imposing limits on national legislatures when taking decisions on any tax which could have 'European' implications. See, in particular, the opinion of Advocate General Rozès, to be found at [1982] 3 *Common Market Law Review*, p. 229, at 236: 'It had not escaped the notice of the draftsmen of the Treaty that, depending on the procedures laid down for its application, direct or indirect taxation is capable of presenting an obstacle to the achievement of the aims which they had set themselves.'

⁶⁶ Indeed, as F. Losada reminds us in chapter 4 in this report, it was not until Directive 88/361 was passed, and *Bordessa* decided, that the free movement of capital became a fourth yardstick of the review of European constitutionality.

applied to dividends. In the case at issue, it was specifically discussed whether the enjoyment of the said tax credit could be conditioned to the actual establishment in France (or eventually to the establishment in a country, such as the Netherlands, Britain, Germany or the United Kingdom, with whom France had signed a double taxation agreement which included a clause extending the right to the tax credit), or whether such a requirement was in breach of freedom of establishment,⁶⁷ or, to be more precise, the freedom to set up secondary establishments in other member states. In its path-breaking ruling, the Court rebuffed the arguments posed by the French government, and put forward two key premises which came to frame case law in the future.

The first premise was that the freedom of establishment (and implicitly, all the economic freedoms bar the free movement of capital, at that stage not formulated in a directly effective article of the Treaty),⁶⁸ imposed limits on the exercise of the sovereign power to tax, even though the member states had failed to agree on common tax norms at European level:

It must first be noted that the fact that the laws of the member states on corporation tax have not been harmonised cannot justify the difference of treatment in this case. Although it is true that, in the absence of such harmonisation, a company's tax position depends on the national law applied to it, Art. 52 EEC prohibits the member states from laying down in their laws conditions for the pursuit of activities by persons exercising

⁶⁷ It is not by chance that the case concerned insurance companies. Foreign companies faced a stark choice. If they operated through secondary establishments, they were required by French law, in this respect fully in line with secondary Community law, to constitute technical reserves in France. Because they could not benefit from the said tax credit (contrary to what is the case of companies primarily established in France), they had an economic interest in sticking to bonds as a means of constituting their reserves, while companies established in France were legally authorised, and economically promoted, to maintain diversified portfolios. Thus, foreign insurance companies not only faced a taller tax bill, but also had less room for diversifying their investments.

⁶⁸ But see how AG Léger had already dropped the exception when delivering his opinion on Schumacker, par. 21: 'Thus, even in areas in which they have exclusive powers, the member states may not adopt measures which, without justification, hamper the free movement of workers (Art. 48), members of the professions (Art. 52), services (Art. 59) or capital (Art. 73)'.

their right of establishment which differ from those laid down for their own nationals.⁶⁹

Or, tantamount to the same thing, the old Art. 100 TEC could not be constructed as a 'reserve' of power in favour of the national law-maker, and more specifically, as an institutional rule excluding the judicial review of tax laws as long as they had not been 'harmonised' at the European level.

Second, the Court claimed that any difference in treatment on account of nationality was to be deemed suspect, independently of whether it was eventually 'compensated' when considered from a systemic perspective:

[T]he difference in treatment also cannot be justified by any advantages which branches and agencies may enjoy *vis-à-vis* companies and which, according to the French Government, balance out the disadvantages resulting from the failure to grant the benefit of shareholders' tax credits. Even if such advantages actually exist, they cannot justify a breach of the obligation laid down in Art. 52 to accord foreign companies the same treatment in regard to shareholders' tax credits as is accorded to French companies.⁷⁰

Despite the fact that the underlying issue had an obvious cross-border implication (to the extent that profits made in France would, sooner or later, be repatriated into the home member state), the Court focused its review on the implications that the denial of the tax credit had for the operation of foreign permanent establishments within the French insurance market.⁷¹ It found that this resulted in the distortion of the common market given that companies not entitled to the tax

⁶⁹ In Par. 24 of the judgment, Advocate General Mancini went further and claimed that national governments could not avoid the obligation of not applying their legislations in a non-discriminatory way by reference to a 'delay' on the part of the Community legislature. See the text of his opinion, 1 [1987] *Common Market Law Review*, 401, p. 410: 'In more concrete terms, delay on the part of the Community legislature does not suspend the member-States' obligation to apply their tax laws in a non-discriminatory way'. The Court also rejected the claim that the old Art. 220 could be constructed as a norm excluding constitutional review of national tax norms in the absence of a complete set of bilateral double taxation agreements.

⁷⁰ Par. 21.

⁷¹ See, in particular, the opinion of AG Mancini, *supra*, note 68, at p. 408.

credit would have to charge higher premia, reduce their profits, or simply perish. There was thus a clear 'common market' focus on discrimination upon the basis of nationality in terms of access.

A similar line was followed in the (handful) of cases actually decided by the ECJ in the first long decade of its personal tax jurisprudence. In *Commerzbank*,⁷² it considered whether the UK Treasury could acknowledge a tax exemption enshrined in a bilateral double taxation agreement to a German company operating in the UK through a branch, but deny it the supplementary payment on account of interest due between the time the tax was wrongly collected and the moment the principal was restituted.⁷³ In *Biehl*,⁷⁴ the judges focused on the tax consequences of leaving a member state to establish residence in another member state, especially when this happened in the middle of the fiscal year. The law governing the Luxembourgish personal income tax precluded taxpayers from recovering the amounts withheld in excess of their final tax liability when they changed residence during the year.⁷⁵ The plaintiff claimed that the Luxembourgish provision not only deterred his freedom to move as a worker, but also imposed indirect discriminatory treatment upon him as a non-national,⁷⁶ breaching his right to equal remuneration.

⁷² Case C-330/91, [1993] ECR I-4017.

⁷³ See also C-264/96, *ICI*, [1998] ECR I-4711; the case concerned the subjection of the right to make deductions on account of a holding company through which a consortium exercised its right of secondary establishment to the holding company holding shares in nationally established companies. However, the Court was clear-cut in denying that constructing in accordance with Community law required that the holding of shares in companies not established in the Communities was considered.

⁷⁴ Case 175/88, [1990] ECR I-1779. Case 24/92, *Corbiau*, [1993] ECR I-1277 dealt with the same issue, even if/though the preliminary request focused on whether the administrative body to which taxpayers could appeal was to be regarded as providing judicial guarantees to taxpayers. Indeed, the Commission brought Luxembourg before the ECJ on account of the failure to repeal the provisions found to be in breach of Community law and the Court decided against Luxembourg again. See Case C-151/94, [1995] ECR U-3685.

⁷⁵ In Case C-1/93, *Halliburton*, [1994] ECR I-1137 the ECJ followed a similar structural way of tackling the review of European constitutionality of personal tax norms. However, the Dutch government was hinting at the *problématique* which was to ensue in the coming years by claiming that the situation was purely internal and did not have a Community dimension.

⁷⁶ Given that the number of non-nationals moving in and out of Luxembourg was likely, especially in the case of the tiny Duchy, to exceed that of nationals in the same situation by far).

The Court swiftly accepted the claim, and openly stated, for the first time, that personal income taxes were also framed by the constitutional principles of Community law:

The principle of equal treatment with regard to remuneration would be rendered ineffective if it could be undermined by discriminatory national provisions on income tax.⁷⁷

The Court not only affirmed that the validity of all national tax norms (including personal tax norms) depended on their European constitutionality, but also that courts (led by the European Court of Justice, but also including ordinary *national* courts) were empowered to review the said European constitutionality of any national tax norm, and, eventually, that national courts could and should set aside those norms found to be unconstitutional. This entailed the simultaneous affirmation that European constitutional norms framed national personal taxes (something which could be genuinely doubted in the first period of the case law of the Court, as we have seen),⁷⁸ and that judges were, indeed, empowered to draw the relevant legal consequences when a national tax norm entered into conflict with European constitutional norm (something which had implicitly been denied during the previous period, and which was, at least formally, at odds with the tendency to judicial self-restraint on tax matters, which characterised the behaviour of all courts, and not just European ones).⁷⁹ This entailed assuming that national tax

⁷⁷ Par. 12 of the judgment.

⁷⁸ Or perhaps, it could be doubted that the yardstick of the European constitutionality of national tax norms should be mainly defined by reference to the Community's economic freedoms; and perhaps not as a 'mirror' of national constitutional tax principles (which typically imposed substantive requirements of fairness to the tax system as a whole). This move was closely related to the progressive dilution in the jurisprudence of the Court of the difference (justified by the literal tenor of the Treaties) between the free movement of goods and all other economic freedoms, in its turn, based upon the assumption that the regulation and *materialisation* of all economic freedoms was necessary actually to uphold, in an effective and fair manner, the free movement of goods. Such an assumption did underpin the world economic architecture since the end of the Second World War to the late 1960s.

⁷⁹ N. Komesar, *Law's Limits. The Rule of Law and the Supply and Demand of Rights*, Cambridge, Cambridge University Press, 2001. On the lack of self-restraint in the United States, see F. D. G. Ribble, 'Some Aspects of Judicial Self-Restraint', (1940) 24 *Virginia Law Review*, pp. 981-98, covering the *Pollock* case (which captured the imagination of Carl Schmitt). See also M. Shapiro, 'Juridicalisation of Politics in the

powers were no longer the full powers of sovereign states, but competences that the member states exercised within the framework of European constitutional norms, and, consequently, were eventually subject to a review of European constitutionality.⁸⁰

Schumacker came rather later, extending the case law of *Avoir Fiscal* to the review of the most characteristic distinction made in national personal tax systems, that between residents and non-residents. Mr Schumacker was a Belgian national and resident who worked in Germany, where he obtained most of his income, and where he was subject to pay income tax. While the ECJ endorsed the general principle that the structural purpose of tax law made it legitimate and necessary to draw lines between residents and non-residents, and assign them different sets of obligations and rights to each category of taxpayers, the Court also claimed that economic freedoms could still be used as a yardstick for European constitutionality to determine the validity of such distinctions. First, Community law would determine the soundness of the way in which the resident/non-resident line was drawn. In particular, the Court took notice of the sociological reality of citizens who, making use of the opportunities provided by European integration, had kept their residence in one member state while working as employees or being self-employed in another member state, as, indeed, Mr Schumacker had. The ECJ claimed that there should be a point at which such citizens should be treated as

US', (1994) 15 *International Political Science Review*, pp. 101-12. On judicial self-restraint in the post-war period, see M. Shapiro, 'Judicial Modesty: Down with the Old, Up with the New', (1963) 10 *UCLA Law Review*, pp. 533-60.

⁸⁰ The synthetic nature of European constitutional law renders the distinction between European and national constitutional standards analytically useful but substantively confusing. The backbone of European constitutional law is indeed formed by the common constitutional norms of the member states, partially 'codified' in the founding Treaties of the Communities. On this, see A. Menéndez, 'Sobre los conflictos constitucionales europeos', (2007) 24 *Anuario de Filosofía del Derecho*, forthcoming. However, the 'autonomy' of the European legal order has resulted in assigning a higher weight to economic freedoms in Community law than in national legal orders. Very clearly and dramatically in the series of related judgments given which have, as its 'head', Case 28/67 *Molkerei Zentrale et al.*, [1968] REC 211: the most specific pronouncement can be found in the opinion of AG Gand in Case 31/67 *Stier*, [1968] REC 347, par. 3: 'The Court must give a ruling on the last question asked of it, which seeks to establish whether, in so far as member-States' right to tax is recognised in principle, their rights are nevertheless subject to some restriction by reason of the Treaty as to the amount of internal taxation, and, if so, to what restrictions'. A question which both the AG and the Court answered affirmatively.

residents for tax purposes in the country in which they work, even if they actually resided in another member state. And, indeed, the found inspiration in a failed European Commission proposal, and granted these 'transnational citizens' (if the reader will allow me to coin this term to make it clear that I am referring to them hereafter) tax residence, wherever they earn more than 90 per cent of their income:

In the case of a non-resident who receives the major part of his income and almost all his family income in a member state other than that of his residence, discrimination arises from the fact that his personal and family circumstances are taken into account neither in the State of residence nor in the State of employment.⁸¹

Second, the Court affirmed that Community law would, indeed, review whether it made constitutional sense to choose residence as a tax triggering or connecting factor. Drawing lines between residents and non-residents could make sense in the abstract, but whether it did or did not in each concrete case would depend upon whether the distinction was, or was not, objectively grounded. Thus, while the Court affirmed that 'In relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable',⁸² it found that there were exceptions to the rule where there was no objective difference between residents and non-residents.⁸³

Limiting the scope of economic freedoms

The Court was very careful when it defined the scope of the constitutional yardsticks which determined the soundness of national personal tax norms, mainly the freedom of establishment and the free movement of workers. The leading 'limiting' cases were *Daily Mail*, *Werner*, *Bachmann*, *Gschwind*, and *Schumacker*.

⁸¹ Par. 38 of the judgment. Similarly, Case 80/94, *Wielockx*, [1998] ECR I-2493 (concerning the right to deduct from taxable income profits allocated to form a pension reserve).

⁸² Par. 31 of the judgment. A phrase completed afterwards in C-107/94, *Asscher*, [1996] ECR I-3089, par. 42, with the explanation of why they are not similar 'since there are objective differences between them both from the point of view of the source of the income and from that of their ability to pay tax or the possibility of taking account of their personal and family circumstances'.

⁸³ Pars 36 to 38, turn into a general and streamlined principle by the ECJ in *Asscher*, par. 42.

Taming economic freedoms in the tax circus

Daily Mail concerned a rather standard strategy of corporate re-organisation in the early 1980s, in which the neo-liberal fervour of the legal advisors of the plaintiff exceeded those of Her Majesty's Treasury. The managers of the company wanted to dis-establish the company, re-constitute it in another member state, sell part of its actives and thereby avoid the capital gains taxes which they would have had to pay if they had sold the activities before moving, and then keep on actually producing and selling the paper, and, in general, conducting all business from London. Given that the company had no real economic links with the Netherlands, it was hard to avoid the conclusion that the whole operation was tax-driven (under Dutch law, taxes would only be due on capital gains calculated by reference to the value of assets on the date in which residence was transferred, and, given that the eventual gains would have cumulated over the years in the UK, the net result would be a capital gains tax free operation).⁸⁴ However, the counsel for the plaintiff sustained that the exercise of the freedom of establishment granted by Community law entitled it to re-incorporate, with British authorities not being empowered to condition the operation to the previous settling of eventual tax liabilities with the United Kingdom (as British law established, and as the British tax authorities insisted upon during protracted negotiations with the plaintiffs).⁸⁵

Following the lead of AG Darmon, the ECJ ruled that freedom of establishment was one thing, and the power of member states to grant corporations personality another, and that the latter included the power to subject an operation, such as that intended by the owners of *Daily Mail*, to the payment of taxes on account of the hidden capital gains realised while resident in the United Kingdom.

While freedom of establishment did contain a *prima facie* right to transfer the company from one member state to another, this did not prevent a member state from conditioning the transfer of the centre of

⁸⁴ See especially pars 37 and 38 of the ruling. AG Darmon insisted on the relevance of effective economic links when claiming the right of freedom of establishment: '[Freedom of establishment] always implies a genuine economic link', in (1988) 3 *Common Market Law Review*, p. 713, at p. 717.

⁸⁵ In the case of *Daily Mail*, the Court made it clear that the right to establishment rules out that the country of establishment hinders the development of economic activity in other member states; see par. 16 of the judgment.

management and the control of the company to its previous winding up, and/or the settling of the taxes upon the capital gains not realised at the time of the transfer (which would have generated tax liabilities sooner or later were the company not to be transferred). The Court put forward a restrained construction of what the community right of freedom of establishment entitled European companies to (upon the basis of a rather literal reading of ex Art. 52 TEC: see par. 17). While not going as far as the Advocate General, who was keen to limit the right of transfer to those cases in which there was a 'genuine economic purpose' involved in the operation, the ECJ was still in favour of reconciling economic freedoms with the exercise of tax and regulatory powers on the part of the member states.⁸⁶ In particular, by ruling against the plaintiff in this case, the Luxembourg judges clarified the breadth and scope of the freedom as a yardstick of the European constitutionality of corporate income taxes. By affirming the power of member states to condition transfers to the settling of pending tax liabilities, the ECJ upheld the effectiveness of corporate income taxation. Were the right to freedom of establishment to be interpreted too widely, so that companies would be entitled to an absolute right to the transfer of their seat, the effective capacity to tax the underlying capital gains will be severely affected.⁸⁷ Indeed, once a company (such as the Daily Mail in the case at hand) has been operating for a certain period of time, it is likely that capital gains would have been realised, but on account of which no tax has yet been paid, as tax liability only results at given points of time. This is why the freedom of establishment could not be constructed as the plaintiffs pretended, because it would have entailed reducing it to a right to 'jurisdiction shopping', which might, in the short run, result in tax evasion on a large scale, and, in the long run, in a tax race to the bottom.

It is important to notice that the Court claimed that, in the absence of a clear cut inclusion of such a right in the Treaties, the normative framework of jurisdictional transfer of companies should be established by the European legislator (and thus not by the ECJ itself):

⁸⁶ See the comment by Lever in (1989) 26 *Common Market Law Review*, pp. 327-34.

⁸⁷ It is important to keep in mind that the ECJ stressed that 'unlike natural persons, companies are creatures of the law' and that (at least for the time being and as indeed keeps on being the case) companies are 'creatures of national law' (par. 19).

It must therefore be held that the Treaty regards the differences in national legislation concerning the required connecting factor and the question whether – and if so how – the registered office or real head office of a company incorporated under national law may be transferred from one member-State to another as problems which are not resolved by the rules concerning the right of establishment but must be dealt with by future legislation or conventions (par. 23).⁸⁸

In general structural terms, *Daily Mail* pointed to a careful delimitation of the breadth and scope of economic freedoms when reviewing the constitutionality of personal taxes. It ruled out the systematic use of economic freedoms as a means of escaping the taxman. Nothing, perhaps, illustrates better the significance of the ruling as the fact that, in the next four years, the Court was only confronted with one request for a preliminary judgment on personal taxation.

Excluding purely internal situations

*Werner*⁸⁹ was a second limiting case, in which the ECJ delineated the scope of the ‘purely internal situation’ in the interplay between economic freedoms and personal taxation. In particular, the ECJ denied that the relationship between national tax authorities and a national who earned all her income in her own state, despite being resident in another member state, were governed by Community law. Mr Werner was a dentist who practiced his profession in Germany but was resident in the Netherlands. He could not be regarded as a ‘trans-national’ citizen in the *Schumacker* sense, and thus, Community law did not add to his rights when dealing with the German tax authorities.⁹⁰

The rationale of this distinction was, perhaps, more clearly stated in *Schumacker*, when the Court borrowed the key principle of

⁸⁸ In Case C-287/94, *Frederiksen*, the Court considered the narrow question of whether the harmonisation brought about by the Capital Duty Directive extended to direct taxes, which it categorically answered in the negative. See [1996] ECR I-4881, par. 21.

⁸⁹ Case 112/91, [1993] ECR I-429. It is rather telling of the assumption of a difference between taxation and legislation that the ECJ drew this conclusion at a time at which its ‘obstacles’ jurisprudence was dramatically shrinking the scope of purely internal situations.

⁹⁰ Par. 12.

international tax law governing the proper differentiated treatment of residents and non-residents:

In relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable [...] Consequently, the fact that a member state does not grant to a non-resident certain tax benefits which it grants to a resident is not, as a rule, discriminatory since those two categories of taxpayer are not in a comparable situation (par. 31 and 34).⁹¹

Indeed, if the plaintiff in *Asscher* was found to be in a comparable situation to residents, even if he was not one, and he did not obtain most of his income in the member states whose legislation he regarded as discriminatory, it was because the Dutch law calculated the tax base of residents and non-residents in exactly the same way. The defence of the progressiveness of the Dutch tax system did not require levying a higher tax on 'foreigners', but merely including foreign income for the purpose of calculating the applicable rate; and thus there was no 'coherence' involved when the higher tax rate was supposed to be 'coherent' with a benefit granted by Community law itself (in the case at hand, subjection to the social security contributions of the country of residence and not to the country in which the taxpayer worked part of his or her time).⁹²

Crafting a rule of reason justification: coherence of the tax system

But the Court was not only cautious in its characterisation of economic freedoms as yardsticks of European constitutionality of personal tax norms, and was eager to exclude purely internal situations, such as that of *Werner*, from the scope of its review. The Court was also receptive to the peculiarity of personal taxation as an object of constitutional review and consequently came to accept a wider set of justifications for national personal tax laws infringing *prima facie* one or the other of the economic freedoms. In particular, the ECJ went so far as to craft a new 'justification', doing so in apparently wide terms ('the coherence of the tax system') and being willing to consider whether it provided cover to a national personal

⁹¹ And similarly in Case C-336/96, *Gilly*, [1998] ECR I-2823 and in Case C-391/97 *Gschwind* [1999] ECR I-5453.

⁹² Case C-107/94, *Asscher*, [1996] ECR I-3089.

tax norm even if the latter was *directly discriminatory* against the nationality of a natural person or the establishment of a legal person (against its constant jurisprudence on overriding public interests since *Cassis de Dijon*). By doing this, the ECJ seemed ready to recognise the high complexity of the balancing of the constitutional principles which underpin any tax statute and even each individual tax norm, and thus to take seriously the fact that the European Union had not assumed legislative competences in the matter, and that it was not improbable that it would not assume them in the near future.⁹³

The key case in this regard was (and continues to be) *Bachmann*. The plaintiff of the same name and the Commission⁹⁴ contested the European constitutionality of Belgian tax norms governing the deductibility of certain premia (relating to insurance against a variety of risks, including sickness and old-age). In concrete, the plaintiffs argued that the contested Belgian tax provisions were in breach of both the free movement of workers and the freedom of establishment, because they subjected deductibility to the condition that the premia *were paid in Belgium*. This was for two reasons: first, it was more than probable that the cohort of taxpayers denied the right to deduct insurance premia would be mainly formed by nationals of other member states (who would have already contracted insurance before moving into Belgium), and that, even if some Belgians were also denied benefits, they were likely to suffer less economic damage than non-nationals (as they were likely to return to Belgium, and thus receive the benefits free of Belgian taxes). Thus, the contested norm posed obstacles which were likely to have a deterrent effect on prospective 'movers', and certainly entailed less beneficial treatment for those who had actually moved to Belgium having previously contracted insurance in another member state.⁹⁵ This was said to be sufficient to ground the claim that the right to free movement of persons had been breached. Second, the Belgian tax provision placed

⁹³ See the first opinion of AG La Pergola in C-35/98, *Verkooijen*, [2000] ECR I-4071, available at <<http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61998C0035:EN:HTML>>. Curiously enough, the Curia.eu site does only refer to the second opinion.

⁹⁴ Joined Cases C-204/90, *Bachmann*, and C-300/90, *Belgium*, [1992] ECR I-249.

⁹⁵ As either the prospective mover had to accept the eventual cost of not being able to deduct his or her contributions, or the economic cost of cancelling his or her policy every time that he or she moved.

insurance companies not established in Belgium in a less competitive position than that enjoyed by companies established in the country; rational taxpayers would add the 'lost' tax deductions to the cost of the premium when deciding which policy to subscribe. Thus, the case concerned both the right of taxpayers as individuals to deduct insurance premia when assessing their income tax liabilities and the right of insurance companies as entrepreneurs to provide their services throughout the whole Community.⁹⁶

Both the Advocate General and the Court were persuaded by the arguments made by the plaintiffs and declared that the contested Belgian provisions did, indeed, infringe the economic liberties of the plaintiffs. Nonetheless, and to the surprise of many, they did not believe that this was the end of the argument. Indeed, they ended up finding that the norm was a necessary, adequate and proportional means to ensure the 'coherence of the [Belgian] tax system', a newly formulated 'rule of reason' exception to economic freedoms.⁹⁷ By this, it seems that it was essentially meant that the European constitutionality of national tax norms could not be established in isolation, but had to consider in a systemic way all the norms which assess the economic ability to pay which derives from a given economic operation (in the case at hand, all the norms applicable to the taxation of the insurance contract over the whole life of the contract, from its signature to its 'maturity'). This was especially so given the fact that there is no overarching Community framework governing the interactions of national tax systems, and this entails that each system could opt for different solutions.

The Court implied a definition of the 'cohesion' exception which left open its precise views on its structural features. By appealing to the idea of 'cohesion' of the 'tax system' and not only of the 'tax figure' or

⁹⁶ And although it was not explicitly stated in the judgment, the ruling had potential far-reaching implications for the public finances of Belgium, and some other member states (especially Italy and Greece) with high levels of public debt, by then still (partially) funded through the obligation imposed upon financial institutions to invest in the national public debt. By the time the case was brought before the Court of Justice, the said States still imposed, on the insurance companies established in their territory, the obligation to subscribe public debt as part and parcel of their safe assets and reserves.

⁹⁷ On the origin of 'rule of reason' exceptions, originating in *Cassis de Dijon*, see K. Lenaerts and P. Van Nuffel, *Constitutional Law of the European Union*, London, Sweet and Maxwell, 2004, pp. 165-6.

specific tax in question, the Court seemed to open up the possibility of making the collective interests articulated in different tax policy choices, or the different objective or temporal elements in the treatment of a given tax base, prevail over the subjective economic freedoms enshrined in the Treaties. In particular, the language of *Bachmann* seemed to consider not so much, or at least not only, the effects that the norms had upon the concrete individuals (*Bachmann* and those whose complaints had motivated the Commission to open infringement proceedings), but the systemic *rationale* behind the way in which they were treated. This 'objective' language is at play in *Bachmann*, perhaps more clearly in the following paragraphs:

The cohesion of such a tax system, the formulation of which is a matter for the Belgian State, presupposes, therefore, that in the event of that State being obliged to allow the deduction of life assurance contributions paid in another member state, it should be able to tax sums payable by insurers (*Commission v Belgium*, 16).

In the case at hand, determining whether the breaching legislation was, nonetheless, justified entailed assessing the relation between the rules governing the deduction of premia and the taxation of the benefits when the contract reached maturity. In particular, whether national norms could be justified as a means of ensuring the coherence of the national tax system was to be determined by assessing whether the differentiated regimes applicable to 'nationals' and 'transnationals' were, nonetheless, equivalent in economic terms (or, tantamount to the same thing, whether the overall economic implications of the rights and duties imposed upon 'national' and 'transnational' citizens were equivalent).⁹⁸ The Court concluded that this was, indeed, the case with the Belgian tax system in the case at hand. On the one hand, taxpayers who subscribed to a policy with an insurance company established in Belgium were entitled to deduct the premia every year from their tax liabilities, but were also required to pay income tax on the benefits which they eventually received. On the other hand, taxpayers who subscribed to a policy with an insurance company which was not established in Belgium could not deduct the premia, but were not required to pay any Belgian tax

⁹⁸ Second, whether the financial sustainability of national public finances would be imperilled unless the discriminating measure was regarded as justified.

when receiving the benefits. Both systems were different, but equivalent. If 'transnational' citizens were entitled to both a deduction and did not have to pay taxes to the Belgian state upon receiving the benefits, this would destabilise the Belgian tax system (by undermining its coherence, to use the very phrase coined by the ECJ).

It follows that, in a tax system of this kind, the loss of revenue resulting from the deduction of life insurance contributions, a term which includes pension insurance and insurance against death, from the total taxable income is offset by the taxation of pensions, capital sums or surrender values payable by the insurers. In cases where the deduction of such contributions was not allowed, these amounts were exempt from taxation.⁹⁹

Without denying the explicit relevance of other factors in arriving at the final decision,¹⁰⁰ it is plausible to reconstruct the ruling in the light of the institutional and democratic implications of the decision. In particular, what clearly distinguishes *Bachmann* from *Biehl* or *Schumacker* is that the number of national norms whose validity was at stake was much larger in the former case. Although both the request for a preliminary ruling and the infringement proceedings of the Commission originated in 'transnational' citizens who were far from happy given that they suffered from what they regarded as a discrimination with negative economic effects, the circle of those affected, had the Belgian tax norm been quashed by the European Court of Justice, would have been much larger than in the other cases. Indeed, it is not far-fetched to claim that 'national' citizens would mainly have been affected, both in numbers and in depth. Had a norm like the Belgian one been declared unconstitutional, and the right to deduct extended to premia paid to non-established insurers, more and more 'national' citizens would have considered subscribing to such a kind of policy. In the short run, this would have required the Belgian state to reconsider overnight how to fund a sizeable part of its public debt, funded, until then, in part, by insurance companies,

⁹⁹ See, in particular, par. 22 of the judgment.

¹⁰⁰ Possible alternative explanations range from the rather under-developed stage of Community law with regard to what constituted the provision of insurance services to the looming implications that a different result would have had for the sustainability of Belgian public debt (and with it, the prospects of a central member state being part of the eventual third stage of the Monetary Union).

obliged to invest part of their reserves in the acquisition of public debt. In the long run, it may have created structural pressure to alter the general framework of the taxation of pensions, especially if a sizeable number of 'nationals' decided to transfer their residence upon retirement, for which they would have an extra incentive. In order to avoid being taxed by tax authorities which had acknowledged them the right to deduct the premia.¹⁰¹

Bachmann was confirmed in *Safir*,¹⁰² even if the ruling did not find the national - Swedish - norm to be justified. As a matter of principle, the ECJ re-affirmed the principle of coherent taxation, now strangely defined as the prevention of a 'tax vacuum'. Even though the Court decided against Sweden, the judges went to considerable length to describe a reasonable and proportional alternative:

Other systems which are more transparent and are also capable of filling the fiscal vacuum referred to by the Swedish Government, whilst being less restrictive of the freedom to provide services, are conceivable, in particular a system for charging tax on the yield on life assurance capital, calculated according to a standard method and applicable in the same way

¹⁰¹ A good deal of the ensuing confusion with the notion of 'coherence of the tax system' may derive from the fact that the Court wished to strike two objectives simultaneously: to retain the larger breadth and scope of economic freedoms, now 'capturing' in their constitutional next national tax norms; and to avoid erecting itself in a constitutional judge of national tax norms. While, in *Daily Mail*, it opted for excluding from the very definition of the freedom of establishment the legal prerogative to change the seat of the company without being forced to wind the company up, thus avoiding expanding the breadth and scope of the freedom of establishment beyond situations in which companies actually extended their economic activity across borders, it avoided affirming that the Belgian national tax law actually did comply with Community law. It could have done so by claiming that, while the tax treatment of transnational citizens was not exactly the same as that of purely 'national' citizens who had never exercised their rights to free movement, or had done so without relevant economic consequences, the two regimes were equivalent. Had the Court done so, it would have to revise its blank rejection of similar claims made by national governments in previous and later cases (and even by some Advocates General). However, the implications of an eventual ruling declaring that the Belgian tax provision was unconstitutional in a European sense would have had consequences not only and not mainly for transnational citizens (putting an end to what seemed to be negative economic consequences for them amounting to a minor discrimination) but basically for the whole structure of the insurance business in the Union.

¹⁰² C-118/96, [1998] ECR I-1897.

to all insurance policies, whether taken out with companies established in the member state concerned or with companies established in another member state (par. 33).

Interim conclusion: self-restrain exercise of the power to review the European constitutionality of national personal taxes

The combined effect of the limited scope of review of constitutionality, and the emphasis placed by the Court on the 'overriding public requirements' which could serve as justifications of infringements of economic freedoms, entailed that the case law of the Court was very cautious and self-restrained. On the one hand, it is certainly the case that the decisions made a difference, and, thus, we can say that the door that was closed before was now open. From then onwards, national personal taxes could be reviewed by reference to the general principles of Community law. Indeed, the complex coalition of forces behind the re-launching of integration through a re-characterisation of the 'single market' shared the view that personal tax norms, and, in particular, those concerning capital income, had become a means of choice to shelter national producers in the wake of the two oil crises of the 1970s. By breaking with the tacit exclusion of personal tax norms from the review of European constitutionality, the Court sent a very strong signal both to private (meaning corporate) plaintiffs and to the Commission.¹⁰³ On the other hand, the Court limited itself to cautiously opening a closed door and leaving it slightly open. The scope of economic freedoms as yardsticks of the constitutionality of national personal taxes was carefully limited (as the Court would make very clear in *Daily Mail*) and the breadth of justifications was to be generously constructed (as the Court made clear in *Bachmann*). Thus, more than opening the door with a bang, it could be said that the Court limited itself to leaving it ajar.

¹⁰³ And, indeed, it delivered a limited number, but nonetheless, significant set of judgments in which it cast long shadows of doubt over the validity of some national tax laws. In this paradigm, *Biehl* fits quite well (even if, in some cases, there was an inkling of what was to come after *Verkooijen*). But while the decision was significant in principle, the rulings of the Court could be interpreted as targeting norms which under the colour of making sensible distinctions necessary to calculate liability to personal taxes, actually operated direct or indirect discriminations upon the basis of nationality.

Indeed, the case law of the ECJ in this period could be interpreted as a means of correcting the persistent democratic mismatch which comes hand in hand with the creation of a single market in which tax liability continues to be determined by each member state. Under such circumstances, the economic community is European while the political community is national. As a result, an increasing number of citizens experience a plural 'belonging' in economic and existential terms, which has to be artificially fragmented or even shattered in order to fit into the neatly divided spheres of both the political and the economic influence of the member states. A moderate bite of European constitutional principles as yardsticks of the European constitutionality of national personal taxes could deal with the worst implications of the mismatch, without questioning the integrity and purpose of national tax systems. Community law did not aim to call into question national collective decisions regarding the shape of national personal tax systems *as long as* the tax systems were not used as a means of differentiating taxpayers from other member states. The same implicitly and explicitly went for the *ancillary regulatory powers* which member states have fleshed out to ensure actual compliance with national tax laws.

This makes it plausible to uphold the decision to operate a limited constitutional review of national legislation on *democratic grounds*, if only because national law-making processes are likely either to silence or to underplay the voices of those who, for most of the time, are not even represented on account of their nationality (in the case of physical persons) or of their centre of economic activity (in the case of corporations).

Radicalising the breadth and scope of Community freedoms

The self-restraint with which the Court undertook the review of the European constitutionality of national personal tax laws was progressively abandoned in a series of judgments, from that rendered in *Wielockx* in August 1995 to that rendered in *Verkooijen* in 2000.

If military terms were not rather inept to describe judicial reasoning, it could be said that the national power over personal taxes was Europeanised through a pincer movement. The Court enlarged the breadth and scope of economic freedoms as a yardstick for the review

of the constitutionality of national personal tax norms by stigmatising not only discriminatory national tax laws, but also those which merely created obstacles to the exercise of economic freedoms; at the same time, it affirmed that the freedom of establishment entitled companies to jurisdiction shopping, and, in the process, legitimised tax avoidance; and, last, but not least, it incorporated double taxation conventions into the list of norms which could be subject to the review of European constitutionality. At the same time, and this explains the military parallel, the Court narrowed down the justificatory breadth and scope of overriding public interests when applied to personal taxation, especially with regard to the coherence of the tax system.

As will be discussed *infra*, this period coincides in time with the consolidation of the project of monetary integration.

Enlarging the breadth and scope of economic freedoms as a yardstick of the review of the European constitutionality of personal tax norms

From discrimination to obstacles: from the tax law governing the relationships between the state and the taxpayer to the tax laws governing cross-border situations

The Court of Justice increased the degree of the Europeanisation of personal taxes by re-defining the breadth and the scope of economic freedoms as yardstick of the (European) constitutionality of national personal tax laws. While, in the previous period, as argued above, only national personal tax laws which were directly or indirectly discriminatory could be regarded as infringing economic freedoms, the Court was now ready to proclaim the invalidity of national personal tax laws which created obstacles to the exercise of economic freedoms. In normative terms, this implied extending the general case law of the ECJ on economic freedoms to tax law, and thus, treating the *problématique* of the review of the European constitutionality of national personal tax laws as a standard *problématique*.¹⁰⁴

¹⁰⁴ Following the interpretation of Community freedoms set already in *Dassonville* and *Cassis de Dijon* on what concerned free movement of goods, but more importantly in *C-76/90, Säger*, [1991] ECR I-4421, *C-55/94 Gebhard*, [1995] ECR I.4165, *C-415/93 Bosman*, [1995] ECR I-4921, and after the entry into force of Directive 88/361, in *C-163/94, Sanz de Lera*, [1995] ECR I-4821. It may be concluded that economic freedoms are no longer to be regarded as the operationalisation of the

The first case in point was *Futura*.¹⁰⁵ Singer was the Luxembourgish branch of a French company, Futura. In 1986, it claimed to carry forward the losses incurred in the previous years. There were no proper accounts for Singer, but the company made use of the possibility provided in the Luxembourgish tax law of calculating the losses as a percentage of the losses of Futura (by establishing the percentage of the total economic activity undertaken by the subsidiary). However, Luxembourgish law limited the extent to which a non-resident company could carry forward its losses; in particular, it excluded such a possibility if the accounts had not been kept in accordance with national accounting standards. While the measure was clearly not discriminatory (as national companies would also be denied the benefit had they not kept accounts according to the said standard),¹⁰⁶ the ECJ affirmed in a fairly straightforward manner that the Luxembourgish provision constituted an obstacle to the operation of branches in another member state,¹⁰⁷ and, as such, was suspect from the perspective of Community law.¹⁰⁸ The actual implications of the 'shift' were very limited in the case at hand. This was so because the Court was ready to accept that this concrete measure was justified by the 'overriding

principle of non-discrimination upon the basis of nationality, but as self-standing economic freedoms.

¹⁰⁵ Case C-250/95, *Futura*, [1997] ECR I-2471. The AG had indicated *obiter dicta* in *Wielockx* that, 'Until now, the Court has always considered that Art. 52 of the Treaty, applied to the area of taxation, requires - in the same way as Art. 48 - evidence of overt or covert discrimination. It may, however, be noted in passing that measures applicable without distinction may have an equally restrictive effect on freedom of movement for persons or freedom of establishment as discrimination', relying for that purpose in the textbook on tax law by P. Farmer and R. Lyal, *EC Tax Law*, Oxford, Oxford University Press, 1994. As is well-known, R. Lyal is the distinguished legal agent of the European Commission, who has appeared in most personal tax cases.

¹⁰⁶ See par. 24: 'Such a condition may constitute a restriction, within the meaning of Art. 52 of the Treaty, on the freedom of establishment of a company or firm which, in terms of Art. 58 of the Treaty, *is to be treated in the same way as a natural person who is a national of a member state*, where that company or firm wishes to establish a branch in a member state different from that in which it has its seat' (my italics).

¹⁰⁷ Had *Futura* been a Luxembourgish company, at least its accounts would have been kept in Luxembourg and according to the national accounting standard. But given that *Futura* was a French company, not only the inspection of its accounts was more cumbersome for Luxembourgish tax inspectors, but it required more time and effort, as the accounts were kept according to the French accounting standard.

¹⁰⁸ Par. 26 of the judgment, in which the Court recalls the key precedents of the 'obstacle' approach.

interest' (i.e., a rule of reason exception) in ensuring the 'fairness and effectiveness of the national tax system)', as we will consider in more detail below.¹⁰⁹

But whatever the concrete outcome in the case *a quo*, a shift had taken place; as, indeed, was confirmed in *Saint Gobain* and, indeed, many times since,¹¹⁰ to the point that we can say that the number of cases in which national personal tax laws have been 'quashed' upon the basis of their creating obstacles to one economic freedom has grown, in both absolute and in relative terms.¹¹¹

This is, perhaps, especially so, in what has become the key review area, the payment of dividends by a company situated in one member state to another company situated in another member state. The most contentious issue in this regard is the relief of the economic double taxation of the said cross-border dividends. By insisting on analysing the question from a formalistic standpoint, which considered neither the policy goals of national tax norms, nor the limits to national competences under a system of uncoordinated national tax systems, and, for that matter, not even the revenue implications of one or the other solution, the Court has *de facto* enlarged the breadth of what is regarded as a restriction of economic freedoms.

The leading case in this regard is *Verkooijen*. The plaintiff challenged the Dutch income tax law. While dividends paid by companies established in the Netherlands were exempted from personal income tax law, the same dividends paid by non-resident companies were subject to tax. The Dutch exchequer argued,¹¹² as other national exchequers would do later, that non-residents could not be considered to be in the same position as residents (and indeed, this seems to be supported by the literal tenor of Art. 73d, 1a of the EC Treaty). A contrary conclusion could only be reached by simultaneously ignoring the multilateral nature of tax law, and of tax

¹⁰⁹ Pars 33 and 36 of the judgment.

¹¹⁰ Case C-307/97, 1999 [ECR] I-6163.

¹¹¹ See, for example, S. Kingston, 'A Light in the Darkness: Recent Developments in the ECJ's Direct Tax Jurisprudence', (2007) 44 *Common Market Law Review*, pp. 1321-1359.

¹¹² See, in particular, pars, 38 and 51 of the judgment of the Court.

institutions.¹¹³ In the case of residents receiving dividends, the granting of relief for economic double taxation is premised on their actually suffering economic double taxation as the result of the dividends being subject to corporate income tax as profits of the participated company and as profits of the recipient company. Both taxes are paid to the same exchequer. In the case of non-residents, not only do member states have greater administrative difficulties in verifying whether and, if so, how much tax has been paid by the recipient company (so there is no certainty that there is tax relief on anything, in which case the relief could entail de-taxation), but also the tax benefit would not be matched by income tax paid by the non-resident on account of corporate income tax, because, as a non-resident, it is not subject to it. While, formally-speaking, it could seem that there is a *discriminatory treatment* of the non-resident company,¹¹⁴ a substantive analysis of the situation reveals that the two situations are actually different. If this is denied, then, both the logical and economic basis of the policy choices underlying national corporate income taxation are openly questioned.

¹¹³ On this, see M. J. Graetz and A. C. Warren, 'Income Tax Discrimination and the Political and Economic Integration of Europe' (2006) 115 *Yale Law Journal*, pp. 1186-1254. The authors follow a different categorisation of restrictions (by reference to whether what is at stake is a discrimination of foreign products, producers or production processes). However, they spot the inconsistency necessarily resulting from not taking the underlying policies to national tax systems seriously. Indeed, relief of economic double taxation is, indeed, a policy which looks beyond formal equality to consider substantive equality. It can be discussed as to whether it is advisable or should not be applied, but it is hard to discuss its substantive, material character. The income tax paid by the company distributing the dividends and the shareholder receiving them are, formally speaking, two different taxes, paid by different taxpayers. It is only when these two taxes are considered from the standpoint of their economic consequences that it is realised that, at the end of the day, the two taxes end up burdening the same taxpayer, i.e., the shareholder (or the final shareholder if there is/was a complex chain of ownership). If the institutional form through which economic activity is to be conducted is to be tax neutral (I insist, perhaps it should, perhaps it should not), then there is a good case for relieving economic double taxation.

¹¹⁴ Something which the European Court of Justice has transformed into a *clause de style*. The most polished quotation may be from the Opinion of AG Mengozzi in C-379/05 *Amurta*, [2007] ECR I-9569, par. 42: 'Once a member state, unilaterally or by Convention, imposes a charge to income tax, not only on resident share-holders but also on non-resident shareholders in respect of dividends they receive from a resident company, the position of these non-resident shareholders becomes comparable to that of resident shareholders'. See, also, C-194/06, *Orange European Smallcap*, [2008] ECR I-3747, par. 79.

Notwithstanding this, the Court rejected the claim made by the Dutch authorities concerning the appropriateness of a more restrictive definition of the breadth and scope of economic freedoms, and concerning the adequacy of a wider characterisation of the overriding public interest 'coherence of the tax system'.¹¹⁵

It was, indeed, mainly this decision which has caused the explosion of cases before the European Court of Justice on personal taxation in the present decade.¹¹⁶

As was argued in general terms in the introduction to this section, the move from the discrimination of obstacles has major practical and normative implications.

First, it implies breaking with the assumption that what was relevant to determine the European constitutionality of national personal taxes were the consequences resulting from the application of the said national tax laws. The discriminatory approach implied, as was pointed to above, that the Court was reviewing national legislation on account of the consequences which it imposed on economic agents operating within the national economy. Because the factual situations were *internal*, there was a perfect match between the judgment of European unconstitutionality and the national law being declared unconstitutional, causing a state of affairs which was regarded as discriminatory. To consider just one example: In *Avoir Fiscal*, the key problematical consequence of French corporate income tax law was that it placed foreign insurance companies in a non-competitive position *vis-à-vis* French companies, foreign companies established in France, or foreign companies operating through a permanent establishment, but being incorporated in a member state which had signed a double taxation convention with France, which granted them national treatment. Whether French law resulted in reduced dividends being transferred back to the parent company was only a

¹¹⁵ Coherence would operate here very clearly at a collective and multilateral level. Denying the factual differences between the two situations, closely related to the lack of harmonisation of national personal taxes, comes, quite naturally, hand in hand with disregarding the logical and economic logic of the very idea of relief of economic double taxation in a cross-border situation governed by two or more tax systems.

¹¹⁶ For a critical assessment of the dividends jurisprudence, see M. J. Graetz and A. C. Warren, 'Dividend Taxation in Europe: When the ECJ Makes Policy', (2007) 44 *Common Market Law Review*, pp. 1577-1623.

background, and secondary, question. The 'obstacles' approach necessarily does away with the match between the unconstitutionality of the law and the consequences of the law itself. If what matters are whether national personal tax laws create obstacles to the exercise of one economic freedom, this can only be determined by considering the actual economic consequences of a national personal tax law, which are dependent on the overall legal regime applicable to any cross-border economic activity. But, because the Court reviews the European constitutionality of one national legal system at a time, it ends up deciding on the constitutionality of national personal tax laws *as if* national legislators had the power to regulate cross-border economic activity as a whole which they do not. This was especially visible when the Court came to consider the taxation of cross-border dividends, and rejected the arguments made by several member states, which pointed to the very limits of their tax and regulatory powers over cross-border economic activity, as hinted at above.

Second, it implies breaking with the characterisation of the standards of the review of European constitutionality by reference to national constitutional law. As long as economic freedoms were characterised as the operationalisation of the principle of non-discrimination upon the basis of nationality, they operated as the requirement of extending the same treatment received by national economic agents, goods or services to those of other member states. This only enlarged the breadth of national tax law, but did not imply any external substantive requirement that were different from those already contained in it. The re-fashioning of economic freedoms as self-standing constitutional standards, realising the ideal of 'European citizenship',¹¹⁷ implies divorcing them from national constitutional standards. Review is no longer necessarily limited to the 'formal' requirement of equality, but implies imposing a given shape and structure to the tax system. Given the narrow breadth of the European yardstick of constitutionality applied by the Court, it implies pushing national tax systems away from the realisation of the complex balance of constitutional principles characteristic of tax law

¹¹⁷ See A. Menéndez, 'More human, Less Social: The Jurisprudence of the ECJ on Citizenship', in M. Maduro and L. Azoulai (eds), *The Past and Future of EU Law. The Classics of EU Law Revisited on the 50th Anniversary of the Rome Treaty*, Oxford, Hart Publishing, 2009.

in a social democratic state to their configuration as the enablers of the single market.¹¹⁸

Third, this has led to the ‘judicialisation’ of personal tax law. Not only was the Court necessarily pushing for the judicial review of European constitutionality, but the actual configuration of the institutional structure and decision-making set-up of the Union on tax matters rendered it improbable that either the European or the national political process would intervene and rectify the normative regime emerging from the case-law of the Court.

Economic freedoms unbound: Centros and Inspire Art

As considered in pars 40-41, *Daily Mail* for a while seemed to clarify not only that national law continued to be the exclusive source of legal personality, but also that the entitlement to freedom of establishment was pre-supposed on genuine economic activity, and was subordinated to exquisite compliance with national tax and regulatory norms. Thus, nobody was allowed to stand on freedom of establishment for the purpose of avoiding national taxes on capital gains or on income flows. With the development of European company law proceeding very slowly, the Commission came to endorse the view that harmonisation could, again, be replaced by mutual recognition of companies. This planted the seeds of the claim that a genuine single market could be one in which there are as many regimes of company law as in the member states, but in which companies can incorporate in the member state the company law of the member state which best suits their interests, even if the whole of their economic activity is developed in another member state.

¹¹⁸ The move from a nationally reliant test of discrimination to a definition of what constitutes an infringement of an economic freedom came hand in hand with the de-coupling of the definition of the economic freedoms from the common constitutional traditions. This implied a double ‘de-coupling’ from national constitutional standards. The direct one was the removal of the direct relevance of national constitutional standards by affirming that European constitutionality required not only formal consistency with European integration of whatever tax policies each member state considered as solid to one stating that European constitutionality depended on substantive compliance with a single and central characterisation of what each economic freedom was. The indirect one was the further denial that the actual definition of each economic freedom was to be modelled on national constitutional standards; and the affirmation of a Community standard, in which much economic freedoms were assigned a higher ‘weight’ when coming into conflict with fundamental collective goods.

*Centros*¹¹⁹ revolved around the decision of Danish authorities to deny the registration of a foreign branch of a British company, upon the basis that the latter did not have actual economic activity. The underlying assumption was clearly that the parent company had been established in the United Kingdom only to avoid the branch (the one that would engage into real economic activity) being subject to Danish company law. In stark contrast to *Daily Mail*, the Court found that:

[T]he refusal of a member state to register a branch of a company formed in accordance with the law of another member state in which it has its registered office on the grounds that the branch is intended to enable the company to carry on all its economic activity in the host State, with the result that the secondary establishment escapes national rules on the provision for and the paying-up of a minimum capital, is incompatible with Articles 52 and 58 of the Treaty, in so far as it prevents any exercise of the right freely to set up a secondary establishment which Articles 52 and 58 are specifically intended to guarantee.¹²⁰

The judgment of the Court could be interpreted as establishing that the concrete Danish law (refusing to register a secondary establishment which was actually the 'real' establishment of a formally British company, *Centros*) was inadequate and disproportionate to the alleged legislative aim, namely, ensuring fairness in the undertaking of economic activities. If this had been the case, it would have meant that it was not so much that member states could not use the correlation between country of establishment and country of real seat to determine whether rules other than national ones concerning minimum capital were being avoided (as the Court, indeed, seemed to suggest in the *provisio* added to the *ratio decidendi*:

[Community law] does not preclude that first State from adopting any appropriate measure for preventing or penalising fraud, either in relation to the company itself, if need be in co-operation with the member state in which it was formed, or in relation to its members, where it has been established that they

¹¹⁹ Case C-212/97, [1999] ECR I-1459.

¹²⁰ Par. 30 of the judgment.

are, in fact, attempting, by means of the formation of the company, to evade their obligations towards private or public creditors established on the territory of a member state concerned.¹²¹

Such a moderate construction was questioned by the ECJ itself in *Überseering*.¹²² The case concerned the denial of legal personality and legal standing in Germany to a company which had been established according to the law of the Netherlands, but which intended to carry its economic activity in Germany. Disregarding the views of the Advocate General,¹²³ the Court denied that the legal characterisation character of the company could depend on the 'real economic substance' of its operations. What mattered was that it had been formally constituted in an impeccable way under Dutch law.¹²⁴

In *Inspire Art*,¹²⁵ the Court came full circle and concluded that:

[T]he fact that Inspire Art was formed in the United Kingdom for the purpose of circumventing Netherlands company law which lays down stricter rules with regard in particular to minimum capital and the paying-up of shares does not mean that that company's establishment of a branch in the Netherlands is not covered by freedom of establishment as provided for by Articles 43 EC and 48 EC. As the Court held in *Centros* (par. 18), the question of the application of those articles is different from the question whether or not a member state may adopt measures in order to prevent attempts by

¹²¹ Par. 39 of the judgment.

¹²² Case C-208/00, [2002] ECR I-9919.

¹²³ R. Jarabo in *Überseering* seemed intent on rendering *Centros* compatible with *Daily Mail*, by means of charactering the relationship between the two as 'complementary': 'It is, to my mind, rather a matter of *supplementing* the former decision; issues regarding definition of the connecting factor determining the law applicable to a company and questions concerning cross-border transfers of companies' head offices were and are governed, in the absence of harmonising measures, by the legal systems of member states which must, none the less, *comply with substantive Community law*. (par. 39).'

¹²⁴ This clearly implied, as Ruiz-Jarabo let be known, that the Court would be forced, sooner or later, to re-consider if the *ratio decidendi* of *Daily Mail* held, especially in what was, until then, assumed to be the breadth and scope of the terms enshrined in par. 23 of the said judgment.

¹²⁵ Case C-176/01, [2003] ECR I-10155.

certain of its nationals improperly to evade domestic legislation by having recourse to the possibilities offered by the Treaty.¹²⁶

As the German government claimed in *Überseering*, one of the key underlying reasons for considering that the proper way of reconciling a single market with the acknowledgement of national taxing powers was, indeed, to recognise the soundness of the real seat theory, as it helps to close the avenues for undermining national tax powers in a structural way. Even if the criteria for the exercise of regulatory and taxing power are different, and the German state could still fully tax *Überseering* by considering it as a resident company, the equation of freedom of establishment to freedom to shop the national legislation of establishment necessarily increases the structural possibilities of tax shopping and avoidance.¹²⁷ This would multiply the chances of manipulating the tax base by means of doctoring the flow of income so as to allocate tax liability under the more lenient tax authority, and to multiply the chances of de-taxation through double enjoyment of tax benefits. Such possibilities, intrinsic to the mismatch between the single market and the design of the European tax system, become a major threat to the stability of the national tax systems once the pool of companies which might eventually profit from them skyrocket; this is particularly so, once member states cannot deny their existence, even if their real economic purpose is dubious.¹²⁸ Indeed, the chances of member states being capable of engaging in the 'ad hoc', 'subjective' monitoring, which the Court considers to be justified in order to limit freedom of establishment, are rather slim. In practice, the structural empowerment of cross-border companies went hand in hand with the naturalisation of tax avoidance as a legitimate practice,

¹²⁶ Par. 98 of the judgment. As the reader will have noticed, the Court claims to be grounding its ruling on par. 18 of its decision in *Centros*. But, there, the Court was considering exclusively the circumvention of one specific requirement, that of minimum capital. In *Inspire Art*, the Court speaks in general of 'stricter rules', of which one concrete instance is minimum capital, which is not exactly the same, neither in degree nor in quality.

¹²⁷ As the Court Restates the German government position in *Überseering*: 'companies might claim and be granted tax advantages simultaneously in several member states (...) cross-border offsetting of losses against profits between undertakings within the same group'.

¹²⁸ From 2003 to 2006, 67,000 of these companies were established in the United Kingdom (an almost fifth-fold increase since *Centros*). Most of these companies aim at conducting business in Germany or the Netherlands. See M. Becht, C. Mayer and H. F. Wagner, 'Where Do Firms Incorporate? Deregulation and the Cost of Entry', (2008) 14 *Journal of Corporate Finance*, pp. 241-56.

indeed, as the natural (and healthy) implication of the proper realisation of a single market *without* the harmonisation of personal taxes.

The strange case of double taxation conventions

The Court also extended the bite of economic freedoms by the (very controversial) decision to extend the set of norms subject to a review of European constitutionality. In particular, the ECJ has claimed that the validity of bilateral double taxation treaties with non-member states was also required to comply with the fundamental principles of Community law, and, consequently, provisions of bilateral treaties could be subjected to a review of European constitutionality.¹²⁹

The leading case in this regard is *Saint Gobain*.¹³⁰ The case concerned the tax treatment of the German subsidiary of the French company *Saint Gobain*. The plaintiff claimed that German tax authorities discriminated against it on several accounts; the key one for our present purpose was access to benefits enshrined in bilateral tax treaties with third countries, and which the German tax authorities claimed were only available to those regarded as residents for tax purposes. While the German authorities claimed that bilateral treaties with third countries were outside the scope of Community law, and that of the scope within which the ECJ could review the European constitutionality of national laws, the Court was not of the same view. While acknowledging that ‘member states remain competent to determine the criteria for taxation of income and wealth with a view to eliminating double taxation’ (ex-Art. 293 TEC), such competence basically concerned the determination of the connecting factors for the purposes of allocating tax powers. The exercise of tax powers, be they in accordance with national or international law, must respect the substantive requirements of economic freedoms (par. 57). In the case in question of taxation under a double taxation treaty with a third country:

[T]he national treatment principle requires the member state which is party to the treaty to grant to permanent

¹²⁹ Quite clearly, to the extent that they failed within the breadth and scope of Community law.

¹³⁰ Case C-307/97, *Saint-Gobain*, [1999] ECR I-6161. However, it must be said that the Court had already hinted at this solution in *Avoir Fiscal* and also in *Halliburton* and *Royal Bank of Scotland*.

establishments of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies (par. 58).

Narrowing down exceptions

Coherence

As has already been stated above, the overriding public interest 'coherence' of the tax system was formulated in rather open-ended terms in *Bachmann*. While the reasoning of the Court focused on the tax implications of Belgian legislation over the tax burden of one concrete taxpayer throughout his life, the very phrase used by the Court ('coherence of the tax system') and the context of the case could be interpreted (and, indeed, were perceived by member states) as reflecting the realisation that the review of the European constitutionality of tax laws and of other laws could not proceed by reference to the same standards; that economic freedoms should have less bite when it was necessary to ensure the realisation of collective goods through national tax systems. For three years, the Court did not really re-consider what breaches of economic freedoms 'coherence of the tax system' could justify as an overriding public interest. In the meantime, the said ruling was much discussed and actively criticised by legal scholars.¹³¹ The coherence justification may have played a role in *Schumacker*, but the ECJ shifted the argumentative ground suggested by the parties, and decided the case on the ground that Community law required considering non-resident trans-frontier workers as residents for tax purposes. It was only in August 1995, when deciding *Wielocx*,¹³² that the ECJ started to review *Bachmann*, and, in doing so, to narrow the scope of the justification. Slowly but steadily, this 'rule of reason' justification was narrowed down by developing a three-prong test for its application: (1) there should be a direct link between the tax constitutionally suspect and a tax advantage; (2) tax charge and tax advantage should be part of the normative framework of the same tax; and (3) the taxpayer being charged and being assigned the benefit should be the same.

¹³¹ See the case notes of W.-H. Roth, (1993) 30 *Common Market Law Review*, pp. 387-95, and L. Hinnekens and E. Schelpe (1992) *EC Tax Review*, pp. 59-62.

¹³² Case C-80/94, [1995] ECR I-2508.

In *Wielockx*, the Court confronted another case in which what was at stake was the taxation of pension plans. The facts were somehow different from those in *Bachmann* for two main reasons, related to the fact that Mr Wielockx was self-employed (while Bachmann was a dependent worker). First, Dutch legislation provided the possibility that self-employed persons simultaneously constituted a pension reserve and enjoyed a tax incentive, while the assets thus earmarked remained available to the company as company assets (and thus could be used by the company as a source of funding). Second, Mr Wielockx was a national and resident in Belgium, but his company was established in the Netherlands. This entailed that, even if Mr Wielockx was not subject to personal income tax in the Netherlands after retirement, he would not be able to obtain any benefits if the Dutch company did not pay them; thus, the residual effectiveness of the power to tax by the Netherlands was, in this case, higher than that of Belgium in *Bachmann*. It is important to note that Advocate General Léger made a fairly wide interpretation of the *Bachmann* exception, which covered a national tax law correlating the double advantage of tax deductibility and the availability of the fund to the company to the taxability of the retirement benefits.¹³³ If Léger found that the Dutch tax norm was contrary to Community law, it was not because of this constitutionally justified correlation, but because the Dutch tax system did not impose such correlation across the board. The network of Double Taxation Conventions signed by the Netherlands implied that the Dutch had opted for ensuring the 'cohesion' of its tax system by means of negotiating mutual concessions with other member states.¹³⁴ However, the Court was much more laconic and less clear on the grounds of why it found the Dutch norm contrary to Community law. In its ruling, the Court seemed to hint at the requirement that the taxpayer whose economic freedom was being curtailed would be 'compensated' by a specific tax advantage, especially when it claimed that 'Fiscal cohesion has not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the

¹³³ Par. 46. He added in the following paragraph; 'Since *Bachmann* it has been clear that, in the name of the principle of the cohesion of the tax system, a member state is free to base the tax regime applying to a particular type of pension on a principle of correlation between the deductibility of the contributions (granted for social reasons or to promote the financing of undertakings) and the taxation of the pensions (necessary for budgetary reasons).'

¹³⁴ Par. 54.

taxation of pensions'.¹³⁵ However, the reasoning of the ECJ seems to have been influenced by the same train of reasons that grounded the opinion of the Advocate General. To the extent that the Netherlands had signed bilateral conventions in the context of which mutual concessions were made concerning the power to tax contributions and pensions, the Dutch government was, in *Wielockx*, in a different position than the Belgian government in *Bachmann*. The coherence of the Dutch tax system was no longer protected by a bilateral equivalence at the level of each taxpayer, but was 'shifted to another level, that of the reciprocity of the rules applicable in the Contracting States'.¹³⁶

In *Svensson and Gustaffson*,¹³⁷ which was decided three months later, the Court was of a clearer mind. In its ruling, it clearly introduced the first prong of what would become the three-pronged coherence test: the 'direct link' between the tax constitutionally suspect and another tax advantage.¹³⁸ Moreover, the Court came to affirm that such a link had to be a revenue link, and not merely a 'policy' link, something which implicitly pointed to the third prong of the 'coherence' test, namely, the identity of the taxpayer.¹³⁹ However, it may be said that this case could still be interpreted as not determining which way the concept should be constructed; it could still be thought that the

¹³⁵ Par. 24.

¹³⁶ See, also, par. 24. And then in par. 25, the Court concluded: 'Since fiscal cohesion is secured by a bilateral convention concluded with another member state, that principle may not be invoked to justify the refusal of a deduction such as that in issue.'

¹³⁷ Case C-484/93, [1995] ECR I-3955.

¹³⁸ Par. 18 of the judgment: 'in these cases, there was a direct link between the deductibility of the contributions and the tax on the sums payable by the insurers under death and old-age insurance policies, a link which had to be preserved in order to preserve the integrity of the relevant fiscal regime, *whereas there is no direct link whatsoever in this case between the grant of the interest rate subsidy to borrowers on the one hand and its financing by means of the profit tax on financial establishments on the other.*' (my italics).

¹³⁹ The Court constrained the breadth and scope of such coherence, by claiming that it was irrelevant whether the concrete history behind the granting of interest rate subsidies (limited to credits taken from nationally established banks) was associated with the existence of a taxing of the profit of financial establishments (which by definition was only applied to *national* financial establishments). Given that the wide majority of taxes in modern polities are not earmarked, the principle results in the narrowing down of the potential breadth of 'coherent' tax norms to those who 'compensated' a discriminatory or restrictive tax levy with a particular tax benefit to the one and the same taxpayer.

connection between the two policies was too far-fetched; whatever the historical context in which the decision was taken, the granting of such reduced rates was part and parcel of the definition of the economic ability to pay of all taxpayers, and there was no longer (if there ever had been) a good reason to claim that the additional expenditure effort should be paid by financial establishments themselves. The subjective turn consisting in the identity of the taxpayer was confirmed in *Asscher, ICI*,¹⁴⁰ and *Saint Gobain*,¹⁴¹. In particular, in *Asscher*, coherence was re-interpreted as requiring that the taxpayers whose economic freedoms were restricted received proper compensation. There was to be a tax tit-for-tat, in other words, for coherence to be available as a justification.¹⁴²

However, it may be said that this case could still be interpreted as not determining which way the concept should be constructed; it could still be thought that the connection between the two policies was too far-fetched; whatever the historical context in which the decision was taken, the granting of such reduced rates was part and parcel of the definition of the economic ability to pay of all taxpayers, and there was no longer (if there ever had been) a good reason to claim that the additional expenditure effort should be paid by the financial establishments themselves.¹⁴³

In *Baars*,¹⁴⁴ the Court introduced the second prong of the coherence test, namely, the requirement that both the tax disadvantage and the advantage concerned one and the same tax.¹⁴⁵ This implied that

¹⁴⁰ Par. 29 of the judgment.

¹⁴¹ Par. 70 of the judgment.

¹⁴² *Asscher*, par. 60: 'The application of a higher rate of tax does not provide any social security protection.'

¹⁴³ The rejection of the defence of cohesion in 55/98 *Vestergaard* may be taken as reflecting the distinction that the Court made between cohesion and the effectiveness of fiscal supervision. It may have opted otherwise, cohesion becoming the larger exception within which the latter would be one part. But it did not do so, and what the Court ruled implied here was an invitation for the member states to keep the two defences clearly separated (see par. 24 of the judgment).

¹⁴⁴ Case C-251/98, [2000] ECR I-2787.

¹⁴⁵ See pars 39 and 40 of the judgment: [39] 'First, there is no double taxation of profits, even in economic terms, because the tax at issue in the main proceedings is not charged on the profits distributed to shareholders in the form of dividends but on the assets of the shareholders through the value of their holdings in the capital of a company. Whether or not the company makes a profit does not in any event affect liability to wealth tax; [40] Second, in *Bachmann* and *Commission v Belgium*, cited

coherence was not to be established only at the economic level, but also at the formal level. This was confirmed in full clarity in *Skandia*, in which the Swedish and Danish argument made an explicit appeal to the fact that the tax regime, even if formally affecting different taxes and taxpayers, did concern the tax regime of old-age and insurance pensions of the very same taxpayer.¹⁴⁶

The restrictive movement came full circle in *Verkooijen*.¹⁴⁷ The participating member states in *Verkooijen* still fought their corner by reference to a wider interpretation of the coherence justification, being sensitive to the multilateral and collective dimension of tax law. By doing so, they seemed to be convinced that there was still room for the Court to re-consider its case law. But from this ruling onwards, member states began in earnest to consider which other overriding interests could be invoked to shelter national personal tax laws from a too radical review of European constitutionality.¹⁴⁸

The final coda came in *Weidert and Paulus*,¹⁴⁹ in which the Court seemed to abandon the extraordinary decision in *Bachmann* to find that openly discriminatory tax laws could be justified by reference to 'rule of reason' exceptions. In *Weidert and Paulus*, the ECJ claimed that coherence, like all exceptions to economic freedoms, should be interpreted narrowly. Indeed, it could be argued that this rendered explicit what the ECJ had been doing implicitly since *Wielockx*.

above, there was a direct link between the deductibility of pension and life assurance contributions and the taxation of the sums received under those insurance contracts, and it was necessary to preserve that link in order to safeguard the cohesion of the tax system in question. There is, however, no such link in the present case, which concerns two separate taxes levied on different taxpayers. It is therefore irrelevant, for the purposes of granting shareholders a tax allowance in respect of the wealth tax, that companies established in the Netherlands are subject to corporation tax in the Netherlands and that companies established in another member state are not.'

¹⁴⁶ See pars 31 and 33 of the judgment.

¹⁴⁷ Case C-35/98, *Verkooijen*, [2000] ECR I-4073.

¹⁴⁸ The case was also significant because the very same Advocate General (La Pergola) wrote two opinions on the case. While this double opinion-making was caused by some difficulties around the construction of national provisions, the first opinion was slightly more amicable to a wider, more collective-oriented conception of coherence of the tax system; in the second, the Advocate General argued by reference to the prong test which has been forged in the case law which we have just considered. The Court did follow the second opinion, and thus consecrated the narrowing down of the coherence of the tax system justification.

¹⁴⁹ Case C-242/03, [2004] ECR I-7379.

Coherence was thus narrowed down as it was re-interpreted. From an exception which seemed to allow member states to uphold a collective good, it was re-defined into a guarantee of consistent taxation for each and every taxpayer. This entailed two shifts: (a) from its objective definition to its subjective assessment, or what is tantamount to the same thing, from coherence as the way in which the tax system allocates burdens and benefits among taxpayers, to coherence in the way each Community citizen is treated by each national tax; and (b) from coherence defined in the context of the social functions of the tax system, to a narrow coherence explicitly limited to the equivalent treatment of each taxpayer.

The effectiveness of fiscal supervision

But the second part of the pincer movement was not limited to coherence; in reality, it extended to all possible justifications of a *prima facie* breach of Community freedoms, of all 'overriding' public interest justifications.

The 'effectiveness of fiscal supervision' was the first 'rule of reason' justification to be coined by the ECJ on tax matters.¹⁵⁰ But as coherence was narrowed by the ECJ, the same judges rejected national claims to justify personal tax laws breaching Community freedoms by reference to the need to ensure proper supervision of compliance with tax laws. First, the ECJ systematically rejected that the curtailment of economic freedoms could be automatically justified by reference to the 'effectiveness of fiscal supervision' or the fight against tax avoidance and evasion by showing that the state had experienced a revenue loss. Second, the ECJ once again rejected the argument that the monitoring of tax compliance was hampered by 'informative' deficits concerning economic transactions with other member states, and thus restricting economic freedoms *ex ante* was justified. The legal agents of member states have once again come to grief on the rocks of Directive 77/799.¹⁵¹

¹⁵⁰ Indeed, even before that personal taxation was subject to review of European constitutionality in *Avoir Fiscal*. It was in the leading judgment on *Cassis de Dijon*, precisely in the ruling in which 'rule of reason' exceptions were first referred to, that the ECJ coined the justification (see par. 8 of the ruling).

¹⁵¹ Even if the Commission itself has recognised once and again the limited effectiveness of cross-border tax administrative cooperation. See, for example, the Commission Communication (2006) 254 on a European strategy to combat tax fraud, available at <http://ec.europa.eu/taxation_customs/resources/documents/

Indeed, only in *Futura and Singer*¹⁵² has the Court accepted the effectiveness of fiscal supervision as a justification of a breach of economic freedoms *on its own*. In this case, to which I have already referred to above, the Court had to determine whether Luxembourgish provisions subjecting the right of permanent establishments of companies established in another member state to carry forward their losses on condition that they kept their accounts in conformity with the accounting standards of Luxembourg, and not granting it when they were kept according to (in the case at hand) French standards. While the rule was regarded as an obstacle to 'secondary' freedom of establishment, the Court emphasised that 'the effectiveness of fiscal supervision was an overriding requirement' that justified limiting the said economic freedom. In particular, it is worth quoting the central passage of the judgment:

The Court has repeatedly held that the effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying a restriction on the exercise of fundamental freedoms guaranteed by the Treaty (see, for example, the judgment in Case 120/78 REWE-Zentral ('Cassis de Dijon') [1979] ECR 649, par. 8). A member state may therefore apply measures which enable the amount of both the income taxable in that State and of the losses which can be carried forward there to be ascertained clearly and precisely [...] As Community law stands at present and contrary to the Commission's submission, the aims pursued by the second condition would not be attained if, in order to ascertain the constituent amounts of the basis of assessment, the Luxembourg authorities had to refer to accounts kept by the non-resident taxpayer pursuant to another member state's rules [...] As yet, no provision has been made for harmonizing domestic rules relating to determination of the basis of assessment to direct taxes. Consequently, each member state draws up its own rules governing the determination of profits, income, expenditure, deductions and exemptions as well as the amounts in respect of each of them which may be included in

taxation/vat/control_anti-fraud/combating_tax_fraud/COM(2006)254_en.pdf>; and the related initiatives at <http://ec.europa.eu/taxation_customs/taxation/tax_cooperation/reports/index_en.htm>.

¹⁵² Case C-250/95, [1997] ECR I-2471.

the calculation of taxable income or of losses which may be carried forward.¹⁵³

This narrow construction of the exception is constitutionally problematical because it assumes an understanding of the phenomenon of tax avoidance in purely bilateral terms between the state and the taxpayer. When considered from the standpoint of an individual taxpayer, the justice of a tax system may seem not to have much to do with the overall revenue being collected. And yet, it does, because, among the purposes of taxation is that of providing sufficient resources to cover the costs of running the institutions and the policies of government. Any fall in revenue has distributive consequences, whether immediate or future. Due to the multilateral and purposeful character of taxation, the amounts not collected from one taxpayer or series of taxpayers end up being collected from other taxpayers. Consequently, a narrow understanding of the justification of tax avoidance does not take seriously the multilateral and distributional character of taxes. Taking the constitutional character of Community law seriously would require the erosion of the tax base resulting from tax avoidance and fraud to be dealt with as a relevant reason *in itself* to restrict economic freedoms. Otherwise, the very nature of tax law in a democratic and social state is not being taken seriously.

Why did the Court abandon self-restraint?

Why did the Court opt for emboldening the standards of the review of the European constitutionality of national personal tax laws? It seems to me that there are four main plausible reasons for this change.

First, the 'single market' approach was confirmed and radicalised by the transformation of free movement of capital from an ancillary freedom (a 'fellow-traveller' freedom in a rather extinct jargon) into a self-standing, and perhaps foundational, economic freedom. This dramatic transformation was the result of the approval of Directive 88/351, further radicalised by the Treaty of Maastricht, which extended the free movement of capital to third countries (a move which was intended to impose the discipline of international financial markets on national fiscal policies; or what is tantamount to the same

¹⁵³ Pars 31 and 33 of the judgment.

thing, accountability back to its roots, or accountability through financial markets).¹⁵⁴

Second, the perspective of monetary integration, of several member states entering into the third and final of the phases laid down in the Treaty of Maastricht on monetary union created a momentum of its own. In particular, the establishment of a common currency among a core set of member states would not only eliminate one major source of distortions in cross-border economic activity (by not only rendering explicit the cost differences, but also eliminating the uncertainty and the 'noise' generated by exchange rate fluctuations, which had been used several times since the 1970s not only to rectify the competitive position of national economies), but also to increase the relevance of the remaining ones, and, in particular, of the potential use of the personal tax system as a protectionist device.

Thirdly, the general case law of the European Court of Justice on the breadth and scope of economic freedoms surely played its role. It was, indeed, in the early 1990s that the Court extended to other economic freedoms the character of the restriction to free movement of goods developed in *Dassonville* and *Cassis de Dijon*, namely, the 'obstacle' approach. Given the considerable weight that systemacity plays in constitutional reasoning, it was just a matter of time before the approach would be considered by plaintiffs and discussed by the Advocates General and the Court.¹⁵⁵ Special importance should be assigned in this regard to the trio *Centros*, *Überseering* and *Inspire Art*, which not only gave 'carte blanche' to law-shopping within the single market, but also naturalised tax avoidance as a legitimate practice, indeed, as a 'natural' implication of the existence of a single market without harmonisation of personal taxation, as was considered above. While *Centros*, *Überseering* and *Inspire Art* were formally about the discrimination of a corporation formally established in another member state willing to perform its economic activities and uphold its subsequent legal rights in another member state, substantially speaking, concerned the power of the member states to prevent companies from fully divorcing their formal nationality as a result of legal establishment from their substantive nationality deriving from

¹⁵⁴ See, on this, the chapter by F. Losada in this report, and, in particular, R. Abdelal, *Capital Rules: The Construction of Global Finance*, Cambridge, Harvard University Press, 2007.

¹⁵⁵ See cases referred to *supra*, note 98.

the seat of management and the centre of economic activities. The Court seems to have assumed that the (impartial) harmonisation of company law in the European Union created the conditions under which it would be less than dramatic to allow companies freely to choose the national law according to which they would be constituted, to the point that it was deemed as part of the right to freedom of establishment to set up shop under whatever national law, even if the only and expressed purpose was to conduct business exclusively in another member state, and the choice of the member state of establishment was motivated by the preference for its regulatory framework (and for paying *less* taxes, even if by means of avoiding them).

Fourthly, it could be argued that the decision of the Commission to abandon its plans for the harmonisation of personal income taxation in a coherent fashion, replaced by a 'punctual' and 'residual' harmonisation programme, promoted by Commissioner Monti in the mid-1990s,¹⁵⁶ sent a signal to the ECJ confirming the soundness of its more aggressive review of European constitutionality. Indeed, if the legislator was not only 'late', as the Court assumed in the early 1980s, but renounced the task of co-ordinating national personal tax systems in comprehensive terms, while it announced a bolder approach to infringement proceedings of national personal tax laws, the Court was being invited, between the lines, to develop a more thorough case-law which could substitute the non-existing legislative framework.

Interim conclusions

The pincer movement of the Court resulted in a major reduction of the structural power of member states on tax matters. The Court expanded the breadth and scope of the bite of economic freedoms by means of opting for a 'formal' reading of when discrimination occurs, which implies a substantive shift from a discrimination approach to an obstacle approach. It narrowed down the 'rule of reason' justifications, and, in doing so, transformed them in ways which were

¹⁵⁶ See, for example, P. Cattoir, 'A History of the Tax Package. The Principles and Issues underlying the Community Approach', Taxation Papers of the European Commission, No 10, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_10_history_en.pdf.

insensitive to the multilateral and collective dimensions of personal tax law.

This turn in the case law of the Court can be assessed from different standpoints, but what is relevant for our present purposes is that it clearly implies opting for a *federalising strategy* of the European Union resonant of the 'liberist' variant. From a democratic perspective, it implied a clear shift from an underlying conception fitting with the 'transmission belt' conception of the legitimacy of the European Union in this area towards a 'liberist' conception, in which legitimacy derives from the enabling democratic effects of the establishment of the right constitutional principles. This was well in line with the overall narrowing down of the project of the single market. While it started as a rather ecumenical project (which could be endorsed from several different standpoints), the way in which it has unfolded has confirmed its ultimate liberist bent. Indeed, no other conception could be rendered compatible with the combination of a wide definition of the discriminatory infringement of a Community freedom and the restrictive interpretation of the 'cohesion' defence.

Whether it realised the consequences of what it was doing, the fact is that the ECJ sent an extremely powerful message to tax lawyers; as a result, Luxembourg was deluged with cases questioning the compatibility of national tax laws with Community law. However, the more cases were solved by the Court, the more the tensions within the underlying conception which inspired the radical shift in the review of European constitutionality of personal tax norms was rendered clear. First, the subjection of national personal tax laws to the demanding standards of the review of European constitutionality revealed the tension between the constitutional form which the ECJ followed and the substantive peculiarity of defining the yardstick of constitutionality by exclusive reference to economic freedoms. Indeed, because tax laws are deeply 'materialised', because they are means of choice for the realisation of the whole spectrum of constitutional values, the more their European constitutionality is scrutinised, the more the tension between the wide definition of constitutional principles in national constitutions and the narrow one in European constitutional law became clear. Second, the detached and abstract approach of the Court when dealing with what, substantially speaking, are vital issues about the scope of the insurance community, of the duties and rights associated to

solidaristic obligations, reveals the perils of the judicialisation of what are generally taken to be political questions. In particular, subjecting national personal tax laws to a strict review of European constitutionality comes very close to the disempowerment of democratic political process from establishing the collective goods and interests which require the trumping of subjective rights and interests. It undermines the necessarily implicit claim in the nationalising, 'social-democrat' federalising and cosmopolitan strategies, which call for political steering (at different levels, and through different procedures) of the relationship between general policy and tax design, and between the different components of the tax system, so as to make the latter capable of discharging complex collective goals. The very internal tensions and limits of the case law of the Court forced the ECJ to reconsider its jurisprudence. This is the main theme of the following section.

Reigning in the review of European constitutionality

The wide breadth of economic freedoms as yardsticks of the European constitutionality of personal tax laws, combined with the narrow construction of possible exceptions to the said freedoms when breached by national tax laws led both to a formidable increase in the number of preliminary requests received by the Court, and to a number of cases in which national Exchequers simply lost. Indeed, between 2000 and 2005, persuading national judges to go to Luxembourg might have been considered as the best possible strategy to win their cases, as many plaintiffs entangled in litigation with exchequers throughout Europe learned was the case.

This pattern made the structural limits of an 'aggressive' constitutional review of national tax laws all too clear. In general terms, the strict review of European constitutionality upon the basis of an 'economic due process' constructed by reference to a transcendental understanding of economic freedoms (in the sense of their being emancipated from their substantive definition in national constitutional law, see above) revealed the fundamental tension between the claim to constitutional dignity and the supremacy of Community law and the narrow definition of its substantive contents. While national constitutions are the repositories of a wide range of constitutional principles, critically including in the text or in the constitutional practice socio-economic freedoms closely associated with the realisation of social justice through welfare institutions, the

'economic due process' of the European Treaties is limited to the four economic freedoms. As stated above, review of tax laws was especially revealing of this tension because tax norms are the means of choice for the realisation of the whole panoply of constitutional values. In the modern *Sozial Rechtsstaat*, taxes are not only the means of collecting revenue to ensure the survival of the state (the 'sinews of war' of the *Ancien Régime*), but also key instruments to ensure distributive justice and to macro- and micro-manage the economy. This tension can easily be translated into the language of constitutional conflicts. From this to concluding that European integration threatens to undermine the constitution as a whole in the name of a narrow, liberist understanding of freedom, there is not much distance.

In institutional terms, the systematic quashing of national tax laws is very problematical in a situation in which neither the European, nor the national political processes are properly equipped to re-adjust the tax system in such ways as to continue to realise its manifold objectives in a way that is less harmful to one or the other of the economic freedoms. The flow of cases from the Court ran the serious risk of, indeed, unleashing the dynamics of the adaptation of national tax systems under the shadow of the (Court reinforced) economic pressure exerted by transnational economic actors. This leads to results that are both unjust *and* sub-optimal.

Alternative paradigms and marginal changes in the review of European constitutionality

The views of the Advocates General

As the radical turn of the case law of the Court resulted in a flood of preliminary requests, and the economic consequences of some of the judgments came to the fore, political and academic criticism flourished. These political and social signals amplified the internal debate within the Court. As judgments are produced in a single voice and we are not aware of the dividing lines in the chambers or in the grand chamber of the ECJ, we cannot know for certain how solid the majority behind the radical transformation of the review of European constitutionality of national personal tax norms was. What we do know is that some Advocates General, sooner rather than later, advised the Court to re-consider its decisions. It seems to me that three of them played a major intellectual and executive role in the process through which the Court altered its course. They were of the

same mind, spotting major problems with the case law, but of different minds concerning how the ECJ should proceed. On the one hand, AG Geelhoed focused on the too wide breadth of economic freedoms as yardsticks of European constitutionality, and supported a more restricted approach, whereby the review would focus exclusively on covert or indirect discrimination, and not on the far wider and far more problematical reviewing of obstacles. On the other hand, AG Kokott and AG Maduro seemed to defend coupling the wide definition of the yardstick of European constitutionality with a wide definition of the overriding public interests that would justify a *prima facie* infringement of Community law. While Kokott seemed to favour taking seriously the multilateral and collateral character of tax law through a re-widening of the justification of 'coherence of the tax system', Maduro favoured turning it into an umbrella justification, to be filled in with overriding interests that would recognise the national sovereignty on personal taxes and would 'rein in' the abuse of economic freedoms. Each of these conceptions assumes a different understanding not only of the process of European integration, but also of the democratic legitimacy of the European Union, and, in particular, of the influence this had on the proper path to be followed in the Europeanisation of personal taxes. AG Geelhoed came close to pushing the case law of the ECJ back to its second stage; AG Kokott could be regarded as favouring a strategy close to a federalisation of the Union in a social-democratic fashion; while AG Maduro offered the logical solution to the reconciliation of the neo-liberal federal vision underpinning the jurisprudence of the ECJ with its structural limits.

Changing the paradigm

Restricting economic freedoms as the yardstick of the European constitutionality of personal tax laws (AG Geelhoed)

Starting in *Test Claimants in Class IV of the ACT Group Litigation*¹⁵⁷ and leading to his Opinion in *Kerckhaert and Morres*,¹⁵⁸ AG Geelhoed supported narrowing down the breadth and scope of economic freedoms by limiting the review of European constitutionality to cases in which there was discrimination upon the basis of country of establishment. Thus, he essentially tried thus to 'push back' the case law of the Court to its second stage.

¹⁵⁷ C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, [2006] ECR I-11673.

¹⁵⁸ C-513/04, *Kerckhaert and Morres*, [2006] ECR I-10967.

AG Geelhoed started by taking note of the growing and 'complex' case law developed by the ECJ. But, while the reasoning of the judges had tended to revolve around the subjective rights of economic agents as bearers of the four economic freedoms, the Dutch jurist stressed the multilateral and collective nature of tax law:

[Corporate income taxation] is [...] an area where predictability and legal certainty are crucially important, so that member states can plan their budget and design their corporate tax systems on the basis of relatively reliable revenue predictions.¹⁵⁹

AG Geelhoed went beyond the rhetorical acknowledgment to the fact that not very much had been achieved on what concerned the co-ordination of national personal tax systems:

The starting point in analysing the scope of Art. 43 EC here is to recall that direct taxation is in principle an area of member state competence. As is well known, harmonisation within the sphere is possible only by means of legislation on the basis of Art. 94 EC, requiring unanimity of voting in the Council for legislation to be passed, and to date little Community legislation exists in the field.¹⁶⁰

The combination of these two factors (the division of competences on personal tax matters, where most law-making powers are in the hands of member states, the decision-making set-up at European level, which subjects the co-ordination of national personal tax systems to unanimity-voting, and thus renders it extremely difficult to approve new personal tax norms; and the multilateral and collective nature of tax law, which makes predictability in revenue a collective good essential to the proper functioning of the social and democratic state) all require re-thinking with regard to what should be regarded as constituting a restriction to an economic freedom. Thus, Geelhoed supported a re-definition of restrictions to economic freedoms which would exclude what, in the jargon of the Court, are known as obstacles. Pending the thorough Europeanisation of national personal tax norms, the only relevant restrictions on

¹⁵⁹ Par. 3 of the Opinion of the Advocate General in C-374/04 *Test Claimants of the Act Group Litigation*.

¹⁶⁰ *Ibid.*, Par. 32.

economic freedoms by national personal tax laws would be direct and indirect discriminations upon the basis of nationality.

Upon rigorous analysis, it is my view that, in the direct taxation sphere, there is no practical difference between these two manners of formulation, *i.e.*, 'restriction' and 'discrimination'. What is essential, however, is to distinguish between two senses of the term 'restriction' when dealing with direct taxation rules.¹⁶¹

This implied accepting *tout court* that the internal market had to co-exist with different tax regimes applicable to internal and cross-border economic activities as long as there was no co-ordination (if not harmonisation) of personal tax law.

Certain disadvantages for companies active in cross-border situations result directly and inevitably from this juxtaposition of systems, and in particular from: (1) the existence of cumulative administrative compliance burdens for companies active cross-border; (2) the existence of disparities between national tax systems; and (3) the necessity to divide tax jurisdiction, meaning dislocation of tax base. I discuss these in more detail below. It is true that, in a general sense, these consequences may 'restrict' cross-border activity. However, use of the term 'restriction' – although employed in the Court's case-law – is in this context misleading. In reality, at issue here are distortions of economic activity resulting from the fact that different legal systems must exist side-by-side. In certain cases, these distortions provide disadvantages for economic actors; in other cases, advantages. While in the first case they are 'restrictive', in the second case they stimulate cross-border establishment activity. Although the Court is as a rule faced with what can be termed the 'quasi-restrictions' flowing from these distortions, one should not forget that there is a second side to the coin – that is, where particular advantages arise for cross-border establishment. In the latter case, the taxable subject concerned does not generally invoke Community law

¹⁶¹ *Ibid.*, par. 36; similarly, conclusions of AG Geelhoed in C-513/04, *Kerckhaert and Morres*, par. 18: 'This means in particular that, in order to fall under the free movement provisions of the Treaty, disadvantageous tax treatment should follow from direct or covert discrimination resulting from the rules of one jurisdiction, and not purely from disparities or the division of tax jurisdiction between two or more member states' tax systems, or from the co-existence of national tax administrations.'

(...) In the absence of an EU-wide tax solution, therefore, such quasi-restrictions should be held to fall outside the scope of Art. 43 EC.¹⁶²

Geelhoed supported this claim on the structural limits of the 'radical' review of European constitutionality of personal tax laws. Legislative co-ordination could tackle obstacles:

The causes and character of these quasi-restrictions mean that they may only be eliminated through the intervention of the Community legislator, by putting in place a cohesive solution on an EU-wide scale, that is, an EU-wide tax system.¹⁶³

If the breadth and scope of economic freedoms as the yardsticks of the European constitutionality of personal tax norms was to be defined in terms so wide as to encompass obstacles to the economic freedoms, and not just discriminations upon the basis of nationality, the Court of Justice would be forced to do things it could not do on account of both institutional limits of what a court can do on tax matters (given its focus on single case decisions, which, in aggregate terms, may be unsustainable) and of the normative limits of judicial decision-making:

I would add that judicial intervention is, by its nature, casuistic and fragmented. As a result, the Court should be cautious in giving an answer to questions arising before it raising issues of a systematic nature. The legislator is better placed to deal with such questions, in particular when they raise issues of inherent fiscal-economic policy considerations.¹⁶⁴

Geelhoed seems to have had in mind the implications of the radical review line followed by the ECJ. First, the Court of Justice was being pushed into reviewing the constitutionality of the tax regimes of cross-border economic activities. Such a regime was governed by a congeries of national laws and bilateral conventions, which had not been 'Europeanised', and thus were not governed by Community

¹⁶² Opinion of AG in *Test Claimants*, pars 37, 38 and 39.

¹⁶³ *Ibid.*, par. 39; Conclusion in *Kerckhaert and Morres*, par. 38: 'the causes and character of these quasi-restrictions mean that they may only be eliminated through the intervention of the Community legislator, in the absence of which intervention they should be held to fall outside the scope of the Treaty free movement provisions.'

¹⁶⁴ Par. 39 of *Test Claimants*.

law.¹⁶⁵ However, the formalistic reading of the cross-border situations to which I have already referred above implied that the Court reviewed the validity of one single set of national tax laws, but, given that the complex legal regime of cross-border economic activities was shaped by two or more legal systems, it ended up reviewing the validity of national tax law by reference to the consequences of two or more national tax laws. This was not only deeply problematical, but also introduced an element of randomness in the constitutionality of national tax norms, as the latter depended on the particular circumstances of the case, and of the national laws with which they overlapped in the case being considered by the Court. Second, the only way in which the Court could reduce randomness was to establish positive norms of tax competence between member states, determining who should tax what, and thus undertaking to do on its own what the member states had failed to do in the application of the old Art. 220, now Art. 293 of the EEC Treaty. But if personal taxation had not been co-ordinated at European level, why should one member state be responsible for obstacles resulting from the very lack of co-ordination? Furthermore, would this not imply that, even if there was no political agreement on the co-ordination of tax systems, member states would be held responsible *as if* the said co-ordination had taken place, upon the basis not of bilateral conventions, but upon the criteria desired by the Court?

In operational terms, this implied that the review of the European constitutionality of personal tax norms was only pertinent when they blocked access in and out of each national market to economic agents, goods, services or capital from other member states, not when they created obstacles to a single market on a European scale. The key question was not the overall treatment of cross-border economic activities on a European scale, but how they were treated in each member state in comparison to purely internal activities. There was no independent, transcendental standard of review, but merely the

¹⁶⁵ While, in the first characterisation of the European review of constitutionality, the Court focus on situations in which restrictions could coherently be blamed on the law of one member state, most cross-border regimes resulted from the overlap of national tax systems. Leaving aside a limited number of secondary norms, such an overlap had not been Europeanised, but was governed either by unilateral tax norms, or by a network of bilateral agreements, most of which were inspired by the OECD Model Convention, but all of which were different.

requirement that the way in which national activities were treated was extended to cross-border activities.

AG Geelhoed has been very influential in shaping a major 'revisionist' line of jurisprudence of the Court. Indeed, starting in *Kerckhaert and Morres* and following in *Test Claimants Act* and *Amurta*, the ECJ seems to have re-calibrated its standard of review in a double sense, as we will see in more detail *infra*. First, it seems ready to distinguish between 'Community situations' in which the tax treatment is the result of applying (1) one national tax law (such as the situation of 'transnational' citizens), in which it is still ready to rely on a wide characterisation of economic freedoms; and (2) two or more national tax laws, in which obstacles are considered by reference to each of the national tax systems *separately*, and, as logically follows from that, by reference to a limited definition of restrictions of economic freedoms, which excludes obstacles. Second, it seems to have endorsed the premise that not all types of laws (not even all types of tax laws) are equal when it comes to review their European constitutionality. The peculiar features of personal tax laws require a less radical, more restrained review of their European constitutionality, a premise implicit in denying the extension of the 'obstacle' standard of restriction to personal tax law. At the same time, as we will see, the arguments which underpin Geelhoed's argument recommend a further re-calibration, the proper re-consideration of the formalistic way in which the Court considers whether there is discrimination on cross-border situations, and which legal order is to bear the blame for the said discrimination. Indeed, this tension is at the heart of the approach followed by AG Kokott and AG Maduro, even though they have focused on the second prong of the review of European constitutionality, namely, the overriding public interests that can justify restricting economic freedoms.

Changes at the margins

Extending the breadth and scope of justificatory overriding public interests (AG Kokott and AG Maduro)

AG Kokott and AG Maduro have embraced a different approach to the re-calibration of the review of the European constitutionality of personal tax laws, focusing not on the scope of economic freedoms, but on the breadth of the justifications which the member states can invoke to justify their tax norms. However, the solutions offered by

each of them reflect different understandings of the single market and of the sources of legitimacy of the European Union. On the one hand, AG Kokott has suggested a less restrictive interpretation of the concept of 'coherence of the tax system', which could potentially reconcile European constitutional law with the economics of cross-border taxation and with the collective and multilateral character of personal taxation. On the other hand, AG Maduro has simultaneously sustained an extremely wide understanding of the latitude of economic freedoms and the enlargement of the concept of 'coherence' of the tax system, giving proper recognition to the remaining sovereignty of member states on tax matters, especially when dealing with grossly abusive practices.

The opinions of AG Kokott on personal taxation have defended the rehabilitation of coherence as a functional justification of national personal tax laws which are *prima facie* in breach of economic freedoms. The theoretical basis of her position is to be found in *Manninen*,¹⁶⁶ where AG Kokott called into question the case law on 'coherence of the tax system', which she started by (correctly) characterising as 'diffuse' (a cunning move and a polite way of pointing to the rather contradictory impulses which the Court had followed in its case law). In particular, she questioned whether the three 'prongs' of the *Verkooijen* test should be met in each and every case, or whether it was possible to consider the 'identity' requirements (same tax, same taxpayer) as 'strong' indicators, and not as 'necessary conditions' to be met by national tax norms to be justified as necessary to ensure the cohesion of the national tax system.¹⁶⁷ Instead of formal identity, she suggested that what really mattered was 'economic' identity. Thus, the key question was not so much that the taxpayer was the same, as that the tax was levied on the same income, or in the same economic process. Similarly, she claimed that the identity of the taxpayer was not absolute necessary, provided that the legal configuration of the tax system would ensure that the advantage accrued to one taxpayer only if the disadvantage to the other is real and to the same amount.¹⁶⁸ In addition, the

¹⁶⁶ Opinion of AG Kokott in C-319/02, *Manninen*, [2004] ECR I-7477.

¹⁶⁷ *Ibid.*, par. 55

¹⁶⁸ *Ibid.*, par. 61. Kokott seems to suggest, between the lines, that this would be only a proper, but modest, 're-centring' of the case law of the Court, given that the central cases (*Svensson* and *Verkooijen*, beginning and end of the 'second' coherence saga)

Advocate General seemed to suggest that coherence should be assessed from a perspective of the collective or public good, and not necessarily from that of individual or subjective rights. This implies gravitating to the complex understanding of tax law embedded in national constitutional law, and abandoning the simplistic view that was implied in the 'radical' jurisprudence of the Court. Although the Court has not directly registered this, following the lead of Kokott's opinion on *Manninen*, Advocate General Mengozzi has, indeed, re-constructed the evolution in the jurisprudence of the Court as an endorsement of her views.¹⁶⁹

The new approach defended by Advocate General Poiares is contained in a rather fully-fledged form in his opinion on *Marks and Spencer*.¹⁷⁰ While, formally speaking, the AG builds on Kokott's views in *Manninen*, concurrence is, in substance, limited to the view that coherence has been defined in too narrow a fashion by the ECJ, and that it should be widened. Indeed, Poiares embraces an understanding of why coherence is too narrowly defined in a very different manner from Kokott. His two ultimate purposes are to give proper acknowledgement to the tax sovereignty of member states (in what is formally presented as a fully neutral manner concerning the choices made in their tax systems) and to create the conditions under which the economic freedoms could be abused. Thus, a wider conception of coherence should be hospitable to concerns over national tax sovereignty¹⁷¹ and the abuse of Community freedoms.

The re-calibration of coherence should aim at the reconciliation of a robust single market, in which all restrictions to economic freedoms (including mere obstacles) are removed,¹⁷² and a proper

would have been decided equally in factual terms under Kokott's re-shaped coherence.

¹⁶⁹ Conclusions of AG Mengozzi in Case C-298/05, *Columbus*, [2007] ECR I-10451, par. 189.

¹⁷⁰ C-446/03, *Marks & Spencer*, [2005] ECR I-10837.

¹⁷¹ Par. 36 of the Conclusions of the AG in *Marks & Spencer*: 'Thus, in the present case regard must be had to the particular respect which is due to the tax competences of the member states. However, it seems to me that in that regard the Court's case-law already provides adequate means of appraisal: on the one hand, sound restrictive criteria and, on the other, a concept of justification founded on the cohesion of the tax regimes of the member states.'

¹⁷² This is based upon a very wide definition of restriction of economic freedoms. Thus, the ECJ 'has the task of ensuring that transnational situations associated with

acknowledgement of the competences of the member states on personal tax matters.¹⁷³ This results in a new concept of cohesion, which, upon the basis of the terminology used by the AG, it would, perhaps, be apt to define as purposive ‘coherence’, or as coherence as integrity.

Before considering what Maduro means by purposive coherence, it is necessary to stress that reconciliation between the single market and national tax powers does not mean equal standing. Indeed, reconciliation is geared to ensure the primacy of economic freedoms within European constitutional law. Consider the following passages:

The function performed by fiscal cohesion is the protection of the *integrity* of the national tax systems provided that it does not impede the integration of those systems within the context of the internal market.¹⁷⁴

[member states] must endeavour to ensure that the choices made in tax matters take due account of the consequences which may flow there from for the proper functioning of the internal market.¹⁷⁵

[T]he national tax rules must be neutral in regard to the exercise of the freedoms of movement.¹⁷⁶

the exercise of the freedoms of movement between the member states are not disadvantaged owing to the choices made by the national legislature’ (ibid., par. 24). And very explicitly: ‘I consider that the principle of non-discrimination on the ground of nationality is not sufficient to safeguard all the objectives comprised in the establishment of an internal market. The latter seeks to secure for the citizens of the Union all the benefits inherent in the exercise of the freedoms of movement. It thus constitutes the trans-national dimension of European citizenship.’ How this can be reconciled with the endorsement of the premise set in *Kerckhaert* that ‘differences in treatment resulting from legislative disparities as between the member states do not constitute discrimination prohibited by the Treaty’, (ibid., par. 23) is not explained. But denying that legislative disparities can be regarded as restrictions to economic freedoms relies on a definition of restrictions which excludes obstacles, as claimed by AG Geelhoed.

¹⁷³ In the opinion, AG Maduro refers to the national autonomy to shape the tax system in general; however, given the premises on which the opinion is built, such autonomy must be understood as being reflective of the remaining competence over personal taxes.

¹⁷⁴ Ibid., par. 66.

¹⁷⁵ Ibid., par. 24.

¹⁷⁶ Ibid., par. 67.

In other words, by widening coherence and given further protection to tax sovereignty, Maduro also aims at re-affirming a constitutional framework in which economic freedoms come first.

Going back to purposive integrity, Maduro affirms that the widening of coherence required by giving proper weight to the tax sovereignty of member states has to be grounded on the purpose of national legislation: ‘Cohesion must first and foremost be adjudged in light of *the aim and logic of the tax regime at issue*’.¹⁷⁷

And, here, the argument becomes slightly circular, because the aims and logic that suit coherence as a justification of *prima facie* breaches of economic freedoms is something to be determined by reference to the very idea of integration, or, to be more precise, of ‘genuine’ integration. In the very words of the Advocate General:

The delicate nature of this equilibrium [an alleged double neutrality, of national tax laws in respect of the single market, and of the single market in respect of the coherence of national tax systems] may be conveyed by the idea of a twofold neutrality. The right of establishment cannot be used by traders with the sole purpose of endangering the equilibrium and the cohesion of national tax systems. That would be the case if use were made thereof either abusively to evade national laws or artificially to exploit differences between those laws. [...] The concept of fiscal cohesion seeks to ensure that Community nationals do not use Community provisions to secure advantages from them which are unconnected with the exercise of the freedoms of movement.¹⁷⁸

Although it is not directly relevant right now, but, on account of the fact that it will be very relevant later, I may add that this circularity is the inevitable result of insisting on a completely technical definition of what a restriction of economic freedoms is. It is only because Maduro (in following the well-established jurisprudence of the ECJ, and contrary to the underpinning rationale of Geelhoed’s move) defends so wide a definition of the breadth of economic freedoms that it makes sense to consider that an action aimed at ‘endangering the equilibrium’ of national tax systems (for example, through

¹⁷⁷ Ibid., par. 71.

¹⁷⁸ Ibid., par. 67.

outright tax avoidance, as the firm Marks and Spencer did in the homonymous case) can be meaningfully presented under the cloak of the exercise of an economic freedom.¹⁷⁹

Under such a framework, Maduro has argued for enlarging coherence from the very narrow category defined in *Verkooijen*, to a larger one, which would at least encompass exceptions by paying homage to residual national sovereignty on tax matters (as will be considered in more detail below) and to anti-abusive national legislation (the latter being defined by reference, however, to the extremely narrow standard of ‘wholly artificial economic arrangements’, as we will see below).

Leaving aside the logical aspects of the argument, Maduro’s approach has contributed to transform the incipient idea of abuse of Community rights into an additional overriding justification (which the Court has subscribed and applied, even if it has disregarded the suggestion of the Advocate General that it should be considered as another dimension of the more general concept of coherence of the tax system).

Reconsidering the breadth and scope of Community freedoms

The breadth and scope of the Community freedoms has fluctuated in this last period of the case law of the Court. It has done so in apparently conflicting or, at least, inconsistent ways. On the one hand, the Court has pushed even further the breadth and scope of the economic freedoms in some respects. In this regard, it has, in several cases, confirmed the lead planted in *Baxter*, concerning the unconstitutionality of restrictive national personal taxes irrespective of the fact that the tax in question was the mere economic means of

¹⁷⁹ The ultimate nonsense of this characterisation is easy to prove by reference to an equivalent in the domain of constitutional freedoms. Imagine that, equipped with a pistol, I enter a bank and say to the cashier ‘Give me the money!’. If a police agent happen to enter the branch at this point and disarm me, would it make sense to characterise the action of our policeman as a *prima facie* infringement of my right to freedom of action and freedom of speech, nonetheless justifiable to avoid an abuse in the exercise of my fundamental rights? Indeed, the wide interpretation of economic freedoms has not much to do with logic, but with the very process of the expansion of the breadth and scope of Community law as a yardstick of validity of national laws, and with the emancipation of concepts in Community law from national definitions.

realising a policy goal in a policy area in which legislative competence remains firmly in the hands of member states (and irrespective of the fact that the same economic result may easily be obtained through measures of public expenditure which will not transgress Community law). On the other hand, it has affirmed that obstacles resulting from the parallel exercise of taxing powers (in the absence of a co-ordinated European legal regime) cannot be blamed on any member state. In addition, the ECJ has been faced with arguments pushing for a deep constitutionalisation of EU, flirting with its characterisation as the guardian of the collective supranational interest, but has not endorsed them (thus, declining the lead offered by AG Mengozzi in *Derouin*). In general, the *bottom line* approach of the ECJ is one according to which economic freedoms are constructed in wide terms as the yardstick of the European constitutionality of national personal tax norms.

Non-revenue purposes of tax law

As already indicated, personal tax law is a means of choice to realise the whole series of constitutional aims and principles proper and characteristic of the social and democratic state which all the member states of the Union claim to be. This is why the personal tax code is populated by many specific norms which do not measure the ability of the taxpayer to pay, but which are a means of realising macro or micro-economic policies. In their regard, tax norms are one among several possible means of realising the said goals. The policy core of the said norms is thus different from the collection of revenue or the realisation of distributive justice.

The ECJ had already touched upon the question back in 1999. In *Baxter*,¹⁸⁰ the plaintiff claimed that the simultaneous imposition of a special levy on all companies exploiting medicinal proprietary products in France *and* the granting of a deduction on account of scientific and technical research on medicinal products was in breach of the freedom of establishment to the extent that the deduction was conditional to the research being conducted in France. However, the French exchequer fought the case by exclusive reference to the effectiveness of fiscal supervision (under the odd claim, in this specific context, that tax authorities could only properly check that the money was actually invested if it was invested at home; however,

¹⁸⁰ C-254/97, [1999] ECR I-4811.

this type of research is, indeed, one of the areas in which an objective control is, indeed, easier). It was in *Laboratoires Fournier*¹⁸¹ that the French government coupled the argument on the effectiveness of fiscal supervision with that of the promotion of research. The Court disregarded this second argument, and, in fact, claimed that it was outweighed by the European public interest of fostering research and technological development on a European scale.¹⁸²

In *Schwarz*,¹⁸³ the Court disregarded the claim of the German authorities that the tax deduction of school fees was purely a means of realising its educational policy.¹⁸⁴ In *Geurts Vogten*,¹⁸⁵ what was at stake was the regional (Flemish) goal of protecting jobs in small companies by means of exempting successors from the inheritance tax on the capital invested in any small company which employed more than five workers in Flanders. The Court claimed that companies employing in Flanders or somewhere else in the Community were in a comparable situation, apparently because, if national and regional authorities were concerned about employment, they should be concerned about employment anywhere in the Community.¹⁸⁶ In *Jundt*,¹⁸⁷ German authorities claimed that the classification as 'expense allowances' of small amounts of income paid for teaching (which economically implied its being tax-free income) was not so much a tax measure aimed at calculating the ability of the taxpayer to pay, as a means of fostering education and research in Germany. The Court not only characterised the measure as a tax one,¹⁸⁸ and claimed that it was restrictive of (at least) the freedom to provide services, but also sustained that it was to be quashed also on the account of the fact that it hampered the

¹⁸¹ C-439/04, [2005] ECR I-2057.

¹⁸² Par. 23 of the judgment

¹⁸³ Case C-76/05, *Schwarz and Gootjes – Schwarz*, [2007] ECR I-6849.

¹⁸⁴ The doubts of the Advocate General on whether education was to be included within the scope of the freedom to provide services, as the ECJ seemed to open to do in C-372/04 *Watts*, concerning health care, were unconsidered by the Court in its judgment.

¹⁸⁵ Case C-464/05, *Geurts and Vogten*, [2007] ECR I-9325.

¹⁸⁶ Par. 27: 'In the present case, in relation to the objective of preventing inheritance from jeopardizing the continuation of family undertakings, and therefore the jobs they bring with them, undertakings having their seat in another member state are in a situation comparable to that of undertakings established in the first member state'.

¹⁸⁷ Case C-281/06, *Jundt*, [2007] ECR I-12231.

¹⁸⁸ Par. 83 of the judgment.

supranational objective of fostering intra-European mobility among scholars and researchers.¹⁸⁹ In *Commission v Germany*,¹⁹⁰ the Court not only rejected the German claim that the measure was part of national housing policy, but made the (problematical) claim that, if Germany changed its law and maintained the housing incentive for those buying houses in other member states, it would be easier to meet the policy objective of ensuring affordable housing to every tax citizen.¹⁹¹

In *Jäger*, the national norm being reviewed was the German inheritance tax, which promoted continuity in agricultural and forestry activities by means of a special tax regime (which included a large tax exemption, a reduction in the value on which the property is to be taxed, which reduced the tax base to 10 per cent of its 'market' value) which avoids the risk of agricultural activities being abandoned because of a lack of cash with which to pay the standard inheritance tax. The Court concluded that promoting agriculture and forestry in Germany is not a good reason to infringe upon the free movement of capital, by not treating taxpayers with similar holdings in other member states equally.¹⁹² In *Commission v Spain*, preferential tax treatment granted to research and development investment mainly undertaken in Spain was not only found to be in breach of both the freedom of establishment *and* the provision of services,¹⁹³ but was also contrary to the EU goal of fostering Euro-wide research.¹⁹⁴

Excluding the obstacles which result from the parallel and non-discriminatory exercise of the power to tax by two or more member states

Following the lead of the opinions of AG Geelhoed in *Test Claimants in ACT IV Group Litigation* and in *Kerckhaert and Morres*, to which I have already referred to above, the ECJ has come to distinguish between two types of restrictions to economic freedoms in the context of cross-border economic transactions. In particular, the Court has drawn the line between discriminatory restrictions, the consequences of which can be traced back to the legislation of an individual

¹⁸⁹ Ibid., par 59 and 60.

¹⁹⁰ C-152/05, *Commission v Germany* [2008] ECR I-39.

¹⁹¹ Par. 28 of the judgment.

¹⁹² Ibid., pars 51 and 52.

¹⁹³ Ibid., pars 22 and 23.

¹⁹⁴ See par. 33 of the judgment. The 'seriousness' of foreign research centres could be determined by recognising the standards applied by all other member states.

member state (triggering the declaration of the national discriminatory norm as unconstitutional unless justified by overriding public interests and proportional to its policy objectives) and mere obstacles resulting from the parallel exercise of the power to tax in the absence of the co-ordination of national tax systems at the European level, in which no relevant infringement of economic freedoms can be established:

In circumstances such as those of the present case, the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue in the main proceedings result from the exercise in parallel by two member states of their fiscal sovereignty [...] Community law, in its current state and in a situation such as that in the main proceedings, does not lay down any general criteria for the attribution of areas of competence between the member states in relation to the elimination of double taxation within the Community. Apart from Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states (OJ 1990 L 225, p. 6), the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (OJ 1990 L 225, p. 10) and Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments (OJ 2003 L 157, p. 38), no uniform or harmonisation measure designed to eliminate double taxation has as yet been adopted at Community law level.¹⁹⁵

However, it must be said that the ECJ has carved out one specific exception, by means of affirming, as reviewable obstacles, the lack of assessment (and the compensation) of losses due to currency depreciation, despite the fact that the obstacles result, strictly speaking, from the parallel exercise of national tax competences. However, the fact that the loss is only visible in one member state (the issuer of the depreciated currency) makes it apparently easy and uncontroversial to affirm that the obstacle should be removed by the state in which the loss is visible. In *Deutsche Shell*, a German company placed start up capital in a permanent establishment in Italy. The

¹⁹⁵ Pars 20 and 22 of C-513/04 *Kerckhaert and Morres*.

permanent establishment was systematically profitable. However, on repatriating the start up capital after selling the establishment, it incurred a loss on account of currency depreciation. This was found to be an unjustified obstacle to the freedom of establishment. The very nature of the case was highlighted by AG Mengozzi:

[This] misses the crucial point of the case, which is that the German and Italian systems have created a regime in which a currency loss cannot be taken into account by either tax authority. In my view, a proper interpretation of Art. 43 EC read with Art. 48 EC requires such a loss to be taken into account in its entirety (like any other operating loss). Given that it was invisible during the Italian tax computation in LIT, it follows that it must be so taken into account during the German tax calculation of Deutsche Shell's global profits.¹⁹⁶

Deep constitutionalisation?

Community law as the guardian of collective interests

In *Derouin*, a partner of the global legal firm Linklaters, which was resident in France but obtained income in several member states, challenged the French decision to calculate his social security contributions by reference to his worldwide income. As is well-known, Regulation 1408/71 allocates the member states the power to collect social security contributions. The resolution of the case revolved around whether the said Regulation limited itself to empowering member states to collect the said social security contributions, or whether it empowered and obliged member states to do so. Mengozzi produced a very bold opinion in which he explicitly disregarded the assumption that European integration should necessarily place the migrant worker in a better position: The Treaty cannot guarantee to a worker that extending his activities into more member states will be neutral as regards social security.

This, indeed, reflects a view of constitutional Community law as the carrier of general principles as varied as national constitutional principles, which occasionally require the sacrificing of subjective rights (especially subjective economic rights) in order to realise collective goods which, on most occasions, are the necessary pre-conditions for the effectiveness of subjective fundamental rights. The

¹⁹⁶ Par. 71 of the Conclusions of the AG in the said case.

allocation of tax powers in Regulation 1408/71 is not to be constructed as aiming *exclusively* at improving the situation of the Derouins of Europe, but to allocate tax power in such a way as to ensure the co-ordination of national taxes, and the realisation of all constitutional principles, not just economic freedoms. However, the Court went in exactly the opposite direction, and concluded that a member state could forego, unilaterally or by means of a Treaty, the powers assigned to it in Regulation 1408/71, as long as this did not result in a reduction of the benefits of the individual.

The continued wide understanding of economic freedoms as the yardsticks of the European constitutionality of personal tax laws

Despite the major change operated by the line of jurisprudence led by *Kerckhaert and Morres*, the Court has persisted in defending a wide breath and scope of Community freedoms as the yardsticks of the European constitutionality of national personal tax laws. The way in which the Court depicted economic freedoms in *Schwarz* and in *X and Passenheim-Van Schott* is exemplary in this regard.

*Schwarz*¹⁹⁷ revolved around the pretence of a German couple to be granted a deduction from their income tax liabilities on account of the cost of sending their children to the Cademuir International School, a private (and expensive: 23 400 sterling pounds full board a year in 2004/2005, or *circa* 34 281 euro) school in Scotland. The Schwarz couple might have obtained the deduction if the school had been established in Germany, and had been certified by the tax authorities. Germany claimed that, even if the policy had been articulated through a tax norm, the policy still remained one of education. Deduction was necessarily linked to supervision by the state, which, in turn, ensured the achievement of a set of goals, including non-segregation of parents by income. The Court, as will be considered again *infra*, disregarded the way in which the German authorities characterised the issue, and seizing the high constitutional ground to claim that the German tax norm was restrictive not only of the freedom to provide the services of Cademuir (and, in general, in the Commission proceedings of all providers of education for fees), but also of the children's right to citizenship, who were discriminated against for the sole reason of making use of their right to be

¹⁹⁷ C-76/05, *Schwarz*; C-317/08, *Commission v Germany*.

Europeans and move.¹⁹⁸ In the emotional language to which the ECJ resorted:

In so far as it links the granting of tax relief for school fees to the condition that those fees be paid to a private school meeting certain conditions in Germany, and causes such relief to be refused to payers of income tax in Germany on the ground that they have sent their children to a school in another member state, the national legislation at issue in the main proceedings disadvantages the children of nationals solely on the ground that they have availed themselves of their freedom of movement by going to another member state to attend a school there.¹⁹⁹

But if one drops the lyrical overtones, what the Court is saying is that European citizenship implies the right of extremely well-off parents not so much to send their children to study at an exclusive British school,²⁰⁰ (a right which it seems to me predates Community law by far: I am not aware of any prohibition to send children to study abroad in any Western democratic European state in the post-war period), as the right to be granted a tax deduction on account of the fees thus paid. But can we really accept that a fundamental right is at stake when we are discussing whether somebody who could pay school fees of 30,000 euro plus in 2004 is to obtain a relatively modest tax rebate from the authorities? Can this be said to be a core content of the right to European citizenship?

¹⁹⁸ See Case C-317/08, pars 129 and 130.

¹⁹⁹ Par. 92 of the judgment. See, also, par. 66: 'Legislation such as that under Par. 10(1)(9) of the EStG has the effect of deterring taxpayers resident in Germany from sending their children to schools established in another member state. Furthermore, it also hinders the offering of education by private educational establishments established in other member states, to the children of taxpayers resident in Germany'.

²⁰⁰ And not long-lasting, alas! The school closed down in September 2006 due to financial difficulties, after severe doubts had been raised in the press concerning the actual quality of the education and of the care and protection which the children received at the school. Her Majesty Educational Inspectors were not especially enthusiastic in the first inspection of 2004 and were far from fully satisfied one year afterwards. Indeed, the Court knew that this had been the case by the time both the Advocate General delivered the case and, of course, when the Court gave its judgment.

Perhaps even more telling is the Freudian slip that the Court made in joined cases *X and Passenheim-Van Schott*. In this case, it was discussed whether a tax recovery period which was longer when it concerned income obtained abroad was, contrary to Community law or not. In *X*, Belgian authorities had spontaneously forwarded to the Dutch authorities information on capital holdings in a Luxembourgish bank. Mr X happened to be among those who held capital but had not informed the authorities, and thus, had not paid the taxes due. Mrs Passenheim-Van Schott was a widow, who decided to make full disclosure of the capital which her late husband and herself held in a German bank to the Dutch authorities. In both cases, the plaintiffs demanded that the recovery period was limited to 5 years, instead of the twelve applicable by law given that the money had been kept abroad. While the Court found that the longer recovery period was justified because it not only contributed to the effectiveness of fiscal supervision,²⁰¹ but was also not disproportionate given that Directive 77/799 does not require an automatic exchange of information among member states,²⁰² it did find that the longer recovery period was *prima facie* restrictive of the free movement of capital, upon the basis of a very odd argument, which is worth reproducing:

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

Indeed, this seems to imply that economic freedom includes the right to minimise the chances of being caught avoiding taxes, which cannot be curtailed by the competence of the member state to establish the length of the recovery period by reference to the intrinsic difficulty of

²⁰¹ C-155/08, *X and Passenheim-van Schoot*, not yet reported, par. 52.

²⁰² And it is correct to assume that it will be hard to spot concealed tax information held abroad than in the member state. See par. 72 of the judgment: 'the fact remains that, in regard of assets and income which are not the subject of a system for the automatic exchange of information, the risk for a taxpayer that assets and income which have been concealed from the tax authorities of his member state of residence will be discovered is less in the case of assets and income in another member state than in the case of domestic assets and income.'

monitoring compliance, upon the basis of the information which is available to them.

Reviving justifications

The ECJ has not been less restrictive in its definition of what amounts to an overriding public interest which justifies a national personal tax norm being in breach of a Community freedom. In particular, it has developed two 'rules of reason' justifications, and has been quite liberal in justifying national tax norms when they aim at realising two or more overriding public interests. To proceed systematically, let us consider (a) the persistent narrow reading of coherence as coherence from the standpoint of the taxpayer; (b) the development of the principle of territoriality as a balanced allocation of the power to tax among member states; (c) the principle of the effectiveness of fiscal supervision; and (d) the abuse of Community rights.

Still a narrow and 'privatised' coherence

Despite the fact that the ECJ has been much influenced by the arguments put forward by both AG Kokott and AG Maduro, and has moved to a more generous treatment of the justifications put forward by the member states to justify their breaches of economic freedoms, it has not followed their lead in doing so by means of a wider construction of the concept of coherence of the tax system; instead, the Court has preferred to translate the arguments of both Advocates General into new lines of justification of national personal taxes (see below). As a result, coherence continues to be understood as coherent and equivalent treatment not from the standpoint of the tax system as a whole, and consequently from a collective and multilateral perspective, but coherence as coherence for the individual taxpayer. Consequently, this justification is narrow and is bound to be a dead end for member states in cases before the ECJ.

Indeed, in the recent jurisprudence of the Court, only in *Hollman*²⁰³ was the ECJ close to accepting the defence of coherence (and not even then!). Under the provisions being challenged, Portuguese residents were subject to progressive income tax and their tax base on capital gains was proportionally reduced, while non-residents were subject to flat-rate personal income taxation, but the tax base on capital gains was not reduced. This met *a priori* the stringent demand of equivalent

²⁰³ Case C-443/06, *Hollmann*, [2007] ECR I-8491.

treatment, with a different tax being compensated by a tax advantage, for the same tax (albeit in the pre-*Manninen* case law that would have been contestable) and for the same taxpayer. However, the Court found that, in most cases, the rules were so much advantageous to residents²⁰⁴ that they did not offer the necessary *quid pro quo* to Community citizens, without which coherence of the tax system could not be regarded as an overriding public interest.

The very narrow reading of the justification was spectacularly confirmed in *Meilicke*,²⁰⁵ in which the ECJ not only rejected that the national tax law could be justified, but did not even acknowledge the grave economic and legal implications of affirming the unconstitutionality of the German law. While the figures were in dispute, and seemed to have been inflated by the German exchequer in the first stages of the proceedings, it was calculated that the unconditional declaration of European unconstitutionality of the national law could cost the German exchequer up to a quarter of a point of the national GDP. However, the Court refused to consider limiting the temporal effects of the ruling, a standard technique resorted to by national constitutional courts in order to avoid dramatic negative effects.²⁰⁶ Not even after asking for a second opinion from a second Advocate General on the matter. Indeed, AG Stix Hackl managed to contribute to the 'privatising' turn of 'coherence', or to general overriding public interests, by claiming that the limitation of the temporal effects of a judgment of the ECJ would only make sense if a limitation would enhance the legal security of taxpayers as private actors.²⁰⁷

Territoriality and the balanced allocation of the power to tax: back to sovereignty?

Fleshing out territoriality: national tax sovereignty re-acknowledged

The principle of the territoriality of tax law has been at the background of a good deal of the cases on personal taxation since

²⁰⁴ Par. 58 of the judgment, 'As is apparent from par. 38 of this judgment, the tax advantage granted to residents, consisting of a reduction of half of the tax basis of capital gains, in any event outweighs the consideration for that advantage, namely, the application of a progressive rate to the taxation of their income.'

²⁰⁵ C-292/04, *Meilicke and others*, [2007] ECR I-1835.

²⁰⁶ See R. Letelier, *Nulidad y Reestablecimiento en procesos contra normas*, PhD thesis, Universidad Carlos III, 2009, on file with the author.

²⁰⁷ Par. 67 of her opinion.

Avoir Fiscal. The principle has its basis in an understanding of national tax sovereignty embedded in an international legal community in which member states mutually respect the tax sovereignty of other states. This community is 'thick' enough to be based upon the mutual recognition of the spheres of tax sovereignty by reference to the connecting factor of residence, establishment and the development of meaningful economic activity. The community is 'thin' enough for the customary principles of international tax law (essentially, the principle of single taxation, or what is the same, the avoidance of both double taxation and non-taxation) to have only legal bite when endorsed bilaterally or multilaterally by sovereign states.²⁰⁸ Such bilateral or multilateral conventions are valid and applicable as a matter of international law, and thus exclusively upon the basis of reciprocity.

The subjection of national personal tax law to a review of European constitutionality was bound to affect the validity of the principle of territoriality in tax law. Indeed, the central theme of the case law is the end of the old-fashioned understanding of national tax sovereignty. The member states remain autonomous, but must exercise their autonomy in accordance with the economic freedoms. And while the ECJ has claimed that this is perfectly compatible with the member states retaining the competence to draw the limits of their respective powers to tax through international conventions, the fact is that, once national personal tax laws are subject to a supranational standard of constitutionality, national tax powers are being seriously affected.

Indeed, as we have seen, this was one of the key structural limits of the radical review of European constitutionality of personal tax laws spotted by AG Geelhoed (see above). In *Schumacker* and in the ensuing case law, the Court affirmed that Community law controlled the very definition of residence for tax purposes, with 'trans-European' citizens to be assimilated to residents. And indeed, the radical review of European constitutionality essentially consisted in denying that there were objective differences between residents and non-residents, which would justify a differentiated treatment of

²⁰⁸ See R. Avi Yonah, *International Tax as International Law: An Analysis of the International Tax Regime*, Cambridge, Cambridge University Press, 2007.

them.²⁰⁹ Finally, the Court has affirmed the primacy of European constitutional law over bilateral international law. In *Avoir Fiscal*, it affirmed very clearly that it was illegitimate to subject the granting of tax benefits to the condition of reciprocity, in full contrast to what is the case in international tax. Furthermore, the ECJ has not hesitated to affirm that double taxation conventions are subject to the review of European constitutionality as part and parcel of the national tax regime.

As we have also seen, the subjection of the operational criteria of the application of the distinction between residents and non-residents to a strict review of European constitutionality led, however, to placing member states close to being obliged to ensure that all economic agents enjoyed the four economic freedoms in full, even when restrictions resulted from the overlap of uncoordinated national tax systems, which, by definition, was what was to be expected in the absence of positive harmonisation of national tax laws. This implied a structural pressure to accommodate national tax systems in favour of the most mobile economic agents and factors, and ran the risk of a major dislocation of the whole financial structure of the member states.

This is the background against which the Court considered again and again the European constitutionality of establishing different tax regimes for residents and non-residents. Following the lead of AG Maduro in *Marks and Spencer*, it has started to take seriously residual national tax sovereignty as a justification of *a priori* unconstitutional national tax law.²¹⁰ Since then, the principle of territoriality as a balanced allocation of tax power has played a key role in rehabilitating the justification of the prevention of tax avoidance. This was the case in *Marks and Spencer* (par 39 and par 49),²¹¹ in *Cadbury*,²¹²

²⁰⁹ See, for example, C-397/98 *Metallgesellschaft*, [2001] ECR I-1727, par. 60; C-168/01 *Bosal*, [2003] ECR I-9409, pars 38-40; indirectly in C-9/02 *Lasteyrie du Saillant*, [2004] ECR I-2409.

²¹⁰ C-446/03 *Marks and Spencer*, [2005] I-10837, par 36; C-347/04, *Rewe Zentralfinanz*, [2007] ECR I-2647, par. 69.

²¹¹ See par. 49 of the judgment in *Marks and Spencer*: 'it must be accepted that the possibility of transferring the losses incurred by a non-resident company to a resident company entails the risk that within a group of companies losses will be transferred to companies established in the member states which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest.'

in *Thin Cap Group Litigation*,²¹³ in *Rewe*,²¹⁴ in *OyAA*²¹⁵ and in *CFC and Dividends Group Litigation*.²¹⁶ It must be noted that the Court made

²¹² See par. 56, in which the Court establishes a link between the principle of territoriality and tax evasion; ruling in C-196/04 *Cadbury Schweppes*, [2006] ECR I-7995: 'Like the practices referred to in par. 49 of *Marks & Spencer*, which involve arranging transfers of losses, within a group of companies, to companies established in the member states which apply the highest rates of taxation and in which the tax value of those losses is therefore the highest, the type of conduct described in the preceding paragraph is such as to undermine the right of the member states to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardise a balanced allocation between member states of the power to impose taxes (see *Marks & Spencer*, par. 46).'

²¹³ C-525/04, *Thin Cap Group Litigation*, [2006] ECR I-2107, par. 75: 'Like the practices referred to in par. 49 of the judgment in *Marks & Spencer*, which involved arranging transfers of losses incurred within a group of companies to companies established in the member states which applied the highest rates of taxation and in which the tax value of those losses was therefore the greatest, the type of conduct described in the preceding par. is such as to undermine the right of the member states to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardise a balanced allocation between member states of the power to impose taxes.'

²¹⁴ C-347/04, *Rewe Zentralfinanz*, [2007] ECR I-2647, par. 42: 'It must be acknowledged in that regard that there are courses of action which are capable of jeopardising the right of the member states to exercise their taxing powers in relation to activities carried on in their territory and thus of undermining a balanced allocation of the power to impose taxes between the member states (see *Marks & Spencer*, par. 46) and which may justify a restriction on freedom of establishment (see *Cadbury Schweppes and Cadbury Schweppes Overseas*, pars 55 and 56). The Court has thus held that the fact of giving companies the right to elect to have their losses taken into account in the member state in which they are established or in another member state would seriously undermine a balanced allocation of the power to impose taxes between the member states, since the tax base would be increased in the first State, and reduced in the second, by the amount of the losses surrendered.'

²¹⁵ C-231/05, *Oy AA* [2007] ECR I-6373 par. 54: 'That element of justification may be allowed, however, where the system in question is designed to prevent conduct capable of jeopardising the right of the member states to exercise their taxing powers in relation to activities carried on in their territory (*Rewe Zentralfinanz*, par. 42)'; and par. 62: 'It should be noted at the outset that the objectives of safeguarding the balanced allocation of the power to impose taxes between member states and the prevention of tax avoidance are linked. Conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory is such as to undermine the right of the member states to exercise their tax jurisdiction in relation to those activities and jeopardise a balanced allocation between member states of the power to impose taxes (*Cadbury Schweppes and Cadbury Schweppes Overseas*, pars 55 and 56, and *Test Claimants in the Thin Cap Group Litigation*, pars 74 and 75).'

explicit this use of tax sovereignty as a 'reinforcement' of the weight of tax avoidance in *OyAA*.

At the same time, it must be noticed that the ECJ has continued to interpret, in a rather formalistic way, the concept of restriction to economic freedoms. In *Rewe Zentralfinanz*, the Court persisted on a formal reading of the obstacles to the freedom of establishment. Germany set limits to the possibility of off-setting positive income in Germany with the losses incurred by foreign subsidiaries, pointing not any longer to the 'coherence of the tax system', but specifically to the 'balanced allocation of tax power among member states'. The objective situation of companies with national subsidiaries was different than that of companies with subsidiaries in other member states because the German exchequer taxed national subsidiaries but not foreign subsidiaries. While, economically speaking, the profits of subsidiaries and parent company form a whole entity, legally speaking, the power to tax is not only fragmented, but uncoordinated at Community level. Subjecting Germany (and implicitly, all other high tax jurisdictions) to Community rules, would prevent a proper protection of tax bases, and would result in the erosion of the taxing capacities of German tax authorities. However, AG Maduro²¹⁷ and the ECJ²¹⁸ rejected this argument as such. They distinguished the case from *Marks and Spencer*, claiming that the legitimate invocation of the balanced allocation of the power to tax depended on a concrete risk of the erosion of the tax base (the tax losses being reported twice and likelihood of tax avoidance, ECJ 41/43). The claim of AG Maduro in par. 31 of his judgment, when comparing the tax problem to any legislative problem is revealing and telling:

Moreover, if the argument of symmetry advanced by the German Government were to be accepted in the area of taxation, there is no apparent reason why it should not be

²¹⁶ C-201/05, [2008] ECR I-2875. More recently, although with a negative outcome, in C-303/07, *Aberdeen*, not yet reported, par. 64: 'For a restriction of freedom of establishment to be justified on grounds of the prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory (*Cadbury Schweppes and Cadbury Schweppes Overseas*, par. 55, and *Test Claimants in the Thin Cap Group Litigation*, par. 74).'

²¹⁷ See par. 29 of the Opinion.

²¹⁸ See par. 43 of the judgment.

extended to the other areas covered by the rules on the freedoms of movement. Just as the principle of the allocation of the power to impose taxes could be invoked, it would then be possible to rely generally on a principle of allocation of the power to legislate. On that principle, a member state would be entitled to refuse to take into account cross-border economic situations that might call into question its freedom to legislate. Thus, for example, goods lawfully produced in accordance with conditions imposed by another member state could be refused entry to a national market on the ground that the goods in question did not meet the legal conditions obtaining in that market. The free movement of goods would then be reduced to a purely formal rule of non-discrimination, consisting of according equal treatment only to goods subject to the rules of the State concerned. Such a result would be completely contrary to the settled case law of the Court on the subject.

Effectiveness of fiscal supervision

The effectiveness of fiscal supervision and the fight against both tax avoidance and tax evasion keep on being interpreted rather narrowly when claimed on their own. In particular, the ECJ continues to assume that the very existence of a structural mechanism of co-operation between tax administrations enshrined in Directive 77/799 turning non-residence into an objective difference which would justify the automatic application of more stringent norms to prevent tax avoidance. Thus, the rule that, in the absence of proper accounts, an objective assessment of business income would be applied only to non-residents was found to be contrary to Community law in *Talotta*²¹⁹ (par. 36), even if the fiscal data were to be obtained from one of the more opaque countries, such as Luxembourg. Similarly, the fact that the relevant data on the tax base could not be required from another member state (Luxembourg) under the terms of the Directive did not justify denying a tax benefit in *Société Elisa*.²²⁰ Indeed, in his opinion, AG Mazak summarised the extremely narrow understanding that the ECJ has of the justification when invoked on its own, which is worth quoting at some length:

²¹⁹ C-383/05, *Talotta*, [2007] ECR I-2555.

²²⁰ C-451/05, *Société Elisa*, [2007] ECR I-8251, par. 78ff.

It follows that, in order to be proportionate, the effective scope of a measure aimed at counteracting tax avoidance and evasion should be limited, as far as possible, only to those cases which present a real risk of tax avoidance by recourse to wholly artificial arrangements and must be designed, in view of all of its conditions for application and exemption, to apply only in very specific circumstances which correspond to cases in which the probability of the risk of tax avoidance is highest.²²¹

Even though it acknowledged the soundness of the argument of the French government that there was no means by which the national authorities could verify whether the information being provided by the taxpayer was correct in the absence of specific bilateral mechanisms of exchange of information, the ECJ ended up upholding the claim of the plaintiff. In particular, the ECJ reminded the reader that the Code of Conduct on Corporate Taxation (which casts a long shadow of a doubt over Luxembourgish holding companies) is not *hard law*, and that, even if Luxembourg has breached Community law by entitling holding companies to operate as they do (and, indeed, the Commission has characterised the holding company regime as an infringement of state aid rules), France was entitled to react *unilaterally* by discriminating against holding companies established in Luxembourg.²²² The Court seemed to be very concerned about the risk of penalising 'holding companies' established in Luxembourg by natural persons resident for tax purposes in France, who established them for genuine economic purposes.²²³ Thus, the fact that it may be impossible to request co-operation from another member state under Directive 77/799 cannot justify the refusal of a tax benefit.²²⁴

In this regard, it must be noticed that the coining of the justification of 'balanced allocation of tax power' contributes to render the contradiction implicit in a good deal of the reasoning of the ECJ clearer, especially on what concerns the easiness with which

²²¹ Par. 99 of the AG's opinion.

²²² Pars 115 and 116 of the opinion.

²²³ Par. 130 of the Opinion.

²²⁴ Par. 94 of the judgment: 'However, it is also apparent from the case-law that, although Art. 8(1) of Directive 77/799 does not oblige the tax authorities of the member states to cooperate when the competent authorities are prevented by their laws or administrative practices from conducting enquiries or from collecting or using information for those States' own purposes, the fact that it may be impossible to request that cooperation cannot justify refusal of a tax benefit.'

information can be obtained from other member states, and the standards of loyalty with which national exchequers operate within the present constitutional framework. The following quotation from the Opinion of AG Maduro in *Rewe Zentralfinanz* reveals the peculiar perception of the Court as a whole:

There is no reason to suppose in this connection that national tax authorities have any interest in allowing tax arrangements to flourish in their territory that contravene the law of the State to which they are subject.²²⁵

National tax authorities are formally not allowed to let such tax avoidance schemes flourish in their territory, but does this mean that they do not have *an interest in doing so*? So, why is there all the talk, even within the very pro-integration and pro-single market Commission of *harmful tax competition*? Why was there a need to write a Code of Conduct? Why is it the case that the Code has not been fully realised yet? Should the law be blind to socio-economic reality (should, in particular, the tax case law of the ECJ be blind to socio-economy reality?) or should it bridge the gap between law and such reality by properly applying the law in a way that is context-sensitive?

The Court has opened a small crack in its case-law by acknowledging that, in some cases, Directive 77/799 may not allow member states to obtain proper information, and thus some distinctions in the treatment of nationally-generated income and income generated abroad may be adequate. In particular, in *X and Passenheim-Paschott*²²⁶ the ECJ seemed to draw a new distinction, between those countries in which tax co-operation included automatic exchange of data, and those in which it did not. In the same line, the Court has become clear on the acceptability of the application of more restrictive norms to third countries, given the absence of an institutionalised framework of co-operation between tax administrations.²²⁷ The scope of the free

²²⁵ C-347/04, *Rewe Zentralfinanz*, [2007] ECR I-2647, par. 45 of the conclusions of AG Maduro.

²²⁶ C-155/08, *X and Passenheim-van Schoot*, not yet reported.

²²⁷ Par. 95 of the judgment: 'Consequently, on the assumption that such a ground may be relied upon as justification for a restriction on the movement of capital to or from third countries, such a justification cannot be taken into consideration in the present case, inasmuch as that reduction affects all shareholders of the collective

movement of capital is the same whether it applies to member states or to non-member states, but differences should be established with regard to what constitutes a proper justification; In particular, the Court states that 'the case-law limiting the rationale of the effectiveness of fiscal supervision in relation to the internal market cannot be transposed in its entirety to movements of capital between member states and third countries, since the movements take place in a different legal context'. Thereby the reliability of the information provided spontaneously by the taxpayer depends on the extent to which there are institutional means to double check those figures.²²⁸

More boldly, the Court has engaged in a limited and constrained revival of the justification of the effectiveness of fiscal supervision *when invoked together* with other justifications. In the previous section, we have already considered to what extent the effectiveness of fiscal supervision operates as an ancillary justification within the structure of the defence of 'balanced allocation of the power to tax'. In particular, the reader should bear in mind what has been said about the justification of applying different tax regimes to different member states. Indeed, in *Columbus*, the ECJ found that drawing a line between high and low tax jurisdictions was not contrary to Community law, to the extent that it resulted from the parallel application of tax systems.²²⁹

Abuse of Community rights

The definition of the scope of economic freedoms in such wide terms, their so ample characterisation as standards of European constitutional review created a major opportunity to make use of the economic freedoms in order to avoid taxes. To tackle the ensuing socio-economic consequences, the ECJ could have either re-calibrated the breadth of the economic freedoms or that of the justifications, by means of making them *sensitive?* to the constitutional principles being frustrated by tax avoidance *through* economic freedoms. Instead, what the Court has done is to make use of the 'rule of reason'

investment enterprise concerned without distinction, whether resident or established in the member states or in third countries.'

²²⁸ Par. 133 of the Conclusions of the AG and par. 63 of the judgment of the Court. See, also, par. 77 of the Conclusions of the AG and par. 32 of the judgment of the ECJ in C-101/05, A, [2007] ECR I-11531.

²²⁹ Case C-298/05, *Columbus*, [2007] ECR I-10451, par. 43.

justification of 'abuse of Community right' to establish a *residual* exception to economic freedoms.²³⁰

The opening case in this regard was *ICI*, in which the ECJ claimed that a breach of an economic freedom was justified if it was intended to avoid '*wholly artificial arrangements*' (my italics) being employed to reduce the tax bill.²³¹ This was confirmed in *Lankhorst*,²³² *Marks and Spencer*,²³³ and *Halifax*²³⁴ (a case which, however, concerned Value Added Taxation, not personal taxation). The doctrine reached consolidation in *Cadbury Schweppes*,²³⁵ and has been further interpreted in *X*.

Through this jurisprudence, the ECJ has ended up accepting the justifiability of the very targeted British rules denying group relief to *Marks and Spencer*, upon the basis of three cumulative reasons: the need to preserve a proper allocation of the power to tax between member states, the risk of losses incurred in other member states

²³⁰ Against: AG Léger, in C-196/04 *Cadbury Schweppes*, [2006] ECR I- 7995, p. 47. In the view of the Advocate General, if that argument were to be followed through, it would be tantamount to conceding that a member state is entitled, without infringing the rules of the Treaty, to choose the other member states in which its domestic companies may establish subsidiaries and benefit from the tax regime applicable in the host State. However, such a situation would manifestly lead to a result that would be contrary to the notion of 'single market'. Advocate General Léger therefore suggested that the difference in treatment depending on the tax rate of the member state of establishment alone sufficed for the system provided for under the United Kingdom legislation on CFCs to be regarded as constituting a hindrance to freedom of establishment. And AG Mengozzi in Case C-298/05, *Columbus*, [2007] ECR I-10451, par. 149: 'As regards the second point, I also consider that the difference identified by the German Government is eclipsed by the more fundamental principle which requires member states to refrain from taking unilateral measures to split up the internal market unless such a measure is justified by a public interest objective'.

²³¹ Case C-264/96, *ICI v United Kingdom*, [1998] ECR I-4711, par. 26: 'As regards the justification based on the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment.'

²³² C-324/00, *Lankhorst*, [2002] ECR I-11779.

²³³ C-446/03, *Marks & Spencer*, [2005] ECR I- 10837.

²³⁴ C-255/02, *Halifax*, [2006] ECR I-1609.

²³⁵ C-196/04 *Cadbury Schweppes*, [2006] ECR I- 7995.

being used twice; and, finally, the risk of tax avoidance, resulting from the practice of managing group losses so as to incur them in the 'higher tax' jurisdictions within the Union.²³⁶ In arguing in this way, the Court left it unclear as to whether the three justifications needed to be simultaneously present,²³⁷ while hinted in the direction of setting limits to what was regarded as lawful use of economic freedoms with a view to reducing the tax bill.²³⁸

[T]he exercise of the freedoms of movement must be as neutral as possible in regard to the tax arrangements adopted by the member states. The right of establishment cannot be used by traders with the sole purpose of endangering the equilibrium and the cohesion of national tax systems. That would be the case if use were made thereof either abusively to evade national laws or artificially to exploit differences between those laws [...]. The concept of fiscal cohesion seeks to ensure that Community nationals do not use Community provisions to secure advantages from them which are unconnected with the exercise of the freedoms of movement.

However, the residual justification is very limited, as the very phrase 'wholly artificial arrangements' indicates. In line with the structural implications of *Centros* and *Inspire Art* on the freedom of establishment, the ECJ has said that 'the fact that the company was established in a member state for the purpose of benefitting from more favourable legislation [my note: thus including tax legislation] does not, in itself, suffice to constitute abuse of that freedom'. It is only an abuse when what it is being used as a mere 'letter box corporation'. Only this seems to qualify as a 'wholly artificial'

²³⁶ In C-414/06 *Lidl Belgium*, not yet reported, AG Sharpston has reviewed the requirement of three conditions being met at the same time, casting some doubts on the logical consistency of the three-fold distinction. See, in particular, par. 18 of her opinion.

²³⁷ *Ibid*, par. 51: In the light of those three justifications, *taken together*, it must be observed that restrictive provisions such as those at issue in the main proceedings pursue legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest and that they are apt to ensure the attainment of those objectives.

²³⁸ Especially in par. 50: 'To exclude group relief for losses incurred by non-resident subsidiaries prevents such practices, which may be inspired by the realisation that the rates of taxation applied in the various member states vary significantly'.

institutional structure.²³⁹ *A contrario*, partially artificial structures, or for that purpose, any structure that is not 'wholly artificial' should be considered as the exercise of economic freedoms, and, consequently, the justification could not be invoked.

Conclusions

European integration has contributed immensely to the shaping of a post-national world, in which the absolute sovereignty of the state and the primacy of the national constitution have (happily) been constrained. The realisation of the limits of politics in one state and the dependence of successful democratic institutions on supranational integration are key premises of the European project, and render it congenial, but not contiguous, to cosmopolitan ideals. European and national constitutional law assumes that there is no sustainable democracy without integration. This logically entails (even if most of the time it is not realised, not even reflected upon) the transformation and supranational integration of tax systems. This is so because, as already stated several times in this chapter, taxes are a key means (sometimes the means of choice) of drawing and policing national economic borders. The re-configuration of such borders cannot but have massive effects on national tax systems.²⁴⁰ The story of the transformation of national personal taxes recounted in this chapter shows that the key question then is not *whether* European integration has affected national tax systems, or, in more fashionable and, perhaps, clear terms, not whether national tax systems have been Europeanised, but *which* taxing powers over *what* taxes have been Europeanised, *when* and *how* such Europeanisation has taken place, and what the democratic implications are.

The differences between the different stages of the case law of the ECJ in personal tax matters can be traced back by reference to (1) the breadth and scope of the set of taxes Europeanised (*ad rem versus* personal taxes); (2) the means of Europeanisation (legislation *versus*

²³⁹ Opinion of AG Mengozzi in C-298/05, *Columbus*, [2007] ECR I-10451, pars 182 and 183: actual physical existence plus financial activity are enough to pass the test.

²⁴⁰ This was something unnoticed by most commentators, but not all, at the time the United Kingdom, Ireland and Denmark became Members. See N. I. Miller, 'Some Tax Implications of British Entry into the Common Market', (1972) 37 *Law and Contemporary Problems*, pp. 265-85, at 265: '[T]he alterations in the tax structure resulting from the impending entry would in themselves be sufficient to affect almost every aspect of Britain's industrial, commercial and social life.'

constitutional adjudication by the ECJ); (3) the breadth and scope of the yardstick of European constitutionality; and (4) the latitude of the exceptions which would justify the infringement of economic freedoms by national personal tax laws.

Tax integration in the common market stage was fuelled by the principle of non-discrimination of national personal tax laws upon the basis of nationality, thus extending the guarantees which nationals enjoyed to Community nationals. The principle was realised through supranational harmonising norms which enhanced the effective tax power of member states through their co-ordination, and led to the transfer of modest tax collecting powers to the European Union. The second stage of the case law of the Court seemed to add a modest and circumscribed review of the constitutionality of national personal tax laws; this seemed to be intended as a means of *anticipating* a much delayed political initiative. In both cases, the Europeanisation of national personal taxes corresponded to the federal and social-democratic understanding of the socio-economic constitution of the Union as described in the first chapter of this report.

Tax integration in the single market has been propelled by the aim of realising a transcendental definition of European (economic) citizenship. This has been realised through the deep judicial review of the national and regional tax norms regarded as obstacles to economic freedoms (even when they are *non-discriminatory*), which has disempowered national and regional levels of government *without* empowering the supranational level (by means of unleashing powerful economic forces steering national tax systems towards an uncoordinated convergence. As results, (1) the financial basis of the social *Rechtsstaat* has been eroded; (2) the capacity of public institutions to macro-manage the economy in an effective and fair manner has been compromised; and (3) the very modest tax collecting powers transferred to the Union in the 1970s were re-contested and partially re-appropriated by national exchequers. This shift has major democratic implications, as it has *negativised* the constitutional discipline of the power to tax in the European Union, and thus not only structured, but actually constrained, the scope within which it is actually possible to collect taxes. This largely corresponds to the neo-liberal federal model described in Chapter 1.

Both tax integration in the common market stage, and the partial 'reining in' of the single market in the last years, result from the realisation of two structural limits that the review of the European constitutionality of national personal tax norms has in the context of European integration. First, the factual complexity of tax laws, due to their operationalising collective ideals of commutative and distributive justice, and their being key means of macro- and micro-economic management, makes tax law an area in which courts correctly feel they lack structural competence. Legislatures (assisted, if not led, by executives) do tend not only to have a wider factual basis upon which to take such decisions, but are also (at least, formally and potentially) capable of rectifying mistakes in ways in which courts cannot. This is, indeed, why tax law, next to foreign relations, is an area in which courts are at their most self-deferential when reviewing the constitutionality of legislation. By venturing into the review of national tax laws, the European Court of Justice has placed itself in an odd position, which is rendered extremely problematical by the structural limits of the design of European decision-making on tax norms. Contrary to what is the case in national contexts, there is a clear mismatch between the review of constitutionality according to a model of 'economic due process' (in which the aspirational and inspirational value of the single market has been transformed into a yardstick of positive constitutionality by the Court) and the capacity of the European political process of 'recomposing' the coherence of the tax system after each of these judgments. While there is no principled reason why corporate income taxation or even personal income taxation could not be subjected to a profound process of re-writing at European level to ensure the overall coherence of national tax systems (it will be very hard to claim that this was not central to European integration, and, as such, well within the remit of competence granted by the European Union), the very structure of European constitutional law is bound to prevent such an outcome. The requirement of unanimous agreement in the Council (at least, as long as there is no political will to travel the safety exit enshrined in Art. 116 of the Treaty on the functioning of the European Union, ex Art. 96 TEC) makes it close to impossible to rectify at European level; the very growth of the review of European constitutionality blocks the possibility of meaningful rectification taking place at national level. As a result, an aggressive review of the European constitutionality of national personal tax norms is bound to result in incoherent tax systems, the evolution of which will not even

be influenced by political processes as a result of the structural empowerment of some social actors to the detriment of others (in the context of the single market, this inevitably means empowering multinational corporations and active transnational economic actors).

Second, the tax system not only plays a key role in the political and socio-economic design of the polity, but is also one of the most deeply 'materialised' set of national norms. Bringing tax law within the breadth of the review of European constitutionality could not but further expose the basic tension at the heart of European constitutional law, namely, the major opposition between the form of 'constitutional law' and the ensuing claim of appropriation of the political dignity associated with it and the narrow substantive content of European constitutional law as the vehicle of an economic due process defined by reference to the four economic freedoms. Because tax law is intrinsically political, and because tax norms are being continuously used as means of realising all constitutional principles, opening the door to the review of the European constitutionality of national tax laws reveals the extent to which the review conducted by the ECJ results in giving an original extra weight to the economic freedoms to the detriment of all other constitutional principles, in stark contrast to the normative hierarchy underpinning the constitutional law of the social and democratic states, in which politics is supposed to be the master, not the slave, of capital.

However, the jurisprudence of the Court is undecided, and, indeed, the diverging blueprints of the Advocates General of the Court could result in the case-law moving in different directions. Whatever direction it takes will have major consequences both for democracy and for social justice.

We may be all post-nationals now, but we continue to be children of the liberal revolutions of the Eighteenth and Nineteenth centuries, and, consequently, attached to the normative ideal of democracy, which, from its inception, had much to do with taxation (indeed, 'no taxation without representation', as James Otis famously put it).²⁴¹ It

²⁴¹ J. Otis, *The Rights of the British colonies asserted and proved*, Boston, J. Almon, 1764, microfilm available at <http://ia341309.us.archive.org/0/items/cihm_20401/cihm_20401.pdf>.

was, indeed, through control of the exchequer and the public purse that, first, the *bourgeoisie*, then, 'we the people', and, finally, the third state imposed the basic institutional and procedural features of modern democracy. While we may find it tedious, inconvenient and onerous to pay our share of taxes on tax day, we tend to establish a close association between the power to tax and (modern) democracy. This is why we should take the risks implicit in the evolution of Community law in this regard seriously. Indeed, it seems to me that the re-construction and normative assessment conducted in this chapter reveals the structural limits of Europeanisation through judicialisation. In the absence of a cohesive supranational legal discipline which co-ordinates national tax laws, judicial intervention runs up against three barriers. First, the ECJ lacks (like any other court, even a constitutional court) the knowledge and the means to establish a coherent tax policy (which is forced to frame by the internal dynamics of its bold approach to the review of the European constitutionality of personal tax norms). Second, the ECJ cannot rely on the political signals issued by the European political process, for the simple reason that the institutional structures and decision-making processes which could provide it are not doing so, for the most part due to the incoherent constitutional framework of the European Union. Third, the ECJ cannot rely on its decisions being rectified by the European legislature, because the combined division of competences and processes of decision-making in the European Union have rendered positive legislative action in the area of personal taxes improbable.

Indeed, if we care about democracy and political participation, it is because we care about social justice and equality. Indeed, we are also the children of the modern welfare state, and thus inclined to think that our socio-economic structures are premised on the assumption that democracy requires a modicum of re-distribution of economic resources (a belief which could be expressed in the motto of 'no democracy without progressive taxation'). Even if the triumph of neo-liberalism²⁴² in the last three decades has made us less eager to pay taxes happily, and more inclined to think that we, ourselves, are the ones who should be on the receiving end of public expenditure, many among us are still inclined to think that equal citizenship requires not only the curbing of the concentration of economic

²⁴² A. Glyn, *Capitalism Unleashed*, Oxford, Oxford University Press, 2007.

resources in very few hands (as this variant of hoarding will sooner or later result in abuse of power), but also the ensuring of a minimum level of resources to each and all of us. The tax system (and, in particular, personal income taxes) plays an essential role in the functioning of the welfare state, as taxes are not only the institutional means of giving monetary value to the obligations that we have towards each other (which, perhaps misusing the title of the famous book by Thomas Scanlon, we may define as what we owe to each other), but also have become key elements of macro- and micro-economic management. Indeed, the tax system is widely used to achieve major and minor policy goals, from rendering housing less unaffordable to fostering private savings or consumption. But the harmonisation of national personal taxes through stealth, which is unavoidable under the present course of the Europeanisation of personal taxes is carrying us in completely the opposite direction. The promise of European citizenship is seriously compromised by the mixture of constitutional forms and narrow and leaden economic substance. The vision of the single market citizen, for whom the ultimate thrill is to cross borders and maximise marginal values, is not easy to reconcile with the image of the solidaristic citizen which animates our constitutional law. The ghost of the unencumbered taxpayer, so free that has no political ties, is, indeed, haunting European law.

Chapter 6

Democracy and non-contractual liability of states for breaches of EU law

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Introduction

The constitutional structure of the socio-economic dimension of the European Union has been assembled through the definition of several economic policies. RECON's work package 7 undertakes research about those policies with the aim to clarify the fundamental guiding principles of the socio-economic constitution of the European Union. This purpose will not be pursued from an isolated or fragmented perspective, but rather from a constitutional one, that enables us to analyse the idea of the EU projected by each policy and to link the different outcomes of this specific environment in a more comprehensive image of the European Union. This perspective aims at contributing to the general plan of the RECON project by shedding light on the way in which democracy can be reconstituted in Europe. In this regard, the study of economic policies and institutions will contribute to the understanding of economic norms, policies and decision making, and hence, it will facilitate the comprehension of the way in which powers are allocated and of the democratic legitimacy arguments that justify this allocation.

One of the socio-economic institutions of the European order is the system of non-contractual liability of both the European institutions and the member states of breaches to EU Law. As will be shown hereafter, the mechanism of compensation that the treaties and the European Court of Justice (ECJ) have developed represents a decision-making procedure with strong political and economic implications. Political implications, because it reveals not only an option to make good the damages that states produce in exercising their powers, but it further expresses a precise design of the distribution of powers within the EU and a particular way to develop both the process of enforcing EU Law and the relation between that process and national legal orders. Economic implications, on the other hand, because when the Court decides to give damages, it also decides a certain model both of how to distribute in a more efficient way public economic resources and of how to build specific communities of risks and insurances.

The current research on public liability is divided into two parts. The first part, which is covered by this chapter, deals with the assumptions and the consequences of state liability for breaches of EU law. To explore this, I will develop two main points. Firstly, I will describe the power-allocating norms in the system of non-contractual liability, showing, in concrete, which theoretical framework is necessary to shape this allocation, or, what is the same, which kind of assumptions are needed to support the power-design that stand behind EU liability norms. Secondly, I want to illustrate what are the consequences of this framework and what are the costs of accepting the institution of public liability as progressively defined and reconstructed by the ECJ.

The second part of the research deals with the effects on democracy of the assumptions and consequences of state liability for breaches of EU law. This will be examined in a future paper, which will show how the assumptions and the consequences of the public liability theory can affect democracy in the European Union. For this purpose, a multiple democratic assessment of the constitutional status quo by reference to the three RECON democratising strategies will be given, formulating at the end concrete proposals to move from the current state of affairs to a more democratic design of public liability in the EU sphere.

Public liability is a classical and relevant topic both in domestic public law and at the EU level. Which are the elements that configure a public liability system, which are the breaches that generate it, which are the different explanatory models or supporting grounds for public liability, and which are the relations between the national models and the European model of public liability are some of the main points of concern considered by the scholars when studying this topic¹. The answer to these inquiries combines normally theoretical and practical approaches.

The system of public liability in the EU sphere includes the study of two main sources: the liability of the European Communities institutions and the liability of the member states for breaches of EU Law. While the first was expressly stated in one of the founding treaties (now Art. 215 EEC), the second one has been recognised in a clear and concise way by case law since the famous *Francovich* case in 1990.² Thus, the treatment of public liability has coincided with the evolution of the judicial and doctrinal interpretation of Art. 215 and the development of the case law post *Francovich*. Both the case law and judicial and doctrinal interpretation of this provision have focused their efforts in determining the conditions or requirements for establishing public liability in the same way in which national legal systems have dealt with these conditions concerning liability for torts during centuries. In developing that task, and especially since

¹ See, among others, G. Bebr, *Development of Judicial Control of the European Communities*, The Hague, Nijhoff, 1981, at p. 219ff; P. Craig and G. D. Búrca, *EU Law*, 3rd ed., Oxford, Oxford University Press, 2003, at p. 257ff; T. C. Hartley, *The Foundations of European Community Law*, 5th ed., Oxford, Oxford University Press, 2003, at p. 235ff; G. Isaac, and M. Blanquet, *Droit général de l'Union européenne*, 9th ed., Paris, Dalloz, 2006, at p. 403ff; G. Lenaerts and D. Arts, *Procedural Law of the European Union*, 2nd ed., London, Sweet and Maxwell, 2006, at p. 369ff; C. Lewis, *Remedies and the Enforcement of European Community Law*, London, Sweet and Maxwell, 1996, p. 250ff; G. Nicolaysen, *Europarecht I*, 2nd ed., Baden-Baden, Nomos, 2002, at p. 419ff; H. Schermers and D. Waelbroeck, *Judicial Protection in the European Union*, 6th ed., The Hague, Kluwer Law International, 2001, at p. 518ff; J. Schwarze, *EU-Kommentar*, Baden-Baden, Nomos, 2000, at p. 2277ff; J. Steiner, L. Woods and C. Twigg-Flesner, *EU Law*, 9th ed., Oxford, Oxford University Press, 2006, p. 288ff; G. Tesaurò, *Diritto Comunitario*, 3rd ed., Padova, CEDAM, 2003, at p. 334ff.

² Case C- 6/90 and C-9/90 *Andrea Francovich and Danila Bonifaci and others v. Italian Republic* [1991] ECR I-5357.

the *Brasserie du Pêcheur* case,³ both models of EU liability – of Community institutions and of member states – became closely interconnected, sharing not only the common problems or the unclear points, but even their legitimacy. Indeed, the legitimacy of the Treaty provisions regulating liability of Community institutions has been transferred to the unregulated and jurisprudentially modelled liability of the member states. Both liabilities, in the opinion of the ECJ, have become part of some common idea of protection of rights, and its legitimacy derives precisely from this guarantee function. As the ECJ said, liability of European institutions was

constructed on the basis of the general principles common to the laws of the member states and it is not appropriate, in the absence of particular justification, to have different rules governing the liability of the Community and the liability of member states in like circumstances, since the protection of the rights which individuals derive from Community law cannot vary depending on whether a national authority or a Community authority is responsible for the damage.⁴

The allocation of the power to compensate

The European Communities did not establish an action to obtain a compensation for breaches of Community law caused by member

³ Case C-46/93 and C-48/93 *Brasserie du Pêcheur SA v. Bundesrepublik Deutschland and The Queen v Secretary of State for Transport, ex parte: Factortame Ltd and others* [1996] ECR I-1029.

⁴ *Ibid.* The same idea was previously held by Advocate General Mischo in *Francoovich*. The court, however, did not share this line of reasoning in that opportunity. However, and despite the fact that the Court has equated both types of liability in some decisions, in practice the Court has not follow this homogenous line of reasoning along its case law, since for some subjects the Court varies its decision depending on the actor that caused the damage. In fact the actions of a Community institution are seen by the Court as primary legislature, and, according to this, it argues that liability must be imposed only in exceptional circumstances, since the freedom of legislature must not be obstructed by the prospect of actions for damages (see *Brasserie*). On the other hand, the ECJ understand the relation between the member states acts and Community law mainly as a matter of hierarchy and hence reparation of damages is appreciate only as a corollary of the supremacy of EU Law. See T. Tridimas, 'Member State Liability in Damages for Breach of Community Law: An Assessment of the Case Law', in T. Tridimas and J. Beatson (eds) *New Directions in European Public Law*, Oxford, Hart, 1998, at pp. 11-33 and p. 24. In a similar vein, W. van Gerven, 'Taking Article 215(2) EC Seriously', in T. Tridimas and J. Beatson (eds) *New Directions in European Public Law*, Oxford, Hart, 1998, at p. 36ff.

states right from the beginning. Indeed, the mechanism created for the purpose of diminishing those breaches was an action for infringement, stated in Art. 169 EEC (now 226). This rule, which continues to have the original wording, provides that

if the Commission considers that a member state has failed to fulfil an obligation under this Treaty, it shall deliver a reasoned opinion on the matter after giving the state concerned the opportunity to submit its observations [...] If the state concerned does not comply with the opinion within the period laid down by the Commission, the latter may bring the matter before the Court of Justice.

On the other hand, Art. 170 (now 227) established the same action, but entitled member states to make use of it.

As we can see, the mechanism was settled in a very flexible way. In fact, not every infringement of Community Law was to be understood as an attempt to disregard it or violate it. As Bebr puts it; 'it would be both premature and too drastic if the Commission would immediately lodge a legal action with the Court as soon it presumes a possible infringement were committed'.⁵ In other terms, the treaties did not consider that all types of infringements would constitute immediately a wrong. As European rules do not impose obligations with clear and complete contents, the infringement would be always an ambiguous and undetermined question. A 'dialogued procedure', this author contents, would be better to pursuit the necessary deterrence of unlawful actions and to impose a voluntary and not forced acceptance of the new reality of Community law. By this way, the action of infringement would stand as a 'subtle, flexible instrument of persuasion, with a gradually increasing force of pressure, seeking to ensure the respect of Community obligations which, if it fails, may ultimately end up with a Court's judgement recording a default of a member state'.⁶

⁵ Bebr, *supra*, note 1, at p. 279.

⁶ Bebr, *supra*, note 1, at p. 280. 'The first stage of the infringement procedure is to serve as a warning, intended to inform the member state about its presumed default and provide it with an opportunity to execute its Community obligations. The subsequent contentious procedure before the Court and its judgement, finding publicly the infringement of a member state is the last resort, the *ultima ratio* of the

It is not so hard to understand why this mechanism was not seen with good eyes by the ECJ. The seminal case *Humblet*,⁷ indeed reflects a first stage in the ECJ thought about the member states liability. It shows some discomfort of the court in the position that it played in the architecture of the powers within the Union. In fact, it perceived contradictions between the rationale of the flexible system stated on the treaties and other powers presumptively given to the Court by the treaties. On the one hand, the Court recognise that it 'has no jurisdiction to annul legislative or administrative measures of one of the member states' because '[t]he ECSC treaty is based on the principle of a strict separation of the powers of the Community institutions and those of the authorities of the member states'. Hence, 'Community Law does not grant to the institutions of the Community [Court included] the rights to annul legislative or administrative measures adopted by a member state'. Up to this point, the Court applies the traditional conception of separation of powers, which is coherent with the mechanism of enforcement provided in identical terms by Art. 88 ECSC and founded on the same basis as Art. 169 EEC.⁸ The ECJ see member states in this stage not only as objects of control, but as an important part of the gear of the Community. This can explain the attitude of the court to insist on an idea of some kind of separation of sphere of actions between member states and ECJ.⁹

EEC Treaty Article 169'. In the same line, see Schermers, and Waelbroeck, *supra*, note 1, at p. 609ff.

⁷ Case 6/60 *Humblet v. Belgium* [1960] ECR 559. The plaintiff was a Belgian official of the European Coal and Steel Community that brought Belgium before the ECJ because Belgium had violated the Protocol on the Privileges and Immunities of the ECSC by considering his Community salary in determining the Belgian supplementary tax rate.

⁸ '[I]f the High Authority' – continues the decision – 'believes that a state has failed to fulfil an obligation under the Treaty by adopting or maintaining in force provisions contrary to the Treaty, it may not itself annul or repeal those provisions but, in accordance with Article 88 of the treaty, it may merely record such a failure and subsequently institute proceedings as set out in the treaty to prevail upon the state in question itself to rescind the measures which it had adopted [...] The same applies to the Court of Justice. Under the terms of Article 31 of the Treaty it has responsibility for ensuring that Community Law is observed and by Article 16 of the protocol has jurisdiction to rule on any dispute relating to the interpretation or application of the protocol but it may not, on its own authority, annul or repeal the national laws of a member state or administrative measures adopted by the authorities of that state'.

⁹ See C-23/59 *Acciaieria Ferriera di Roma (F.E.R.A.M.) v. High Authority of the European Coal and Steel Community* [1959] ECR 245; C-5, 7 and 13 to 24/66 *Firma E. Kampffmeyer and others v. Commission of the EEC* [1967] ECR 245; C-30/66 *Firma Kurt A. Becher v. Commission of the European Communities* [1967] ECR 285; C-9 and 11/71 *Compagnie*

But – and here comes implicit the possible source of the discomfort of the ECJ – if the Treaty attributes the Court the power to decide about the interpretation of a European rule, it is necessary to know what would be the material effects of that interpretation. In other words, as AG Lagrange pointed out in his opinion on this case, one of the questions that the court had to solve in *Humblet* was what the powers of the Court were when someone applies directly to it.¹⁰ The applicants in this case intelligently argued that if the Court cannot order a real nullity, its decision would be ineffective and the judgement would be reduced to a mere opinion ‘unable to annul illegal measures adopted by national authorities and order the member states to make reparation for the resultant damages’. The argument sustained by the applicants puts the finger on the sore spot; to say that if the Court does not exercise a power it really means that it has not such a power, is a provocative strategy. And the Court reacts, and decides to take over this reasoning:

It would be erroneous to accept that this provision [Art.16 ECSC] enables the Court to interfere directly in the legislation or administration of member states [...] In fact if the Court rules in a judgment that a legislative or administrative measure adopted by the authorities of a member state is contrary to Community Law, that member state is obliged, by virtue of Art. 86 of the ECSC treaty, to rescind the measure in question and *to make reparation* for any unlawful consequences which may have ensued. This obligation is evident from the treaty and from the protocol which have the force of law in the member states following their ratification and which take precedence over national law.

At this point, judges seem to ask themselves if it would be an empty power only to decide on the interpretation of state liability rules, and

d'approvisionnement, de transport et de crédit SA and Grands Moulins de Paris SA v. Commission of the European Communities [1972] ECR 39.

¹⁰ ‘Has the Court’ – asks the AG – ‘as the applicant maintains, the power to make an order affecting the national authorities, that is to say in the present case, the power to order the discharge or the reduction of the contested tax and to order that the consequential relief be given? In my opinion it certainly has not; that would be a clear incursion into the jurisdiction which the national courts have retained; the Court may not substitute its judgment for that of the authorities or of the national courts acting within the scope of the national fiscal legislation’. Opinion of Mr. Advocate Lagrange in case 6/60 *Humblet v. Belgium* [1960] ECR 583.

not to order the reparation of unlawful consequences of legislative or administrative measures of member states.

A second stage of the evolution of the EU liability began with the continuous process of both stressing the second questioning and weakening the first one. In *Commission v. Italy*,¹¹ for instance, appeared again the idea of the vain effects of the Court's decision when it has not a real force or contains no effective sanction. While in the operative part of its decision the Court stated the normal pronouncement that the state had failed to fulfil its 'European obligations', it adds, in the findings of the judgment, that its decision 'may be of substantive interest as establishing the basis of a responsibility that a member state can incur as a result of its default, as regards other member states, the Community or private parties'. At the same time, the ECJ starts to take the first steps in affirming that member states can be liable no matter which organ of the state is responsible for the failure, and that these states may not plead provisions, practices or circumstances existing in its internal legal system in order to justify a failure to comply with the obligations and time-limits under community directives.¹²

Years after the Court solved the *Rewe* case¹³ brought before it via a reference made by the *Bundesverwaltungsgericht*, the German court asked whether, in the case that an administrative body of a state has infringed the prohibition on charges having an effect equivalent to customs duties, the Community citizen concerned has a right under Community Law to ask the annulment or revocation of the administrative measure, and/or to a refund of the amount paid, even if under the rules of procedure of the national law the time-limit for contesting the validity of the administrative measure has expired. The question dealt precisely with the distribution of powers between legal orders. To solve the case, the Court grabbed the language of rights, a technique which was strongly incorporated to European

¹¹ Case 39/72 *Commission of the European Communities v. Italian Republic* [1973] ECR 101.

¹² Case 52/75 *Commission of the European Communities v. Italian Republic* [1976] ECR 277. In the same vein, see C-60/75 *Carmine Antonio Russo v. Azienda di Stato per gli interventi sul mercato agricolo. (AIMA)* [1976] ECR 45; C-52/76 *Luigi Benedetti v. Munari F.lli s.a.s.* [1977] ECR 163.

¹³ Case 33-76 *Rewe-Zentralfinanz eG et Rewe-Zentral AG v. Landwirtschaftskammer für das Saarland* [1976] 1989.

judicial reasoning in the well-known *van Gend en Loos* case.¹⁴ The rules of a regulation 'have a direct effect and confer on citizens rights which the national courts are required to protect'. '[I]t is the national courts which are entrusted with ensuring the legal protection which citizens derive from the direct effect of the provisions of Community Law'. This entails that the domestic legal systems of each member state are the ones that must grant the procedural conditions governing actions 'to ensure the protection of the rights which citizens have from the direct effect of Community Law'.¹⁵

It appears from the forgoing that the idea of direct effect was closely related to state liability for breaches of EU law. At the time of *Rewe* the state of the art on this topic was very clear. On the one hand, both Treaty and regulation provisions had direct effect as ruled in *van Gend en Loos*, and since *van Duyn v. Home Office*¹⁶ also Directives could have direct effect under some circumstances. This direct effect – as will be shown below – implies that those EU norms give rights to the citizens, who can ask for the protection of those rights before their national courts, and that national courts are obliged to provide the conditions to protect them. Thus, assimilating the consequences of the direct effect doctrine, national courts understand their Community role within the judicial structure as supervisors in the implementation and application of Community law by legislative authorities.¹⁷ And, in the same vein, the power of the ECJ was understood actively and not only passively, since it can impose obligations on member states precisely to protect rights of citizens.

Furthermore, since the first cases of liability of European institutions both under the interpretation of Arts 178 and 215 EEC, 34 and 40

¹⁴ Case 26-62 NV *Algemene Transport- en Expeditie Onderneming van Gend & Loos v. Netherlands Inland Revenue Administration* [1963] ECR 1.

¹⁵ In the same line, see case C-101/78 *Granaria BV v. Hoofdprodukschap voor Akkerbouwprodukten* [1979] ECR 623. The rationale of these cases permits to some scholars to claim that the *Francovich's* liability principle was inherent to Community Law even before that judgment. D. F. Waelbroeck, 'Treaty Violations and Liability of Member States: the Effects of the *Francovich* Case Law', in T. Heukels and A. McDonnell (eds) *The Action for Damages in Community Law*, The Hague, Kluwer, 1997, at p. 313.

¹⁶ Case 41-74 *Yvonne van Duyn v Home Office* [1974] 1337.

¹⁷ M. Granger, 'National Applications of *Francovich* and the Construction of a European Administrative Ius Commune', (2007) 32(2) *European Law Review*, at p. 166.

ECSC or 188 and 151 Euratom Treaty,¹⁸ the European courts have begun to consolidate its doctrine of liability of EU institutions and to understand this doctrine and its developments as common rationale to all system of protection of rights. With this assumption the penetration of this construction into the arguments of member states liability was only a question of time.¹⁹

This is the 'atmosphere in which *Francovich* - the most important decision in the framework of state liability and the beginning of the third stage of the evolution of that principle - appears. In this influential decision the ECJ recognised the duty of the member states to make good the damages in citizens' rights caused by breaches of EU Law. Due to its importance, this decision has been largely studied.²⁰ Hence, it will not be analysed in detail here, but its underlying rationale will be reconstructed. The ECJ stated that

¹⁸ About the features of this doctrine, see H. Schermers, T. Heukels and P. Mead (eds) *Non-contractual liability of the European Communities*, Dordrecht, Martinus Nijhoff, 1988.

¹⁹ This argument will be mentioned explicitly afterwards in case C-46/93 and C-48/93 *Brasserie du Pêcheur SA v. Bundesrepublik Deutschland and The Queen v Secretary of State for Transport, ex parte: Factortame Ltd and others* [1996] ECR I-1029.

²⁰ Among others, see R. Caranta, 'Governmental Liability after *Francovich*', (1993) 52(2) *Cambridge Law Journal*, 272-297; A. Carnelutti, 'L'arrêt *Francovich* Bonifaci. L'obligation des États membres de réparer les dommages causés par les violations du droit communautaire', (1992) 1 *Revue du Marché Unique Européen*, at pp. 187-192; P. Craig 'Francovich, Remedies and the Scope of Damages Liability', (1993) 109 *Law Quarterly Review*, 594-621; M. Dougan, 'The *Francovich* Right to Reparation: Reshaping the Contours of Community', (2000) 6(1) *European Public Law*, 103-128; L. Flynn, 'Francovich in the National Courts', (1995) 13 *Irish Law Times and Solicitors' Journal*, at p. 16; J. E. Hanft, 'Francovich and Bonifaci v. Italy: EEC Member State Liability for Failure to Implement Community Directives', (1992) 15(4) *Fordham International Law Journal*, 1237-1274; C. Harlow, 'Francovich and the Problem of the Disobedient State', (1996) 2(3) *European Law Journal*, 199-225; T. L. Hervey, 'Francovich Liability Simplified', (1997) 26 *Industrial Law Journal*, at pp. 74-79; M. Künnecke, 'Divergence and the *Francovich* remedy in German and English courts', in S. Prechal and B. van Roermund (eds) *The Coherence of EU Law: The Search for Unity in Divergent Concepts*, Oxford, Oxford University Press, 2008; L. Neville Brown 'State Liability to individuals in Damages: An Emerging Doctrine of EU Law', (1996) 31 *Irish Jurist Reports*, 7-21; M. L. Ogren, 'Francovich v. Italian Republic: Should Member States be Directly Liable for Nonimplementation of European Union Directives?' (1994) 7 *The Transnational Lawyer*, at p. 583; M. Ross, 'Beyond *Francovich*', (1993) 56 *Modern Law Review*; E. Scoditti, 'Francovich' presa sul serio: la responsabilità dello Stato per violazione del diritto comunitario derivante da provvedimento giurisdizionale', (2004) 4 *Il Foro italiano*, at p. 4-7; H. Smith, 'The *Francovich* Case: State Liability and

The full effectiveness of Community rules would be impaired and the protection of the rights which they grant would be weakened if individuals were unable to obtain reparation when their rights are infringed by a breach of Community law for which a member state can be held responsible. Such a possibility of reparation by the member state is particularly indispensable where the full effectiveness of Community rules is subject to prior action on the part of the state and where, consequently, in the absence of such action, individuals cannot enforce before the national courts the rights conferred upon them by Community law [...] It follows that the principle whereby a state must be liable for loss and damage caused to individuals by breaches of Community law for which the state can be held responsible is inherent in the system of the Treaty.

Francovich liability meant a radical change in the way in which Community Law would deal with states' infringements. Indeed, it meant an evolution from a flexible mechanism to deter states from committing wrongs to a more direct and inflexible respond towards EU law breaches. According to the former, the solution to face the infringement is 'institutional', given that the Commission is competent to adopt the measure and decide whether to bring the state involved before the Court or agree with its different plans for restituting the legal order. At the same time, it is the Commission, as an EU institution, that balances the European interests, the national sovereignty, and the private interests. On the other hand, the *Francovich* doctrine entitles private citizens before a wide range of national courts with the power to question the actions of their member state. This entail that the states' breaches of EU law are solved at a judicialised environment, and not any more allowing negotiations or agreements among the states and European institutions.

It is seemingly clear that after *Francovich*, member states wanted to stop judicial activism through the reform of the mechanism of penalty payments for breaches under Art. 228 EEC (old Art. 171), expressing an unambiguous sign to recover the flexible mechanism before the Commission and undermining the liability model.

the Individual's Right to Damages', (1992) 13(3) *European Competition Law Review*, at pp. 129-132.

Following the will of member states, the 1992 Maastricht Treaty changed Art. 171 in order to enable the ECJ to order lump-sum payments or penalties to be paid by member states for non-compliance with one of its judgments. The *raison d'être* of the change was to develop a more credible public alternative to the *Francovich* mechanism. In other words, after the change it would be 'more difficult for the Court to extend the non-contractual liability doctrine based on the argument that no credible alternative for enforcing Community legislation existed'.²¹ But the amendment came late, the *Francovich* doctrine had come to stay.²²

Moreover, despite the fact that *Francovich* had been the attempt to solve a specific case of non-transposition of directives, it was clear from the beginning that its rationale could be applied beyond the boundaries of this breach, regardless of the warnings that some scholars pointed out during the time after this decision concerning the problems of such a likely broadening.²³

Thus, new types of breaches were added after *Francovich*, and new kind of acts were subjected to the liability control exercised by the ECJ. Indeed, the failure or the delaying on the transposition of a directive was reaffirmed in *El Corte Ingles*,²⁴ in *Dillenkofer*,²⁵ in *Bonifaci*,²⁶ in *Palmisani*,²⁷ in *Maso*,²⁸ in *Rechberger*²⁹ and in *Robins*;³⁰

²¹ 'Moreover, member states gave a significant political signal by *not* picking up the *Francovich* doctrine with any provisions in primary law. Individuals were *not* granted the written right in Community law to proceed against member states for breaches of Community law and no mention is made of damage compensation to be paid to individuals for state acts not compatible with European law'. B. van Roosebeke, *State Liability for Breaches of European Law: An Economic Analysis*, Wiesbaden, Deutscher Universitäts-Verlag, 2007, at pp. 72-73.

²² '*Francovich* must then be seen as an assertion of power or even act of defiance by the ECJ – it was certainly not a step taken at the behest of the member states'. C. Harlow, *State Liability. Tort Law and Beyond*, Oxford, Oxford University Press, 2004, at p. 58.

²³ See Craig, *supra*, note 20, at p. 604ff.

²⁴ C-192/94 *El Corte Inglés SA v. Cristina Blázquez Rivero* [1996] ECR I-1281.

²⁵ C-178/94, C-179/94, C-188/94, C-189/94 and C-190/94 *Erich Dillenkofer, Christian Erdmann, Hans-Jürgen Schulte, Anke Heuer, Werner, Ursula and Trosten Knor v. Bundesrepublik Deutschland* [1996] ECR I-4845.

²⁶ C-94/95 and C-95/95 *Danila Bonifaci and others and Wanda Berto and others v. Istituto nazionale della previdenza sociale* [1997] ECR I-3969.

²⁷ C-261/95 *Rosalba Palmisani v. Istituto nazionale della previdenza sociale* [1997] ECR I-4025

national statutes that were found to be contrary to EU law were understood as ground of liability since *Brasserie du Pêcheur*,³¹ *Eunice*³² and *Konle*;³³ not proper incorporation of directives – if they fulfil the general requirements – could give rise to liability since *British Telecommunications*³⁴ or *Denkavit*;³⁵ and administrative acts should be as well subjected to the control of the court since *Hedley Lomas*,³⁶ *Norbrook*³⁷ and *Salomone Haim*.³⁸ Since *Köbler*,³⁹ even court decisions were considered as able of causing damages when contrary to EU Law. Finally, the obtaining of compensation by lawful statutes had been also considered and evaluated by European courts as perfectly possible.⁴⁰

²⁸ C-373/95 *Federica Maso and others and Graziano Gazzetta and others v. Istituto nazionale della previdenza sociale and Repubblica italiana* [1997] ECR I-4051.

²⁹ C-140/97 *Walter Rechberger, Renate Greindl, Hermann Hofmeister and Others v. Republik Österreich* [1999] ECR I-3499.

³⁰ C-278/05 *Carol Marilyn Robins and Others v. Secretary of State for Work and Pensions* [2007] ECR I-1053.

³¹ *Supra*, note 3.

³² C-66/95 *The Queen v. Secretary of State for Social Security, ex parte Eunice Sutton* [1997] ECR I-2163.

³³ C-302/97 *Klaus Konle v. Republik Österreich* [1999] ECR I-3099.

³⁴ C-392/93 *The Queen v. H. M. Treasury, ex parte British Telecommunications plc.* [1996] ECR I-1631.

³⁵ C-283/94, C-291/94 and C-292/94 *Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v. Bundesamt für Finanzen* [1996] ECR I-5063.

³⁶ C-5/94 *The Queen v Ministry of Agriculture, Fisheries and Food, ex parte: Hedley Lomas (Ireland) Ltd.* [1996] ECR I-2553. Even some scholars have argued that breaches of International agreements can be sanctioned through state liability. See P. Gasparon, 'The Imposition of the Principle of Member State Liability Into the Context of External Relations', (1999) 10(3) *European Journal of International Law*, 605-624.

³⁷ C-127/95 *Norbrook Laboratories Ltd v. Ministry of Agriculture, Fisheries and Food* [1998] ECR I-1531.

³⁸ C-424/97 *Salomone Haim v. Kassenzahnärztliche Vereinigung Nordrhein* [2000] ECR I-5123.

³⁹ C-224/01 *Gerhard Köbler v. Republik Österreich* [2003] ECR I-10239.

⁴⁰ T-138/03 *É. R., O. O., J. R., A. R., B. P. R. and Others v. Council of the European Union and Commission of the European Communities* [2006] ECR II-4923. 'The second paragraph of Article 288 EC bases the obligation which it imposes on the Community to make good any damage caused by its institutions on the 'general principles common to the laws of the member states' and therefore does not restrict the ambit of those principles solely to the rules governing non-contractual liability of the Community for unlawful conduct of its institutions. National laws on non-contractual liability allow individuals, albeit to varying degrees, in specific fields and in accordance with differing rules, to obtain compensation in legal proceedings for certain kinds of damage, even in the absence of unlawful action by the perpetrator of the damage. When damage is caused by conduct of the Community institutions not

Thus, through the analysis of all these decisions, it is possible to reconstruct the functioning of the current system of member state liability for breaches of EU Law as containing the following features:

- 1) State liability for breaches of EU Law is a principle inherent in the system of the Treaty that applies to any case in which a member state breaches Community law, whichever is the authority of the member state whose act or omission is responsible for the breach,⁴¹ and whichever public authority is in principle, under the law of the member state concerned, responsible for making reparation.⁴²
- 2) Three conditions must be fulfilled to cause member state liability for breaches of EU Law, namely a) the rule of law infringed by the state must be intended to confer rights to persons; b) the breach must be sufficiently serious; and c) there must be a direct causal link between the breach of the obligation and the damage sustained by the injured party.⁴³
- 3) It is for the national courts to determine whether the conditions for member state liability for breaches of Community law are met. The ECJ may nevertheless indicate certain circumstances which the national courts should take into account in their evaluation.⁴⁴

shown to be unlawful, the Community can incur non-contractual liability if the conditions as to sustaining actual damage, to the causal link between that damage and the conduct of the Community institutions and to the unusual and special nature of the damage in question are all met'. In the same vein, see the so called 'Banana saga': Cases T-69/00 *Fabbrica italiana accumulatori motocarri Montecchio v. Council of the European Union and Commission of the European Communities* [2005] ECR II-5393; T-151/00 *Le Laboratoire du Bain v. Council of the European Union and Commission of the European Communities* [2005] ECR II-23; T-383/00 *Beamglow Ltd v. European Parliament, Council of the European Union and Commission of the European Communities* [2005] ECR II-5459; T-135/01 *Giorgio Fedon & Figli SpA, Fedon Srl and Fedon America, Inc. v. Council of the European Union and Commission of the European Communities* [2005] ECR II-29 and the recent and ambiguous judgment of 9 September 2008 C-121/06P *FIAMM and FIAMM Technologies v Council and Others*.

⁴¹ *Supra*, note 39.

⁴² *Supra*, note 33.

⁴³ *Supra*, note 3.

⁴⁴ *Inter alia*, C-150/99 *Svenska staten v. Stockholm Lindöpark AB and Stockholm Lindöpark AB v. Svenska staten* [2001] ECR I-493.

- 4) Although national legislation on liability regulates the obligation for the state to make reparation for the consequences of the loss or damage caused, the conditions for reparation of that loss laid down by national law on cases of breaches of EU Law must not be less favourable than those relating to similar domestic claims and must not be so framed as to make it virtually impossible or excessively difficult to obtain reparation.⁴⁵
- 5) In order to determine whether there is a serious breach of Community law, account must be taken of the extent of the discretion enjoyed by the member state concerned in taking the measure subjected to judicial review. However, the existence and the scope of that discretion must be determined by reference to Community law and not by reference to national law. The sphere of discretion, which may be conferred by national law on the official or the institution responsible for the breach of Community law, is therefore irrelevant in this respect.⁴⁶ At the same time, in cases where the allegedly wrongful act committed by the state consists of legislative action involving measure of economic policy, the applicant, following the *Schöppenstedt* case,⁴⁷ must prove that the act consists of a sufficient flagrant violation of a superior rule of law and that the rule of law is for the protection of the individuals.⁴⁸
- 6) The ECJ has empowered national courts to determine when an infringement of Community law by a member state constitutes a sufficiently serious breach with a very open and flexible (if not ambiguous) method. As the ECJ has pointed out, 'a national court hearing a claim for reparation must take account of all the factors which characterise the situation put before it. Those factors include, in particular, the clarity and precision of the rule infringed, whether the infringement and the damage caused was intentional or involuntary, whether any error of law was excusable or inexcusable, and the fact that the position

⁴⁵ *Supra*, note. 26.

⁴⁶ *Supra*, note 38.

⁴⁷ Case 5/71 *Zuckerfabrik Schöppenstedt v. Council* [1971] ECR 975.

⁴⁸ Case C-213/89 *R. v. Secretary of State for Transport, ex parte Factortame Ltd. Ans others* [1990] ECR I-2433.

taken by a Community institution may have contributed towards the adoption or maintenance of national measures or practices contrary to Community law'.⁴⁹ Therefore, it remains unclear which of these elements must exist to cause liability, since the court asks national courts to take into account 'all of them' for evaluating the admissibility of the claim, but at the same time it only exemplifies a couple of them.

As we can see, through development of the case law, the ECJ has empowered national courts with a very forceful tool, i.e. the competence to analyse the European legality of national public acts in the moment when they assign to those acts the category of 'wrong' originating compensation to citizens affected by them. Two immediately consequences can be derive from this overall system of compensation fashioned by the court. It gives citizens some kind of 'right to enforce rights' since it aims to protect supposedly stated rights, and it gives national courts the power to remedy damages caused on citizens goods through the levying of an obligation on states' budget to pay them a quantity equal to the damage. However, these two consequences of *Francoovich* liability and the features of it mentioned above cannot be spontaneously auto-derived. Rather, for being sustained in a coherent way, it is necessary to assume the following specific premises.⁵⁰

First of all, the ECJ doctrine on state liability needs to presuppose that EU Law produces immediate rights on citizens. On this regard, every decision of compensation is always an exercise of comparison between an action, an omission or a rule with other rules that contain either a general ground of liability or precise causes of it. To bring about a result from this contrast we need to precise the contents of the latter rule, which means to individualise the obligations drawn by

⁴⁹ *Supra*, note 38. In the same vein, C-63/01 *Samuel Sidney Evans v. The Secretary of State for the Environment, Transport and the Regions and The Motor Insurers' Bureau* [2003] ECR I-14447. In the case of liability by the national Courts' decisions and in order to determine whether the infringement is sufficiently serious the ECJ has argued that 'the competent national court must, taking into account the specific nature of the judicial function and the legitimate requirement of legal certainty, determine whether that infringement is manifest'. *Supra*, note 39.

⁵⁰ A detailed study of these premises will overflow the boundaries of this research, so we will only limit here to enunciate them.

it.⁵¹ The research of this topic leads to the well known problem of the direct effect of the EU Law – a field where several studies have been done and where we will not enter mainly because the considerable size and depth of the debate⁵² – ever since the idea of contrasting presupposes the understanding of the type of relation among the rules involved in the contrasting.

However, it is worth to point out that the explanation of this first premise is strongly complex since one of the key ideas of direct effect is related precisely with the creation of individual rights. Thus, it represent a curious paradox that the explanation of the conferral of rights on individuals generated by EU Law provokes an argumentative circle since, as it has been argued, the necessary precondition for the existence of direct effect is precisely that conferral.⁵³

Secondly, we must assume that rights imposed by EU Law contain clear obligations and that national regulations cannot be valid if they lessen the contents of those rights. In other words, it must be presupposed that rights imposed by EU Law are understandable by themselves and that they cannot be appreciate in relation or in coordination with national legal orders.

⁵¹ This is the way by which the control of legality/constitutionality has been fashioned at the national level.

⁵² See, among others, H. P. Ipsen, 'The Relationship Between the Law of the European Communities and National Law', (1965) 2 *Common Market Law Review*, 379-402; P. Pescatore, 'The Doctrine of Direct Effect: An Infant Disease of Community Law', (1983) 8 *European Law Review*, 155-177; P. Craig, 'Once Upon a Time in the West: Direct Effect and the Federalization of EEC law', (1992) 12(4) *Oxford Journal of Legal Studies*, 453-479; P. Craig, 'Directives: Direct Effect, Indirect Effect and the Construction of National Legislation' (1997) 22 *European Law Review*, 519-538; S. Enchelmaier 'Supremacy and Direct Effect on Community Law Reconsidered, or the Use and Abuse of Political Science for Jurisprudence' (2003) 23 *Oxford Journal of Legal Studies*, 281-299.

⁵³ From this point of view, 'direct effect' is understood as 'the capacity of a provision of EC law to confer rights on individuals which they may enforce before national courts'. P. Craig and de G. Búrca, *supra*, note 1, at p. 180. A large part of this conundrum is clearly caused by the ambiguity of the term 'right'. The mere faculty to invoke something before courts or a specific content of this invocation can be understand as the contents integrated in the idea of rights and the consequences of each understanding will deeply change the way to comprehend the form to enforce them.

Accordingly, since the object of comparison is national law, it is binding to take for granted that European Law, as the parameter of constitutionality, cannot be integrated by the group of national rules that could be contested. Nevertheless, this conclusion is in clear contradiction with several claims made by the ECJ on other matters. Firstly, it contradicts the integration of the system of European liability stated by Art. 288.2 EEC where the general principles common to the laws of the member states must be taken into account in the creation of this system. Secondly, it is hardly compatible with the idea of the constitutional common traditions of the states as a way to complement the constitutional law of the EU. Finally, it is clearly incoherent with the structure of normative sources where national legislation is the way to enforce and develop the aims contained in directives.

Thirdly, it must be understood that it is inherent to a process of conferral of rights that the way to enforce them has to be implemented through the design of an action of compensation when a public or private act diminishes the contents of those rights.⁵⁴ Nonetheless, I think that it can also be accepted that compensation should not be inherent to the structure of rights and that there could be other ways to enforce them, but even in this case it must be accepted that compensation is the most efficient form to protect those rights.

However, these premises are not easy to accept. As the early EU Law taught us, compensation is not the only way to enforce rights. Indeed the so-called 'public enforcement' – i.e. the use of governmental agents to detect and to sanction violators of legal rules⁵⁵ – stated on Art. 228 EEC is a strong instrument to protect a vast number of rights, in the same way, for instance, as Criminal or Environmental responsibility protects several and defined public goods.⁵⁶ On the

⁵⁴ See Craig (1997), *supra*, note 52, at p. 77ff.

⁵⁵ A. M. Polinsky and S. Shavell, 'The Theory of Public Enforcement' in A. M. Polinsky and S. Shavell (eds) *Handbook of Law and Economics*, vol. 1, Amsterdam, North Holland, 2007, at p. 405.

⁵⁶ For that reason, it is unsupported the argument that the Treaty contained no provisions concerning the consequences of breaches of Community Law by member states and that the liability rule was only conceived through a method of Treaty interpretation pursuant to Art. 164 of the Treaty. *Supra*, note 3; Craig (1997), *supra*, note 52, at p. 78.

other hand, concerning the level of efficiency there is no agreement whether the private enforcement such as the current mechanism of *Francovich* state liability is more efficient than the above mentioned public enforcement. For instance, regarding the deterrence effect of both types of enforcement van Roosebeke contents that public enforcement can be more efficient than private one in diminishing some kinds of states wrongs.⁵⁷

Finally, it must be assumed either that there exists a rule that entitle national courts to protect rights through a compensation system and that those courts are the ones who must operationalise that system, or without existing a specific rule, this entitlement is inherent to the conferral of rights. However, it is quite clear that the treaties do not contain such a rule, as it does exist in the field of liability of European institution. On the other hand, the argument of the inherence of the empowerment of national judges as a way of protecting rights is clearly unconvincing.⁵⁸ In fact there are countries where despite certain rules are fashioned through the form of rights, the enforcing of those rules is not developed before national courts through compensation actions. In federal states like the United States, for instance, it is a general rule that the enforcement of Federal statutes cannot be done through action of compensation initiated by national citizens before its national courts. In this sense, the Supreme Court has repeatedly held that the Eleventh Amendment to the Constitution established on that regard a constitutional rule of state immunity⁵⁹ and that only the legislatures of the states can limit their sovereignty through a regulation of liability. This is so mainly because this regulation calls for 'a careful weighing in the balance of public interest against that of the individuals, an estimation of the remoteness and foreseeability of the damage, and an assessment of the expense and administrative difficulty involved'.⁶⁰ This idea of balancing of the interests involved was clearly exposed by Mr. Justice Holmes in *Kawananakoa v. Polyblank* when he claimed that '[a]

⁵⁷ See Van Roosebeke, *supra*, note 21, at p. 203ff.

⁵⁸ The question of the relation between rights and judicial protection is far from being simple as Beljin have pointed out. S. Beljin, 'Rights in EU Law', in S. Prechal, and B. van Roermund (eds) *The Coherence of EU Law. The Search for Unity in Divergent Concepts*, Oxford, Oxford University Press, 2008, at p. 98ff.

⁵⁹ See *Alden v. Maine* [1999] 527 U.S. 706.

⁶⁰ H. Street, 'Tort Liability of the State: The Federal Tort Claims Act and the Crown Proceedings Act', (1949) 47 *Michigan Law Review*, at p. 367.

sovereign is exempt from suit, not because of any formal conception or obsolete theory, but on the logical and practical ground that there can be no legal rights as against the authority that makes the law on which the right depends'.⁶¹

Thus, in a large series of cases, which began with *Seminole Tribe v. Florida*,⁶² the Supreme Court of the United States has consistently held that the Congress may not authorise individuals to sue states in federal courts for damages to enforce laws regulating state commercial activity.⁶³ As we can see, the support of the *Francovich* doctrine is not precisely strong enough. More than a few of its assumptions are not supported by convincing justifications. This panorama generates problems in several fields linked to the very design of the EU architecture, and this is so because the decision to implement a mechanism of public liability in the way stated in *Francovich* implies a diverse range of other decisions. As mentioned above, when the Court decides to give damages it decides about both a design of the distribution of powers within the Union, a particular way to develop both the process of enforcing EU Law and the relation between that process and the national legal orders, and a certain model both of how to distribute in a more efficient way the economic resources and of how to build a specific community of risks. These implicit choices, indeed, reveal how important the decision to implement a mechanism of enforcing EU Law via compensation is, and how necessary the legitimacy of a decision is when it involves a series of other options that at the end of the day fashion the specific way by which we look at the EU and its relation with the member states.

Accordingly, a weak structural basis of that fundamental decision of damages can cause serious problems in the other collateral decisions, as will be shown below, and it enable us to comprehend where is the legitimacy deficit located and how can we begin to reconstitute it.

⁶¹ 205 U.S. 349 (1907)

⁶² 517 U.S. 66 (1996). In the same vein, *Alden v. Maine*, 527 U.S. 706 (1999); *Florida Prepaid Postsecondary Educ. Expense Bd. V. College Savings Bank*, 527 U.S. 627 (1999); *College Savings Banks v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 527 U.S. 666 (1999).

⁶³ See J. Pfander, 'Member State Liability and Constitutional Change in the United States and Europe', (2003) 51(2) *American Journal of Comparative Law*, at p. 237.

The incidence of liability in the design of the distribution of powers in the EU

One of the most important theorist of public tort law in the United States, Peter Schuck, wrote that 'if we would design a just and effective system of public tort remedies, we must first ask ourselves how we wish to be governed'.⁶⁴ In fact, it is uncontested that private theory of tort law is an important part of the study of European liability, but only its combination with the theory of judicial review of acts of public bodies can explain state torts in a more suitable way.⁶⁵ When a court deals with a case of liability of public powers (either of member states or of Community institutions) the problem is not only to look for a fair compensation of the damages that apply the principles of commutative justice or to find the best corrective sanction. In cases of liability for normative acts there is a legal rule that supports the action considered against EU Law by the court, and to tackle this type of liability implies, thus, to make a comparative judgment between the normative act that has been challenged as unlawful and the EU rule that stands as a parameter. Public liability is, therefore, a decision about how we wish to be governed because it always involves an idea of how to design checks and balances between public powers, and how to build a suitable relationship between norms.⁶⁶ To give the power to compensate citizens for the damages produced by unlawful statutes, for example, entail always a power to review them.

On this regard, it is common that one of the strong arguments used by supporters of *Francoovich* liability is the inherency of the compensation system when assuming the supremacy of the EU Law,

⁶⁴ P. Schuck, *Suing Government*, New Haven, Yale University Press, 1983, at p. 1.

⁶⁵ M. Andenas and D. Fairgrieve, 'Sufficiently Serious?: Judicial Restraint in Tortious Liability of Public Authorities and the European Influence', in M. Andenas (ed.) *English Public Law and the Common Law of Europe*, London, Key Haven, 1998, at p. 295ff.

⁶⁶ This way of thinking explains better the restrictions, conditionings, or additional requirements posed by the Court in judging public liability. The requirement of a 'sufficiently serious breach' of the EU rule of law, the restrictive approach when the unlawful act is a choice of economic policy or the exceptionality of the liability for judicial acts shows the different approach between this kind of liability and the private one. Indeed, those restrictions are better explained from a public perspective of distribution of power than a private one focused only in a corrective or commutative justice.

or better, when a superior rule of law gives rights to citizens.⁶⁷ This argument, however, is clearly fragile, because in national systems even acts *prima facie* against rights can be considered legitimate and can be protected by law. In fact, it is possible to say that the relation between norms inside national orders has not been built upon a simple structure of reasoning such as the mere application of the hierarchy principle. Accordingly, this relation has been understood in a way where decisions that contravene a superior rule not always deserve the nullity or the compensation to supposedly affected citizens. In the case of judicial review of legislation – and this is the central feature of the European model by contrast with the American one – there is some kind of ‘regulated hierarchy’ by which the Law rules the relation between norms and the effects of a possible contravention. The judicial review is in this vein a regulated, positivised and rationalised function. As Cruz Villalón says; ‘by contrast to the unlimited scope of the principle of the primacy of the Constitution, in the way in which courts actually understand it and interpret it, in the European system, it is the legislature, normally constituent power, the one that determines which are the specific consequences for statutes derived from the principle of supremacy of the Constitution: which is the content and scope of the principle, who and before whom it can be invoked, with what consequences’.⁶⁸ Thus it is common to see that in several countries statutes are set aside by Constitutional Courts, but its past effects are protected by law and this protection involve the impossibility to ask damages caused by the annulled norm.⁶⁹ In other legal orders the Constitution states that the unconstitutionality only generates the abolition of the norm, with

⁶⁷ See, for instance, *Opinion of Mr. Advocate General Mischo in case C-6/90 and C-9/90 Andrea Francovich and Danila Bonifaci and others v. Italian Republic* [1991] ECR I-5357; *Opinion of Mr. Advocate General Tesouro in case C-46/93 and C-48/93 Brasserie du Pêcheur SA v. Bundesrepublik Deutschland and The Queen v. Secretary of State for Transport, ex parte: Factortame Ltd and others* [1996] ECR I-1029; Hanft, *supra*, note 20, at p. 1266ff. On the other hand, the idea of rights as the central point in the public liability debate has been strongly pointed out by I. B. Lee, ‘In Search of a Theory of State Liability in the European Union’, (1999) 9 *Harvard Jean Monnet Working Paper*, at p. 50ff.

⁶⁸ P. Cruz Villalón, *La formación del sistema europeo de control de constitucionalidad (1918-1939)*, Madrid, Centro de Estudios Constitucionales, 1987, at pp. 32-33.

⁶⁹ Even the same consequence must be sustained when the ECJ exercise the power that Art. 231.2 EEC entrust it, that is, to state which of the effects of a regulation that has been declared void by the Court shall be considered as definitive. This power, even when it was settled only for regulations, it has been used as a general competence of the ECJ in cases of nullity of European norms. See R. Letelier, ‘Nullity and Restoration in EU Law’, (2007) 1 *Europe and Law Journal*, at p. 26ff.

the consequences that no action on damages can be exercised since the court acts only as 'negative legislature' paraphrasing Kelsen's famous words. As we can see this way of thinking involves a specific position about the nature and importance of statutes. They are conceived as the most perfect exercise of representative powers, and as such, they enjoy some kind of 'democratic dignity'.⁷⁰ This dignity imposes that the relation of hierarchy with the Constitution is not understood as a zero-sum game, but it admits strong and deep nuances.

Consequently, the relation of norms must not be deduced only from a rights-based structure, but it must be constructed from the perspective of the specific design of allocation of powers that the society is willing to have in a particular moment of its history.⁷¹ This

⁷⁰ Among others, see J. Waldron, *The Dignity of Legislation*, Cambridge, Cambridge University Press, 1999; id., *Law and Disagreement*, Oxford, Oxford University Press, 1999; F. J. Laporta, *El imperio de la Ley: una visión actual*, Madrid, Trotta, 2007.

⁷¹ The problem concerning which is the Court entitled to determine the nullity of acts of the European institutions is a good example of the assertion that hierarchy or conferral of rights does not determine by themselves the competence of national courts for protecting those rights or this legal order. Indeed, since the ECJ had held that national courts were also judges of the European Law, and that pursuant Art. 234b EEC national courts must only refer questions to the ECJ in case of doubts, it was perfectly possible that national courts were entitled to set aside acts of the European institutions when they contravene in a explicit way the contents of the treaties. But, despite this, the ECJ retained this competence ruling in *Foto-Frost* that national courts can consider the validity of those acts only in a positive way that means only considering that this act is valid. On the contrary, the decision points that national Courts 'do not have the power to declare acts of the Community institutions invalid', mainly because 'the main purpose of the powers accorded to the Court by Article 177 is to ensure that Community law is applied uniformly by National Courts'. 'That requirement of uniformity is particularly imperative when the validity of a Community act is in question. Divergences between courts in the member states as to the validity of Community acts would be liable to place in jeopardy the very unity of the Community legal coherence of the system of judicial protection established by the treaty'. Case 314/85 *Foto-Frost v. Hauptzollamt Lübeck-Ost*. [1987] ECR 4199. The same rationale can explain the restricted competence of ECJ in cases of liability of European institutions. 'Since the Community judicature has exclusive jurisdiction under Article 215 of the Treaty (now Article 288 EC) to hear actions seeking compensation for such damage, remedies available under national law cannot ensure effective protection of the rights of individuals aggrieved by measures of Community institutions'. T-18/99 *Cordis Obst und Gemüse Großhandel GmbH v. Commission of the European Communities* [2001] ECR II-913. In the same line, T-52/99 *T. Port GmbH & Co. KG v. Commission of the European Communities* [2001] ECR II-00981.

design shapes at the same time both the contents of rights and the allocation of public powers synthesising the ancient task of societies, namely the optimisation both of private and public goods. Therefore, the option for a liability system implies a policy-making decision, even when its justification is right-based. The decision to enforce rights as the main requirement to determine the existence or inexistence of liability cannot be an independent, neutral or 'aseptic' decision.⁷²

Despite this, the logic applied by the Court when it compels states to make good damages is based on a very instrumental idea of compensation, because, as shown above, it is conceived only as a consequence of the protection of rights. Following Cohen, that simplistic idea ignores the special characteristics of one of the actors and overlooks the institutional position of the Court within the architecture of public powers. It fails as well to appreciate the peculiar role of the state in allocating and distributing wealth, in a variety of forms, to individuals and groups.⁷³ Peter Cane points out this perspective: If the regulation of tort law is a matter of distribution of the benefits and burdens of tort liability and not only a question of commutative justice, one of the challenges with which we must deal is a constitutional one, namely 'to delineate the respective roles of the courts and the other branches of government in expressing distributive judgments through rule-making'.⁷⁴

The incidence of *Francovich* liability in the process of enforcing EU Law and its aptitude to change national law.

The overall implications of *Francovich's* doctrine are not so easy to predict even nowadays. But one thing is at least clear. This theory has penetrated in national legal orders and it has transformed them in a very powerful way. This invasion and transformation is however paradoxical. In fact, one of the main arguments since *Francovich* and mainly through its development in *Brasserie du Pêcheur*⁷⁵ has been that

⁷² See D. Cohen, 'Suing the State', (1990) 40 *University of Toronto Law Journal*, at p. 636.

⁷³ See D. Cohen and J. C. Smith, 'Entitlement and the Body Politic: Rethinking Negligence in Public Law', (1986) 64(1) *The Canadian Bar Review*, at p. 5.

⁷⁴ P. Cane, 'Distributive Justice and Tort Law', (2001) *New Zealand Law Review*, at p. 420.

⁷⁵ *Supra*, note 3.

the liability of states is based on the idea of the existence of common rules among member states' public liability.⁷⁶ The wording of Art. 288.2 EEC applies in this matter since it states that the Community shall make good any damage 'in accordance with the general principles common to the laws of the member states'. In this regard it can be said that the legitimacy of the European system of torts is based on national legal orders. These principles act in liability issues in a similar way as common constitutional tradition act in human rights matters. They integrate the solution and legitimate it.

On the other hand, the national-based construction of the system of liability has also been recognised by ECJ when it held that Community Law 'was not intended to create new remedies in the national courts to ensure the observance of Community Law other than those laid down by national law'.⁷⁷ Through this reasoning the EU Law manifest the will to respect national systems of torts and to use this normative background as a way to enforce European law.

Finally, the idea that the *Francoovich* liability is based in some national rationality by which states face their own liability is reflected in the determination of the extension of the reparation. As the ECJ held the criteria must not be less favourable than those that are applied in national legal orders, and they cannot be such as to make the claims for damages impossible or excessively difficult to obtain a monetary compensation.

Nevertheless the praxis exhibits a clear and contrary tendency. The decisions of the Court in liability matters have meant a real and strong change of national rules on state liability.⁷⁸ In this regard, it is possible to state that EU Law has used national principles on torts to define and complete its system of compensation, but has ignored

⁷⁶ It is curious also that the European Group on Tort Law has renounced to study this topic in its task to identify the common core of European Tort Law. As Fedtke says, state liability 'is too much under the influence of national public law (both administrative and constitutional) as to be amenable to straightforward common solutions'. J. J. Fedtke, 'State Liability in Times of Budgetary Crisis', in H. Koziol and B. C. Steininger (eds) *European Tort Law 2005*, Wien, Springer, 2006, at p. 42.

⁷⁷ Case 158/80 *Rewe-Handelsgesellschaft Nord mbH et Rewe-Markt Steffen v. Hauptzollamt Kiel* [1981] ECR 1805.

⁷⁸ See T. Tridimas, 'Enforcing Community Rights in National Courts: Some Recent Developments', in C. Kilpatrick, T. Novitz and P. Skidmore (eds) *The Future of Remedies in Europe*, Portland, Hart, 2000; Dougan, *supra*, note 20.

other strong principles laid on national states after years of debates and deliberative agreements.

At least three manifestations of this contradiction can be identified. Firstly, in many countries, the influence of *Francovich* liability has changed the current restricted idea of liability, mainly through the transformation of the requirement of 'unlawfulness' of public authorities' acts. The conception of public duties, the idea of proportionality in administrative practice, the premise that an illegal act *per se* will not give rise to damages liability,⁷⁹ for instance, both of them elements developed through decades by judicial decision-making and doctrine, have mutated since this European decision. In Italy, the idea of legitimate interest (*interesse legittimo*)⁸⁰ that constituted a necessary elements for fulfilling the standing's requirement has been affected as well. In the same way, from the perspective of public liability grounds, *Francovich* has obliged UK to evolve from a system of precise causes of public liability to a general action for damages completely strange for UK's common law system.⁸¹

Secondly, in several countries the doctrine of *Francovich* liability produced deep distortions in the regulation of compensation for damages caused by statutes admitting it, although in a very

⁷⁹ See P. Craig, 'The Domestic Liability of Public Authorities in Damages: Lessons from the European Community', in J. Beatson and T. Tridimas (eds) *New Directions in European Public Law*, Oxford, Hart, 1998, at p. 83ff.

⁸⁰ Caranta, *supra*, note 20, at p. 287ff; L. Malferrari, 'State Liability for Violation of EC Law in Italy: The Reaction of the Corte di Cassazione to *Francovich* and Future Prospects in Light of its Decision of July 22, 1999, No. 500', in S. M. de Sousa and W. Heusel (eds) *Enforcing Community law from Francovich to Köbler*, Köln, Bundesanzeiger, 2004.

⁸¹ See R. Thompson, 'The Impact of the *Francovich* Judgment on UK Tort Law', in S. M. de Sousa and W. Heusel (eds) *Enforcing Community law from Francovich to Köbler*, Köln, Bundesanzeiger, 2004, at p. 166ff; M. Hoskins, 'Rebirth of the Innominate Tort?', in T. Tridimas and J. Beatson (eds) *New Directions in European Public Law*, Oxford, Hart, 1998; T. Tridimas, 'Member State Liability in Damages for Breach of Community Law: An Assessment of the Case Law', in T. Tridimas and J. Beatson (eds) *New Directions in European Public Law*, Oxford, Hart, 1998, at p. 91ff. It has meant for UK courts that they have had applied extraordinary efforts to cluster that general ground in one of the traditional causes of liability. The breach of statutory duty seems to be the favourite of the scholars. See J. Convery, 'State Liability in the United Kingdom after *Brasserie du Pêcheur*', (1997) 34 *Common Market Law Review*, at p. 603ff.

restrictive way.⁸² In this regard, e.g. the Federal Supreme Court of Germany has consistently rejected claims of victims based on a budgetary prerogative of the Parliament.⁸³ The important contribution of German Law in this field and the important self restraint attitude of national judges to give this type of compensation have been completely neglected by the ECJ.⁸⁴ Thus, it has obviated the constantly rejection of this instrument by the states.⁸⁵

Thirdly, the *Francovich* doctrine, and in particular the right-based construction of compensation, has produced an evident disrupt in cases of recovery of unlawful payments. Many countries have chosen a system of prospective decision (even giving them constitutional status like in Austria) by which the Courts can manipulate the effects of the annulments of administrative acts or statutes invoking mainly reasons of legal certainty. Also the ECJ has this power in case of annulment of regulations. But the ECJ has understood that only a completely restitution of the unlawful payments by the state can restore the rights of the citizen in a proper way.⁸⁶ The same idea can be applied when the national judges restrict state liability based on the idea that the imposition of a demanding standard of duty of care

⁸² See Lee, *supra*, note 67, at p. 21ff. In France, for instance, despite liability by statutes was recognised before *Francovich*, it was build under the restrictive ground of 'rupture of equality before public burden' and only available for abnormal and special damages caused by legislation. R. Chapus, *Droit administratif général*, 8th ed., Paris, Montchrestien, 1994, at p.1152ff. 'Since *Francovich* calls for something more akin to a fault-based regime, it put pressure on the French courts to modify this case law, to avoid a dual regime for responsabilité du fait des lois, depending on whether a claim fell under the Community umbrella or not'. Granger, *supra*, note 17, at p. 165.

⁸³ Fedtke, *supra*, note 76, at p. 47

⁸⁴ In analysing this topic, we can see very clear the false relation between rights and liability. The fact that a country does not accept compensation for unlawful statutes either because the unlawfulness is declared by no retroactive effects or because this kind of liability is not accepted in general terms does not mean that in this country the Constitution is not enforced.

⁸⁵ See Granger, *supra*, note 17, at p. 163ff

⁸⁶ Cases C-309/85 *Bruno Barra v. Belgian State and City of Liège* [1988] ECR 355; C-62/93 *BP Soupergaz Anonimos Etairia Geniki Emporiki-Viomichaniki kai Antiprossopeion v. Greek State* [1995] ECR I-1883; C-309/06 *Marks & Spencer plc v. Commissioners of Customs & Excise* [2008]; C-199/82 *Administration des finacés de l'État italien v. SpA San Giorgio* [1983] ECR 3595; C-397/98 and C-410/98 *Metallgesellschaft Ltd and Others), Hoechst AG and Hoechst (UK) Ltd v. Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727; C-192/95 a C-218/95 *Société Comateb and others v. Directeur général des douanes et droits indirects* [1997] ECR I-165.

could lead to an undesirable diversion of the limited resources available to the state.⁸⁷

But above all, the change introduced by EU law in national legal orders has spread several questions about the coherence of the system. If national legislations restrict the effects of the annulment of unconstitutional statutes, and restrict as well the compensation for state liability, which would be the reasons that explain why other forms of unlawfulness, such as the breaches of EU law, should have more guarantees.⁸⁸ The principle of equivalence should be applied in this topic. Moreover, if since *Francovich* member states must fix the jurisdiction and the procedure by which that special liability have to be exercised, the problem appears immediately: how can member states deal with a system of liability unknown for them or not ruled by their legal orders.⁸⁹ The ECJ has rather imposed its doctrine of supranational liability on national systems – as Harlow says – in a clear ‘selfish’ way.⁹⁰

Following this reasoning, *Francovich* liability is problematic precisely in its basis because it has not read properly national liability principles. The way out is not simple, and even tougher if this debate is inserted in the bigger discussion about which is the right way to understand the supremacy of EU Law, which is the same debate that neo-constitutionalists and legalists have developed concerning the supremacy of the constitution in the national sphere. Perhaps the greatest expression of this complexity arises when the principles of state liability are constitutionalised, because in this case the discourse of the Court is affecting not only legislation, but overriding or changing member states’ fundamental laws.

⁸⁷ See Fedtke *supra*, note 76, at p. 50; B. Markesinis & J. Fedke, ‘Authority or Reason? The Economic Consequences of Liability for Breach of Statutory Duty in a Comparative Perspective’, (2007) 18(1) *European Business Law Review*, at p 25.

⁸⁸ In relation to damages for violation of constitutional rights, Mullan says that ‘the great variety of rights and freedoms created by the Charter as well as the range of situations in which those rights may be violated suggest strongly that the task of defining the scope of damages for constitutional wrongs involves a careful calibration of a wide range of considerations and factors’. D. Mullan, ‘Damages for Violation of Constitutional Rights – A False Spring?’, (1996) 6(1) *National Journal of Constitutional Law*, at p. 126.

⁸⁹ P. Senkovic, *L'évolution de la responsabilité de l'état législateur sous l'influence du Droit communautaire*, Bruxelles, Bruylant, 2000, at p. 103ff.

⁹⁰ Harlow, *supra*, note 20, at p. 200.

Harlow tries to search for a solution arguing that certain degree of flexibilisation is needed; 'a constructive relationship between the Community organs demands dialogue rather than command and understanding rather than sanction'.⁹¹ But, as it can be expected, the determination of the conditions and procedures for achieving flexibilisation is a very complex task. This latter discussion is tightly connected with the level of Europeanisation required for national decision-making process to be coherent with the design of the institutional set up that has been politically decided.

Liability as a way to encourage efficiency and to build a community of risk

The market has been recognised as the main source of allocation of goods in modern societies, but it is not the only one. Allocation of goods can be done with results similar to the ones of the market, among other ways, by acts of public powers.⁹² When the government levies taxes or when it specifically distributes social welfare benefits it distributes goods among citizens. In this sense, it is possible to assert that the justice's yardsticks are not but the ideological projection of the allocation of goods' systems that one society privileges.⁹³

Accordingly, one of the main justifications of public liability is being a response to, or a consequence of, the structure of rights. If we want to give rights to individuals they must be logically protected by enforcement mechanisms, because otherwise they would be only declarations of intention and not real rights. In this scenery, liability appears evidently as an inherent way to produce that enforcing. This approach is held by the ECJ when it says 'that the purpose of a member state's liability under Community law is not deterrence⁹⁴ or punishment but compensation for the damage suffered by individuals as a result of breaches of Community law by member states'.⁹⁵ The logic behind this assertion is clearly a right-based idea.

⁹¹ Harlow, *supra*, note 20, at p. 200.

⁹² See G. Tarello, *Cultura giuridica e politica del diritto*, Bologna, Il Mulino, 1988, at p. 221ff.

⁹³ Tarello, *supra*, note 92, at p. 229.

⁹⁴ Such as the majority of the scholars think. P. Craig, 'Once More Unto the Breach: the Community Law, the State and Damages Liability', (1997) 113 *Law Quarterly Review*, at p. 85.

⁹⁵ C-470/03 *A.G.M.-COS.MET Srl v. Suomen valtio and Tarmo Lehtinen* [2007] ECR I-02749.

However, this rationale has several problems. First of all, it presupposes that the process of giving rights follows a straightforward and unambiguous logic. Advocates of the line of argumentation which conceives liability as a mechanism of enforcing rights are probably of the opinion that the specific task of giving rights is a political one, while compensation is only an instrumental task. But the problem is that the structure of rights is not so clearly delimited in EU Law; in fact, it is very common that the ECJ creates rights in the very moment of offering the compensation. Hence, on the one hand, the political tasks to give and define rights and, on the other, the commitment to enforce them, have no clear boundaries, and in practice they converge in a single relevant aim: the distribution of economic resources.

A second problem concerns the level of executions of each and all rights. Indeed, this vague scenario of giving and executing rights implies that when the ECJ enforces a certain right it necessarily debilitates others. In fact, when resources are limited and rights are guaranteed in general terms, for instance through constitutional open-texture clauses, the specific way to develop some of those rights is not defined in advance. Thus, when the state compensates some specific action or omission, it moves away money from other items (built with a form of rights as well) of the general budget, e.g., health and other welfare benefits, for covering the right that the Court creates, specifies or intends to protect.⁹⁶ In these terms, the decision of compensation of the ECJ has a very intense political content⁹⁷ and I think it can be affirmed that rights are always in a pitched battle for gaining resources.⁹⁸ Following these reasoning, it can be asserted that

⁹⁶ The way to enforce open texture norms such as the ones that generate some of the fundamental rights is a very complex issue since normally the contents of those rules are left to legislative development. Thus, health, social security and housing rights are prerogatives with soft enforcing since it is not so obvious in which situations it is possible to sue the State for a lacking of those social services, mainly because the standards of service are defined by statutes or regulations, and its level of guarantee depends on the public budget available and of the specific measures taken by the legislature and executive.

⁹⁷ That is, because legal rules are tools or 'an instrument deployed in order to cut down some expenditure here, and to allocate a little more elsewhere'. Fedtke, *supra*, note 76, at p. 42.

⁹⁸ As Holmes and Sunstein pointed out in the sphere of execution of rights, these rights are costly because they always presuppose taxpayer-funding of effective supervisory machinery for monitoring and enforcement. S. Holmes and C. Sunstein,

the measures of execution or the normativity of some rights is precisely the resources that state spend to put them into practice. And the decision of this normativity needs not only a close democratic legitimation but an environment where the public agency that read the social needs and decide where the economic resources are allocated have the skills to do that job properly. In that regard it is not clear that the judiciary would be in the best position to implement this kind of distribution of resources since its capacity of reading these needs is strongly limited. Moreover, the judiciary, as an institution, is also poorly equipped to make assessments of the net social cost or benefit of governmental decisions.⁹⁹

The ideas just mentioned have been extensively developed through the debate about the nature and function of tort law that tackles the ECJ's rationale asserting that the aim of state liability is only a compensative one. Weinrib's proposal is that only corrective justice is the central and immanent topic of tort law, and that is in particular the concept of risk the link between plaintiff and defendant in a relation dominated by his idea of 'correlativity'. The plaintiff's right (recognised by the legal order) constitutes the subject matter of the defendant's duty (not to interfere with the embodiment of the plaintiff's right) in such a way that wrongful interference entails the duty to repair.¹⁰⁰

Instead, Cane's theory of tort law differs from Weinrib's. For Cane, tort liability can be examined from both sides of the relational situation inserting relativity into the analysis. Thus, tort liability is, from the defendant's perspective, a burden in the form of obligation to avoid and repair harm, and from the claimant's perspective, a resource and benefit. Thus, 'when courts make rules about the

The Cost of Rights: Why Liberty Depends on Taxes, New York, W.W. Norton and Co, 1999, at p. 44. 'All rights make claims upon the public treasury'. *Ibid.*, p. 15. The same consideration has been pointed out by Lord Hoffmann in *Stovin v. Wise* [1996] 3 WLR 388 at p. 419.

⁹⁹ Lee, *supra*, note 67, at p. 33. 'Compared to the legislative and executive organs of government, the courts have less flexibility, less access to technical expertise, and less capacity to investigate the social and economic impact of various policies'.

¹⁰⁰ E. Weinrib, *The Idea of Private Law*, Cambridge, Harvard University Press, 1995, at p. 135. And the remedy 'reflects the fact that even after the commission of the tort the defendant remains subject to the duty with respect to the plaintiff's right'. Several effects of this theory can be seen in E. Weinrib, 'Restitutionary Damages as Corrective Justice', (2000) 1(1) *Theoretical Inquiries in Law*, 1-37.

circumstances in which tort liability to repair harm will arise, they contribute to the establishment of a pattern of distribution of that resource and burden within society'.¹⁰¹

One of the strong objections to the distributive justice explanation of tort law is that in tort the justice can be obtained only at local scale, while a distributive goal can only be assessed at global scale.¹⁰² However, this objection, which can be successfully justified in the private liability sphere, is problematic when applied to public tort law since the payer is a public entity guided by a distributive goal and funds come precisely from the community of tax payers. This point of view can justify the restrictive approach of this type of liability. Indeed '[w]here an action in damages is successful, it is ultimately the taxpayer who is called upon to cover the cost. Viewed from that perspective, a public authority should incur liability as a result of legislative action only where the interest of compensating a group of person who suffer loss is judged as more worthy of protection that the interest of the taxpayer'.¹⁰³ This is only part of the arguments that explain why is so important the way by which a society fixed its standards of public liability. As the definition of the burdens of the duty of care implies a decision about distribution of public resources, that definition of burdens can vary according to the capacity of taxation that this community have. And that means that there is not a simple matter of uniform requirements of public liability, without making reference to the way in which each country has decided its own manner to distribute economic resources and public duties.

On the other hand, efficiency is one of the principles that advocates of *Francovich* liability defend. However, this argument suffers also from a pathologic lack of clarity. In fact, efficiency can be understood as a neutral value that strongly depends on which is the task that it aims at improving. In carrying out that task it is not so difficult to see that scholars do not agree about what type of assignment should be

¹⁰¹ Cane, *supra*, note 74, at p. 419.

¹⁰² In the classical example, if four persons have 10 units of goods and A caused the destruction of 4 B's units, the equality will not be restored if A gives B four units. It will be restored only if B receives one unit of each of the others, thereby constituting a new distribution of nine units each. L. A. Alexander, 'Causation and Corrective Justice: Does Tort Make Sense?', (1987) 6 *Law and Philosophy*, at pp. 6-7.

¹⁰³ Tridimas, *supra*, note 4, at p. 32.

considered efficient. Some agree that *Francovich* increases the efficiency of the general system of judicial review,¹⁰⁴ while others refer to some idea of economic efficiency.¹⁰⁵

Concerning the latter, it is far from clear that *Francovich* liability involves such an idea of economic efficiency. In fact, in terms of the deterrence objective pursued by state tort law, there is no empirical evidence to support that conclusion; in addition, not even private torts is conclusive in this respect.¹⁰⁶ Furthermore, even by using a system for measuring the deterrence effects of *Francovich* liability, it has been concluded that this mechanism cannot be efficient in all types of breaches of EU Law.¹⁰⁷

Concerning the community of risks that *Francovich* liability seems to create, we can see that, at a first sight, this type of liability appears as promoting a solidaristic view of the EU since it hinders the transferral of the costs of state's action to other actors within a common area of interest. In fact, one of the explanations of the purpose of that liability uses the externalities theory, which suggests that its purpose 'is to ensure that public decision-makers in each member state internalise the costs which their decisions may impose on interests located in other member states'.¹⁰⁸ In this regard, *Francovich* doctrine would promote 'decisions that maximise the aggregate welfare of the entire Union, and prevent decisions that increase the welfare of one country while imposing greater costs on another'.¹⁰⁹ The problem of this point of view is that the social costs and benefits of it need to be measured.

A democratic point of view of *Francovich* liability

The relation between the effects of *Francovich* liability principle and democracy is twofold. As shown in this chapter, public tort law is a mechanism for allocation of economic resources and this type of allocation is precisely one of the tasks of the political process. Thus,

¹⁰⁴ Waelbroeck, *supra*, note 15, at p. 314.

¹⁰⁵ Although it is referring to the impact of tort on accidents generated by activities of the state itself through bureaucrats and public bureaucracies. Cohen, *supra*, note 72, at p. 213ff.

¹⁰⁶ See D. Dewes, D. Duff and M. Trebilcock, *Exploring the Domain of Accident Law, Taking the facts Seriously*, New York, Oxford University Press, 1996.

¹⁰⁷ See Van Roosebeke, *supra*, note 21, at p. 207ff.

¹⁰⁸ Lee, *supra*, note 67, at p. 24.

¹⁰⁹ Lee, *supra*, note 67, at p. 38.

the questions of why and how to distribute economic wealth can involve a wide component of democratic legitimacy. *Francovich* liability implies a decision of a specific structure of political power allocation and in that choice the ECJ has attributed itself a central role that it is necessary to revisit. The way by which this process of allocation has been carried out must be analysed from a democratic legitimacy perspective, with the purpose of evaluating both the rationale underlying this process and its conformity with democratic values.

On the other hand, *Francovich* liability has meant a strong intervention on national legal orders changing some of its important democratic decisions about how to deal with unlawful acts and how wrongs can be converted or not in compensation. The ECJ has decided not only about European matters but about core components of national systems. This situation must also be considered from a democratic point of view because it involves a group of decisions that not so evidently improves democratic values.

These and other cleavages in the relation between liability and democracy will be specifically tackled in a future paper, the inquiry to be solved being in which way the constitutional set up of *Francovich* liability generates a democratic deficit at EU level, and if so, what are the possible paths for reconstituting European democracy.

Chapter 7a

Taxation, free movement of capital and regulation

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Introduction

This comment aims at assessing the arguments made in the chapters by Agustín José Menéndez and Fernando Losada Fraga regarding the evolution of European integration and the relationship between economic and political rights. Accordingly, the comment starts by clarifying the narratives of the two chapters and linking them to the emergence and development of the Community's sectoral regulatory policies. The comment then relates the chapters to the evolution of the legal and institutional framework of the single financial market, whose features confirm and provide grounds for expanding the arguments in the chapters, particularly in light of the implications of the financial crisis of 2007/2009, which is analysed at the end.

The main arguments of the two chapters

The chapters by Menéndez and Losada reconstruct the evolution of the EU's social and economic constitution by distinguishing between the 'common market approach and the 'single market approach', and also between re-nationalisation and constitutionalisation strategies to achieve European integration. In particular, the chapters explore how

the relationships between economic, insurance and political communities have defined the terms of European integration under each approach and strategy.

Under the common market approach initiated in the 1950s, market integration was meant to proceed in tandem with economic and political integration. In essence, the national relationships between economic, insurance (mutualisation of economic risk) and political communities would have been replicated at the European supranational level. This would be achieved through the exercise of the four freedoms, which would expand the economic rights enjoyed at the national level to the Community. Market integration would then be supported through extensive regulation under the Community method. Further integration would ensue through the Council's decision-making powers, which would progressively mutualise economic risks across member states and realise political integration through the transfer of competences to the Community. The common market approach was put to a stop following the political 'empty-chair crisis' in 1965 – as a consequence of the Commission's supranational proposals for the financing of the common agricultural policy – and also the economic and financial crises of the 1970s, leading to uncoordinated responses by member states, which questioned the feasibility of the European integration project. As Menéndez concludes,

[o]n the one hand, the postwar consensus on the imperative need of the political steering between economic, insurance and political communities was seriously contested. [...] On the other hand, the economic crisis rendered evident that the European institutional structure was not attuned to serve the purpose of collective management of the crisis.

Following the *Eurosclerosis* period between 1965 and 1986, the Single European Act represented the shift to the single market approach. This approach was fundamentally based on the premise that speeding-up market integration in advance and as a priority, would necessarily lead to increased social and political integration. In particular, the market integration would produce spillovers, which would affect the balance of the social and political rights of national communities. This, in turn, would result in strong demand for further European integration in order to restore such balance. The

assessment of Menéndez is that the single market approach has not led as intended by functionalist theories to social and political integration. The Community was not able to provide the constitutional means for restoring the balance of social and political rights. First, the prominence given to the pursuance of economic freedoms by the Community led to a political resistance to further transfer of competences from the national level. Second, the combination in the co-decision procedure of the Council's legitimacy based on the representation of member states with the Parliament's legitimacy based on the representation of European citizens undermined, rather than reinforcing, the democratic legitimacy of the European political process. Indeed, as Menéndez puts it; '[t]his was neither a new decantation of the transmission belt legitimacy, not still a source of direct legitimacy for the Union, but something in between'.

The evolution of the case law of the Court on personal taxes is then tracked and analysed by Menéndez against the background of the common market and single market approaches. The main findings are that during the common market approach, the Court showed self-restraint and unwillingness to review the constitutionality of national personal tax norms. The Europeanisation of personal taxes was a political process to be conducted by the Council. By contrast, under the single market approach, the Court expanded the set of national personal tax norms subject to the scope of European constitutional law. In particular, the Court moved from assessing whether such norms were discriminatory to assessing whether such norms represented obstacles to the exercise of the four freedoms. Furthermore, the Court went as far as employing a restrictive interpretation of the so-called 'cohesion defence' by member states regarding their respective national tax system. In particular, the cohesion argument was shifted to refer more to the impact of national tax norms on the four freedoms, and less to the (political) balance achieved in national tax systems between burdens and benefits. In the view of Menéndez, this undermines the 'claim in the nationalizing, 'social-democrat' federalizing and cosmopolitan strategies, which call for political steering [...] of the relationship between general policy and tax design, and between the different components of the tax system, so as to make the latter capable of discharging complex collective goals.'

In the same vein as Menéndez, Losada's chapter analyses the Court's jurisprudence on the freedom of capital movements. Losada identifies three different stages in the evolution of the Court's reasoning. The first phase corresponds to the 1980s, when the freedom of movement of capital was a complement to the common market approach. In this phase, the exercise of this freedom was significantly constrained in the framework of the Treaty. Accordingly, and by contrast to the other freedoms, the Court followed essentially a renationalisation strategy, which restricted the scope of the freedom of movements of capital.

In the 1990s, the freedom of movement of capital was elevated to the same constitutional status as the other freedoms. The Court broadened consistently in its decisions the scope of this freedom through a range of legal techniques, as identified by Losada, namely through including a range of areas under this freedom, providing a narrow interpretation of national restrictions, and also providing direct effect to the directive 88/361. In this context, Losada considers that in this phase the Court adopted a renationalisation strategy as far as it takes into account the national perspective on sensitive issues regarding the flows of capital. However, and after the introduction of the single currency in 1999, the Court adopts a strategy of constitutionalisation, which is apparent in its rulings on privatisation operations, and particularly with regard to the states' golden-shares. More specifically, the Court places the economic freedoms on a constitutional standing, above matters such as the property ownership system of member states put into question in the golden-shares rulings. Losada concludes that the Court's approach to the freedom of capital movements fits the federalist strategy of ultimately leading to a single community of economic risks.

'No regulation without taxation'

The arguments set out by Menéndez and Losada are worth being explored further and better related to the emergence and development of the Community's regulatory policies. In particular, the single market approach did not only give prominence to the four freedoms. The emphasis on economic market integration also required the promotion of EU-wide sectoral regulatory policies which increasingly replace national policies, for instance in the areas of monetary policy, finance, energy, telecommunications, aviation and maritime safety, etc. These sectoral policies are often supported by

new executive structures (EU committees and agencies) which congregate national regulators and integrate them in the Community method by supporting the Commission's right of initiative and exercise of implementing powers through comitology procedures.

In line with Menéndez and Losada, it can also be argued that such sectoral policies have been implemented without considering the relationship between economic, insurance and political communities. This represents their main limitation and ultimately a potential cause for ineffectiveness. In particular, they decouple the pursuance of economic regulatory policies from the member states' insurance- and political functions. For instance, the setting-up of EU committees and agencies involves the detachment of national regulators from their political and insurance communities to serve Community-wide objectives. As a result, the elaboration of Community policies in this setting is focused on market integration and the regulation of integrating markets. In other words, economic risks are expanded throughout the single market without consideration as to how such risks should be managed politically and mutualised among (ultimately) taxpayers.

Moreover, the reading of Menéndez of the Court's jurisprudence on taxation matters elucidates well the extent to which Community regulatory policies may face serious limitations in the lack of federalisation strategies, which take in social and political rights. More specifically, Menéndez argues that the Court's more recent jurisprudence risks de-stabilising the capability of national taxation systems to pursue complex collective goals due to the Court's emphasis on the four market freedoms. However, in the single market context it appears to be appropriate that taxation systems are indeed de-stabilised as, among other things, income is increasingly drawn from several member states, while negative externalities have more and more a European scope and are not covered by national budgets.

Conversely, it is also true that national tax systems de-stabilise Community regulatory policies for the single market as a whole. Indeed, the power to tax is intimately linked to the power to regulate, to the extent that one can state 'no regulation without taxation'. This is so because regulation is an instrument for safeguarding public goods, while providing a balance between the benefits and burdens

of economic activity. The balance achieved by regulation reflects the political and social choices as to the taking of economic risks and the sharing of such risks among taxpayers. In this context, member states preserve their sovereignty over market regulation to the extent that they hold accountable national regulators and bear the cost of regulatory failures for their respective communities. In this sense, and in the lack of a European federal taxation system, the regulatory policies at the Community level can never lead to a level of market integration which fully expands the scope of the four economic freedoms to that of a single market without political and social mutualisation of the related economic risks through fiscal arrangements.

Therefore, the reasoning in Menéndez' chapter also leads to the finding that the preservation of national taxation powers must necessarily also be understood as an obstacle to the effectiveness of the Community's regulatory policies for achieving a single market. Accordingly, it follows that they must also represent an obstacle to the enhancement of the democratic legitimacy of the EU polity. National taxation powers imply that member states should remain as the intermediaries for the regulation of the single market. Taxpayers will need to continue to rely on national structures to safeguard them from economic risks. The combination of sources of democratic legitimacy in the EU (nationally-based and direct legitimacy) does not provide the answer, as asserted by Menéndez.

The evolution of the law and regulation of the single financial market

The legal analysis of the evolution of the integration of the single financial market confirms and expands the arguments made in Menéndez's and Losada's chapters, particularly in light of the implications of the financial crisis of 2007/2009.

As explained by Losada, the pursuance of the common market approach to financial services was significantly constrained in the framework of the EEC Treaty. In contrast with the other fundamental freedoms, the freedom of movement of capital did not have direct effect in member states. As a result, the freedom to provide financial services could only be invoked on the basis of capital movements which were expressly liberalised by the Council, in accordance with

the original version of Article 61 of the EEC Treaty, which was confirmed by the Court in several occasions as pointed out by Losada. In addition, Article 57 (2) of the EEC Treaty required the Council to act by unanimity on measures concerned with the protection of savings, in particular the granting of credit and the exercise of the banking profession. The economic and political context also did not support a common market approach, as the collapse of Bretton Woods in 1971 and the waves of increases in oil prices implied that the priority was to safeguard member states' monetary and exchange rate policy. This in turn led to the reintroduction of restrictions to capital movements in the few areas where they had been lifted.

The single market approach to financial services started in 1985. There were a number of economic, political and legal factors which provided the conditions for progress in market integration. Economically, by the mid-1980s the member states were only starting to recover from the 1982 recession. There remained high levels of unemployment, declining growth in productivity, loss of market share to the US and Japanese industries, accelerating inflation and rising fiscal imbalances due to the lag between revenues and the government spending required for the upkeep of the welfare state. In addition, the heavy state presence in the economy gave rise to rigidities which prevented a sustainable growth. Instead, growth had to be based more on the operation of markets. In this context, member states were also increasingly interdependent as a result of the increasing trade linkages, capital flows, and obligations stemming from the European Monetary System.

Accordingly, this economic context provided the backing for the political willingness for undertaking economic reform, namely in the direction of market liberalisation and further market integration within the Community. The Community provided the appropriate platform for economic reform of member states, also in terms of leading to deregulation of economic sectors which were very protected at the national level such as financial services. This was supported by the successful UK experience in liberalising financial services since 1979, which therefore provided impetus for the elimination of barriers to financial market integration across the Community. In addition, the liberalisation of international capital flows also meant that member states had less scope for protecting

their financial markets through protectionist measures. Accordingly, there was a shift in member states from regulatory intervention to market liberalisation, which provided further impetus for the financial integration within the Community.

Against this background, the Court's jurisprudence of *Dassonville* (1974) and, in particular, *Cassis de Dijon* (1979) provided the legal approach to enhance market integration, as required by economic and political reasons. In particular, market integration could be advanced by constraining the regulatory autonomy of member states in protecting their national markets. Rather than requiring the coordinated harmonisation of national laws and regulations, the legal approach to market integration could be limited to setting out the minimum requirements at Community level for the operation of mutual recognition between member states. Therefore, market integration could be pursued largely through liberalisation and deregulation. This fitted the economic and political needs of both member states and the Community to advance the single market and the single financial market in particular.

The Commission's 1985 White Paper followed-up to the Court by providing that the cross-border provision of financial services would be facilitated essentially through the extension of the *Cassis de Dijon* doctrine from industrial and agricultural products under Article 28 (ex Article 30) EEC Treaty to the free circulation of 'financial products' throughout the Community. This would involve the application of three legal principles. First, the principle of home-country control, according to which the primary task of regulating a financial institution and its branches established in host-countries would be entrusted to the authorities of the member state of origin. The financial institution would therefore only report to its home-country authorities regarding both domestic and cross-border provision of services directly or through branches. The authorities of the host-country would only have a 'complementary role'. The second principle was the mutual recognition by member states and their respective authorities of the regulatory regimes and practices of each other. Financial institutions would be free to provide financial services directly or through branches in the jurisdiction of host member states, subject to the laws, regulation and supervision of the home-country. For host-countries, this would imply recognising that the safeguard of the public interests underlying financial regulation

in their jurisdictions – such as depositor and investor protection, and financial stability – would be adequately pursued by the home-country authorities. Third, home-country control and mutual recognition would be supported by the minimum harmonisation of national laws, which would set the standards regarding authorisation, supervision and winding-up of financial institutions.

Therefore, the development of the single financial market would no longer depend on the extensive harmonisation of the relevant national laws but rather rely on the ‘regulatory competition’ between member states which would unfold from the application of the principles of home-country control, mutual recognition, and freedom to provide cross-border provision of financial services, directly or through branches, thus without being required to require a separate license in the host-countries. The application of these principles would provide a *single passport* to financial institutions for the provision of services throughout the Community. Accordingly, as financial institutions would be free to select the member state of origin, member states would be required to adapt their laws and regulations to the cross-border business needs of financial institutions in order to both attract and retain them in their jurisdiction. At the same time, the coexistence of several regulatory regimes across the Community for the provision of financial services would set off a dynamic of legal integration, which could eventually lead to the spontaneous harmonisation of national laws on the basis of the most efficient standards. The minimum harmonisation of national laws would prevent a ‘race to the bottom’ by member states on regulatory standards, as well as the application by host-country of the ‘public good exception’ under Article 58 (1) b) of the Treaty. The vision of the White Paper was therefore that market integration would develop out of the dynamics of competitive market forces, whose interaction with national legal orders would lead to positive spillovers in terms of market regulation.

The Single European Act (SEA) introduced three main innovations relevant for the field of financial services. First, the SEA placed the free movement of capital at the same level as that of goods and services. This provided the basis for Directive 88/361, which established the basic principle of free movement of capital as directly enforceable as a matter of Community law, both between member states and with third countries. Second, the SEA lifted the unanimity

requirement and introduced voting by qualified majority for the adoption by the Council of harmonisation measures for the achievement of the internal market, including therefore the single financial market, in accordance with Article 95 (1) (ex 100a). Decisions on fiscal matters remained subject to unanimity. The SEA also broadened the range of legal acts that the Council could enact for fulfilling the internal market. While Article 94 would only contemplate directives as the instrument for the approximation of laws, Article 94 refers to 'measures' which may include both directives and regulations. In addition the SEA also subjected the legislation on internal market to the newly introduced 'co-operation procedure', according to which the Parliament would be consulted by the Council on such legislation. Third, the SEA formally recognised the possibility of comitology procedures as a condition that the Council may set for the exercise by the Commission of delegated powers. The constitutionality of these procedures had been previously challenged before the Court, which confirmed their validity in the *Koster* case.

The Maastricht Treaty also marked the evolution of the single financial market in this period. First, it introduced the co-decision procedure between the Council and the Parliament in Article 251 of the Treaty, which governs the adoption of measures regarding the approximation of national laws under Article 47 EC, the legal basis for the directives regarding the single financial market. Second, the principle of subsidiarity, which was first introduced for environmental policy in the SEA, became of general applicability to all Community policies, including therefore the single financial market. Third, the Maastricht Treaty set out the framework for EMU and the creation of the single currency, involving the establishment of the ECB and the ESCB.

The introduction of the euro implied the establishment of the first regulatory federal structure of the Community through the full transfer of competences on monetary policy to the ECB and the ESCB. This represents the pinnacle of the single market approach. This move towards federalisation was based on the realisation – diagnosed in the 1989 Delors Report – that the development of the single market necessitated more effective co-ordination of economic policy between national authorities, as there was a fundamental incompatibility between (i) full freedom of capital, (ii) freedom to

provide cross-border financial services, (iii) fixed exchange rate under ERM, and (iv) autonomous monetary policy. This was proved correct in 1992/93 when the UK and Italy had to leave the ERM.

The federalisation of the currency and monetary policy in 1999 provided the impetus for the regulatory reform of the single financial market and the introduction of EU-wide regulatory structures. At this stage, functionalist theories as to the spillovers of economic integration into increased market regulation and political integration appeared to be proven correct. The Financial Services Action Plan (FSAP), which was launched in May 1999, provided the basis for the renewal of the Community policy on financial services following the introduction of the euro. Its aim was to introduce and obtain the commitment of the Council, the Parliament and the member states to forty-three (mostly) legislative initiatives for harmonising by 2005 the national laws relating to the provision of financial services. Such initiatives represented a shift from implementing the single passport concept on the basis of minimum harmonisation to an approach based on a high-level of harmonisation of national laws. The obstacles to the cross-border provision of services could not be addressed through the negative integration on the basis of the construction of the single passport. Re-regulation was instead required to replace such obstacles by a regulatory framework designed both for safeguarding the regulatory objectives of member states and for making effective the rights relating to the exercise of the single passport for the provision of financial services. This, in turn, also implied that regulatory policies regarding the provision of financial services would be defined at the Community level, thus prevailing over the national regulatory frameworks and choices. Therefore, the FSAP marked the move from integration to the regulation of the single financial market through Community law.

In 2001, the so-called Lamfalussy Report (after the chairman of a 'Committee of Wise Men' established by the ECOFIN in 2000) provided the overall diagnosis that there was a lack of a EU regulatory system able to provide practical effect to Community legislation and also to cope with the needs of a single financial market as a whole. Community law provided both insufficient and unsatisfactory harmonisation and uniformity among national laws, was cumbersome to design and adopt, and the procedure for law-making was too rigid for coping with the fast pace of market

integration. The governance of financial markets was provided by an uneven patchwork of national laws, regulations and enforcement practices. This was particularly worrisome at the time since the FSAP contained a number of measures, most of them directives, aimed at introducing a complete, coherent and consistent legislative and regulatory framework for securities markets. At the rhythm of current procedures and with the current loose implementation practices by member states, the FSAP would not be able to meet its objectives.

Table 7.1: The committee architecture of the single financial market

Legislative and political decision-making	Council, Parliament, Commission			
Policy-making (finance ministries)	Economic and Financial Committee, Financial Services Committee			
	Banking	Insurance and Occupational Pensions	Securities (including UCITS)	Financial conglomerates
Regulatory committees for comitology procedures	European Banking Committee (EBC)	European Insurance and Operational Pensions Committee (EIOPC)	European Securities Committee (ESC)	Financial Conglomerates Committee (FCC)
Independent committees of regulators	Committee of European Banking Supervisors (CEBS) (London)	Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) (Frankfurt)	Committee of European Securities Regulators (CESR) (Paris)	Joint Committee on Financial Conglomerates (comprising CEBS, CEIOPS and CESR)

The Lamfalussy report proposed the setting-up of a European regulatory system for the single market in securities. Such a regulatory system would rely on the existing institutional framework for the adoption of Community legislation, it would be implemented on a voluntary basis – without a specific over-arching legal instrument – and would not involve any transfer of competences from the national to the Community level, thus not requiring any Treaty change. The regulatory system relied essentially on two elements: (i) the expansion of the use of comitology procedures, in

order to enable more flexible, swift and detailed enactment of rules at the Community level; and (ii) the establishment of committees of national regulators (supervisors), in order to facilitate, on the one hand, the development of EU-wide regulatory solutions in the form of technical advice to the Commission, and, on the other hand, the convergence of national regulatory practices in the implementation of Community law. As a result, the governance of the single financial market became largely based on a committee-architecture, without any transfer of competences to the Community or arrangements for the mutualisation of economic risks.

Implications of the financial crisis

The financial crisis, which started in Europe in August 2007 with the freezing of the EU's interbank markets, put the single market approach and federalisation strategies to a momentous test. In particular, the crisis involved the loss of confidence in European banks, bank-runs, the failure of cross-border financial institutions, the adoption of unilateral initiatives by member states to protect their national financial systems, the public rescue of financial institutions, and even the financial collapse of an entire country which integrated the single financial market as a member of EFTA.

In line with Menéndez' and Losada's conceptualisations, the financial crisis revealed the limitations of a single market approach and federalist strategy towards market integration, which is not accompanied by the development of political integration and mutualisation of economic risks. In particular, the crisis put into evidence the mutual incompatibility between (i) pursuing financial market integration through free movement of capital and establishment, (ii) safeguarding the stability of an integrated market, and (iii) retaining national fiscal responsibilities and competences for financial regulation and supervision.

Accordingly, the financial crisis has challenged fundamental assumptions regarding the functioning and expansion of the single financial market, relating in particular to the operation of the single passport based on the principles of (i) home-country control of cross-border financial services, (ii) mutual recognition of member states' competences, and (iii) minimum harmonisation of national laws.

First, the home-country control principle enabled financial institutions to expand unlimitedly their provision of services across the EU without due consideration for the eventuality of a financial crisis and related spillovers across member states. Moreover, some financial institutions were also able to expand cross-border beyond the capacity of the home-country to provide them with fiscal support. Therefore, it appears likely that in the future the safety and soundness of a European financial institution will be dependent on the capability of the home-country to support it. This, in turn, undermines the principles of home-country control and mutual recognition, which are based on non-discrimination of services providers, independently of their country of origin. The further integration and development of the single financial market may be constrained as a result.

Second, the national nature of fiscal responsibilities and of the mandates of authorities implied that national interests often prevailed over joint EU solutions, sometimes leading to sub-optimal outcomes for the stability of the single financial market. Some member states took unilateral actions to protect their respective financial systems. Certain national measures were also only aimed at domestic financial institutions, thus contravening the basic principle of non-discrimination. As a result, these nationally-based and uncoordinated actions distorted the level playing field among financial institutions within the single financial market. In addition, the policy coordination among member states' governments deepened at a relatively late stage of the development of the crisis. Member states took coordinated actions to jointly support the single financial market only after the euro area summit of heads of state in Paris on 12 October 2008. This implied that the coordination at the technical level between authorities also took place at a late stage. Without a political agreement, financial stability authorities felt compelled to safeguard national interests by containing potential national fiscal costs, which in turn hindered EU-wide solutions to the crisis.

Third, the crisis demonstrated that the harmonisation of national laws required for the operation of the single financial market should be extensive and encompass matters deeply rooted in member states' legal systems, such as bankruptcy law.

The financial crisis is therefore challenging the expansion of a single financial market without political arrangements on fiscal responsibilities, which can ensure a mutualisation of economic risks. This would require some degree of federalisation of competences, which can support the functioning of the single financial market.

In October 2008, the Commission set up a new group of wise men, chaired by Jacques de Larosière, to consider the allocation of competences and tasks for the functioning of the single financial market between the national and the European levels. In the report issued in February 2009, this group acknowledges the limitations of the institutional and legal architecture of the single financial market which were made evident by the crisis. In order to improve the architecture, the group proposes the setting-up of a number of European agencies, replacing the committee-structure described above. However, in lack of fiscal arrangements, the functions and tasks of these new agencies will fall short of a federal architecture. In the words of the report, the new 'European System of Financial Supervision would be a largely decentralised structure, fully respecting the proportionality and subsidiarity principles of the Treaty. So existing national supervisors, who are closest to the markets and institutions they supervise, would continue to carry out day-to-day supervision and preserve the majority of their present competences.'

Conclusion

This comment aimed at expanding the arguments made by Menéndez and Losada to the analysis of the emergence and development of the Community's sectoral regulatory policies. In this context, parallels were made with the evolution of the legal and institutional framework of the single financial market, also in light of the implications that may already be drawn from the financial crisis.

Accordingly, the main argument made in this comment is that the single market and constitutionalisation approaches identified by Menéndez and Losada also involve the sectoral fragmentation of regulatory policies in the Community. This sectoral fragmentation has the potential to further exacerbate the mismatch between the economic, insurance and political communities at the national and European levels. In this context, this comment also argues that further economic and market integration will be constrained by a lack

of a framework for the mutualisation of economic risks through the exercise of fiscal responsibilities at the Community level – involving either the federal transfer of responsibilities or the setting-up of fiscal facilities. Furthermore, the lack of this framework also has an impact on the possibilities to enhance democratic legitimacy, as market integration will remain subject to technocratic, rather than political, institutional structures.

Therefore, as in 1965 with the empty-chair crisis related to the lack of agreement on the Community's financing policy for the common agricultural policy, the financial crisis of 2007/2009 demonstrates the limitations of either a single market approach or a federalising strategy to European integration in the lack of political integration. The issue is whether a new period of 'eurosclerosis' will follow as well after 2009 or whether a more 'common market approach', as described by Menéndez, will re-emerge. In the latter case, functional theories may ultimately be proven right if political integration, as well as democratic legitimacy at the Community level, is considerably reinforced to underpin the regulation and further integration of European markets which is required to safeguard European citizens from ever increasing economic risks.

Chapter 7b

The theoretical basis of member state liability for infringement of Community law

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Introduction

The search for a theory of justice underlying member state liability for infringement of Community Law is a very significant endeavour. However, most scholars have focused on the implications of the rules set out in *Francovich*, not on the theoretical basis of member state liability.¹ European scholars do not usually include either of these kinds of considerations when dealing with their own national systems of public liability. In Europe, only private lawyers seem to be concerned about the issue. Historically the main conceptions of liability were actually developed in the field of private law. That is why Letelier's contribution is of considerable interest: being one of the few that deal with the philosophical foundations of member state liability for infringement of Community law. In addition, Letelier develops a critical approach which is far from being the norm when dealing with public liability matters. Sometimes scholars tend to see liability just from the claimant's perspective. The Law of torts concerns itself not only with the victim, but the tortfeasor as well, and

¹ An important exception is to be found in I. B. LEE, 'In Search of a Theory of State Liability in the European Union', Harvard Jean Monnet Working Paper 9, 1999.

that is something which Letelier's paper clearly assumes when dealing with the subject. We always have to take into account the State position, since, at the end of the day, that is the tax payers' position.

This paper will attempt to outline a number of arguments in relation to the issue of member state liability. To do so, I will divide my comments into two parts. One has to do with Letelier's position concerning the main issue of dispute surrounding *Francovich* liability: the understanding of member state liability under the umbrella of whole-state liability regardless of whatever the national authority might be involved. The second part will attempt to evaluate Letelier's opinion regarding the different theories of justice that might underline member state liability: deterrence, distributive justice and corrective justice.

Member state liability and whole-state liability in international law

Under the *Francovich* doctrine of liability, the state is regarded as a whole, regardless of whether the breach of Community law is imputable to the legislative, judicial or executive power. According to Letelier, this conceptualization fails to properly address national liability principles, where legislative or judicial acts either completely fail to provide a right to reparation or do so only in very exceptional cases. In line with this reasoning, the European Court of Justice (ECJ) has in effecting been promoting a clearly incoherent line of reasoning: with the undesirable consequence that national judges whose domestic systems either tend to prohibit or restrict attempts to redress the injustices caused by unconstitutional statutes, now find themselves under an obligation to address the injustices resulting from legislation that infringes EU law.

This incoherence is in fact one of the main imbalances associated with member state liability as set forth by the ECJ. Though the initial reluctance shown by national courts to impose liability based on the *Francovich* doctrine is gradually fading, there remain very few judgments awarding damages for legislative breaches.² Greece

² Evidence of this can be found in the national case law study by M.-P. F. Granger, 'National Applications of *Francovich* and the Construction of a European Administrative *Jus Commune*', (2007) 2 *European Law Review*, 157-192. According to

provides a good example of this reluctance. In Greece recognition of foreign higher education diplomas is viewed as a means for private education institutions to break the State's monopoly on higher education. To this end private institutions are setting up educational establishments abroad and then availing of the benefits of EC rules on diploma recognition. For this reason, Greece had not transposed the Recognition of diploma directive.³ In 1999 the Greek Council of State avoid the imposition of state liability by relying on the principle of the separation of powers. It denied its own competence to declare the Hellenic Republic liable through the fudge of a Parliamentary omission.⁴

The incoherence between national rules on public liability (that rarely impose damages on the legislature) and the *Francovich* doctrine (which applies to any organ of the state, including the legislature) is highly problematic. It may indeed be legitimately asked if it does not come down to a lack of interest on the part of the ECJ on the entire question of national liability principles. From my point of view, this incoherence arises from the peculiar characteristics of European law. The existence of a supranational state liability which may involve legislative acts should not surprise us in the least. That fact is that whole-state liability is a principle of international law. Occasions arise under international law when individuals, not just states, are entitled to claim this head of liability. The best example is provided by the European Convention on Human Rights. Individuals can take a case before the European Court of Human Rights (ECHR) seeking the imposition of liability against any of the organs of State including the legislative and judicial branches.⁵ International law and,

this research, national courts were, at first, reluctant to embrace the *Francovich* doctrine, particularly in relation to legislative and judicial activities, but such resistance is fading and being replaced by a 'more faithful, and even extensive, applications of the doctrine' (at p. 159).

³ Directive 89/48 on the general system for the recognition of the higher education diplomas awarded on completion of professional education and training of at least three years duration [1989] OJ L. 19/16.

⁴ *Symvoulío tis Epikarteias*, plenary session, February 26, 1999.

⁵ However, the ECHR tends to concentrate on the definition of human rights and the actions that breach these. Despite the importance of the question of financial compensation, it has not given specific attention to this matter. Therefore, the resulting case law may be described as somewhat rudimentary. Nevertheless, it exercises a direct and decisive influence with respect to damages which traditionally have not received protection under national systems. See L. M. Alcoz, 'Spanish Law

particularly, the European Convention therefore provide a much more effective model to understand why member state liability is perfectly capable of giving rise to awards of damages caused by acts of the Parliament. In fact, the Court in the *Brasserie* case justified its position with reference to international law rather in terms of the national legal systems that do not possess the concept of whole-state liability, and where compensation arising due to legislative or judicial harm is rare or very limited.⁶ It has clearly stated that

[in] international law a State whose liability for breach of an international commitment is in issue...will be viewed as a single entity irrespective of whether the breach is attributable to the legislature, the judiciary or the executive. This must apply a fortiori in the Community legal order.

The problem is that Community law does not allow the ECJ to do what the ECHR does. In the Union, national authorities, not the ECJ, have jurisdiction to annul measures that are in breach of Community law and to award damages. If the ECJ was in a position to redress harm caused to individuals by member states, this doctrine of whole-state liability would be embraced regardless of whether the organs responsible were the legislature or the judiciary. But this is not the case. So one may legitimately conclude that *Francovich* liability to say the least is problematic, not because the ECJ has failed to properly interpret national liability principles; but rather that the special characteristics of European law fail to allow for the development of a system similar to the one under the European Convention of Human Rights.

A theory of justice from member state liability

Deterrence

Letelier argues that the main aim of the ECJ when developing a member state liability system is to protect individuals' rights. In his view, the Court has built up a right based construction whose foundations seem to be based in the notion of corrective justice. It is

System and Internationalisation of Human Rights Protection', (2006) 18 *European Review of Public Law*, 489-521, at pp. 509-512.

⁶ Cases C-46/93 and C-48/93 *Brasserie du Pêcheur SA V. Bundesrepublik Deutschland and The Queen v. Secretary of State for Transport, ex parte: Factortame Ltd and others* [1996] ECR I-1029.

true that in *Francovich* the Court stated that in the absence of an action for damages, individuals cannot enforce the rights conferred upon them by Community law before the national courts. This statement demonstrates, in fact, a right based conception of public liability. However, *Francovich* combines this perspective with a very different one which seems to be preferred by ECJ case law. By this I mean a *punitive* approach where liability is understood as a tool, not for the protection of rights, but for enforcement of Community law, which is a very different thing. It can then be unequivocally stated that, according to the ECJ, the basis of the system is all, but corrective justice.

From the beginning, damages have been primarily understood as way to fill a gap in the enforcement system for Community norms. It was a mechanism employed to force member states to implement directives, especially in cases in which those Directives did not give rise to direct effects because the litigation in question arose between private parties or because the terms of the relevant legislation left an element of choice open to the national implementing authorities. As it was pointed out in *Francovich*, the *raison d'être* of a right to reparation lies in the pursuit of the 'full effectiveness of Community rules'. That is why damages are understood more as a sanction imposed for a sufficiently serious unlawful breach than in terms of a restoration for unfair damage. In this sense, some scholars have pointed out, rightly in my opinion, that the Court has developed a system whose basis is essentially criminal and whose function is rooted in the doctrine of deterrence, (i.e. to reduce the number of future infringements).⁷ The perspective which has finally prevailed is a punitive one, which focuses not on the damages suffered, but in the wrongdoers' behaviour. Evidence of this is to be found in the absence of a clear criterion of liability for what constitute lawful acts; and in the obligation imposed on the claimant to demonstrate a 'sufficiently serious breach' which in effect amounts to a fault criterion by another name borrowed by the Court in *Brasserie* from its case law on the liability of Community institutions. The ultimate justification of the system is therefore, not to guarantee the protection of rights, but to avoid the most flagrant infringements of Community law through appropriate economic sanctions. Hence, deterrence is what the Court

⁷ See E. Guichot, *La responsabilidad extracontractual de los poderes públicos según el Derecho comunitario*, Valencia, Tirant lo Blanch, 2001, at pp. 536-539.

pursues by developing the notion of member state liability. In reality, such a conception is quite understandable: as the enforcement mechanisms of Community Law currently lack real teeth (the Court has no jurisdiction to annul national measures) and were even less effective at the time of the *Francovich* case.

However, this does not entail that we have to take this approach for granted. In my view it can be argued that deterrence does not provide a solid basis for member state liability for transgressions of Community Law. First of all, a deterrence approach to member state liability seems to fly in the face of the development of modern tort law in both the private and public spheres; and in national and international law likewise. Such an approach lay at the heart of old systems of liability which were closely inspired by the doctrines of criminal liability. Liability based on reasons other than fault; restoration of personal injuries; or relaxation of the strict burden of proof as regards causation (i.e. 'beyond all reasonable doubt', which is the standard laid down in all criminal law cases) are just products of a new approach where the target of damages is to protect the victim and not to punish the tortfeasor.⁸ Secondly, member states are not influenced to such a great extent by liability rules, granted that States have very deep pockets and imposing a payment sanction for the victim may have little practical effect in preventing the violation of their rights.⁹ In addition, damages are not normally paid out of a departmental budget, but out of the general Treasury; a bill that will ultimately be borne by the taxpayer, whose ability to control the efficiency of government is very limited.¹⁰ In the case of the judiciary, this criticism is even more apt granted the common principle of judicial independence: bearing this in mind it is difficult to say the least to see how the award of damages against the State could influence judicial behaviour.¹¹ But even if we adopt the view that a monetary penalty is an effective tool of deterrence, we must agree that the lump-sum payments and penalties following non-compliance with an ECJ judgement (as foreseen by the Maastrich Treaty in 1992) are a much more effective tool than damages. As Letelier has pertinently remarked, in diminishing states wrongs, public

⁸ See L. M. Alcoz, *La responsabilidad patrimonial por acto administrativo*, Cizur Menor, Thomson/Civitas, 2005, especially chapters one and two.

⁹ Lee, *supra*, note 1, at p. 4

¹⁰ *Ibid.*

¹¹ *Ibid.*

enforcement through these penalties can be more efficient than private enforcement through damages.

Distributive justice

According to Letelier, distributive justice might be the answer. This conception, just like the punitive one we have already examined, can be understood as an instrumental approach. Liability is not an end in itself; it is a tool to pursue a goal. In the case of deterrence, the goal is to avoid future harm. In the case of distributive justice it is the equitable allocation of wealth according to criteria such as merit or need.

It is my view that distributive justice fails to provide a sound theoretical foundation for member state liability. Such a theory of justice is an important duty of government, but it cannot be the theory underlying either the private law of torts or public liability. Tort liability is always based on causation of harm through violation of rights; and therefore considerations as to the financial status of the plaintiff are largely irrelevant. Assistance to the underprivileged is considered an important state duty in most European countries, but responsibility lies with state welfare institutions and has nothing *per se* to do with liability. Tort liability provides wealth to the wealthy and poverty to the poor, nothing else.¹² Circumstances such as the plaintiff's economic situation are irrelevant as far as the issue of liability is concerned. Otherwise we end up running the risk of converting the notion of liability into a different institution.

I think however that Letelier points out a very interesting idea when he states that tort liability represents a pattern of distribution of resources within society. In fact, when the state compensates, it is obliged to transfer resources away from other items of the public budget. For instance in the Canal Satélite case of 2003, where the Spanish government approved emergency legislation to introduce specifications against Community law which had a devastating

¹² See F. P. Prieto, 'Artículo 1902', in R. Bercovitz Rodríguez-Cano, L. Díez-Picazo Ponce de León, C. Paz-Ares Rodríguez and P. Salvador Coderch (eds), *Comentario del Código civil*, vol. II, Madrid, Ministerio de Justicia, 1991, 1971-2003, 1971-1973; 'Cómo repensar la responsabilidad civil extracontractual (También la de las Administraciones Públicas)', in J. A. Moreno Martínez (ed.) *Perfiles de la responsabilidad civil en el nuevo milenio*, Madrid, Dykinson, 2000, at pp. 439-442.

financial effect on a company.¹³ The Spanish Supreme Court awarded the highest amount ever to a private party in a Spanish public liability case: almost 27 million euro, which had a considerable impact on the state's budget. In the light of this legislators should always take into account the impact of liability on the budget. But it does not follow that the ultimate goal of liability is distributive justice. The reality is that evaluating such potential financial fallout is not within the competence of the judiciary whose role is to resolve conflicts between two parties, the claimant and the defendant.

Corrective justice

My own view is that corrective justice is the only theoretical approach in which million liability can be correctly based. Persons must be treated as ends in themselves, not merely as objects or instruments of policy.¹⁴ Tort liability cannot treat the victim merely as a convenient conduit of social consequences rather than someone to whom damages are owed to correct the wrong suffered.¹⁵ Therefore, relations between the government and individuals are subject to the concept of right. In line with this, if governments' wrongdoing gives rise to individual injury, it should be redressed by the award of damages, without regard to the antecedent or resulting distribution of wealth.¹⁶ Tort liability should primarily seek to award the appropriate allocation of damages according to an idea of justice, and not directly the fulfilment of obligations or the distribution of wealth, which are goals pursued by different institutions such as penalties or public aids.

Liability is therefore connected to the idea of justice that arises in democratic societies where fundamental rights and the rule of law are central. Liability is not therefore a complex mechanism of social engineering; it is very much a down to earth institution whose responsibility it is to decide where to allocate harm, in the claimant's

¹³ Tribunal Supremo, June 12, 2003, RJ 2003/8844.

¹⁴ J. C. Jeffries, 'Compensation for Constitutional Torts: Reflections on the Significance of Fault', (1989) 88 *Michigan Law Review*, at pp. 94-95.

¹⁵ E. J. Weinrib, 'Restitutionary Damages as Corrective Justice' (2000) 2(6) *Theoretical Inquiries in Law*. See also P. Schlesinger, 'La ingiustizia del danno nell'illecito civile' (1960) *Jus*, 336-347; R. Scognamiglio, 'Responsabilità civile', in A. Azara and E. Eula (eds) *Novissimo Digesto italiano*, vol. 15, Torino, Utet, 1968.

¹⁶ Lee, *supra*, note 1, at p. 5.

or defendant's pocket pursuant to an idea of justice.¹⁷ This does not mean that tort liability has to be orientated to the victim. Corrective justice rejects all one-sided accounts: the justification for awarding damages must include not only the reason for making the wrongdoer pay but also the reason for entitling the victim to receive them; the same reason must apply on both sides.¹⁸

The corrective justice theory has been mainly developed in the field of private law. But we should avoid a simplistic separation of branches in order to justify a different rationale for public liability. In Europe, the modern feature of liability among private parties is directly based on the evolution of damages in the field of public law. Public lawyers like Kaufmann (Germany), Orlando (Italy) and García de Enterría (Spain) developed a modern approach to which private law jurisprudence subsequently adapted itself.¹⁹ Actually, most of the differences between public and private liability, as they were initially developed at the beginning of the XX century, have more to do with the fact that public law was more open than private law to embrace the enormous social transformations which were taking place due to the absence of a respected Code of Administrative Law among other factors.²⁰ The ulterior evolution is in a great measure a process of convergence in which differences tend to fade. That is why one can even say that the modern theory of liability in Europe – which is largely based on the notion of corrective justice – has been shaped to a greater or less extent by public lawyers. So, if we apply the corrective justice approach to member state liability we are not transposing a private law solution.²¹ We are applying a solution whose origins are 'public' and that is very coherent with societies organized according to the rule of law.

Obviously, legislators have discretion to establish rules on public liability considering the type of activities and risks involved including many other factors. Corrective justice only attempts to offer

¹⁷ See Prieto, *supra*, note 12.

¹⁸ Weinrib, *supra*, note 15, at p. 6.

¹⁹ See Alcoz, *supra*, note 8, at pp. 124-128.

²⁰ See S. M.-R. Baquer, *El Derecho civil en la génesis del Derecho administrativo y de sus instituciones*, 2nd ed., Madrid, Civitas, 1996, at pp. 25-67.

²¹ Compare D. Cohen, 'Suing the State' (1990) 40 *University of Toronto Law Journal*, 630-662.

a theoretical foundation of liability in the framework of which single solutions should be found. However, all these rules and their interpretation should be directly inspired by an idea of justice, not by goals of mere efficiency and wealth distribution. From my point of view such an approach is imminently applicable to questions of member state liability for infringement of Community Law and can be used to fight the instrumental approach developed by the ECJ.

Chapter 8

Theoretical models of fiscal policies in the Euroland: The Lisbon Strategy, macro-economic stability and the dilemma of governance with governments

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Introduction

In March 2000 at the Lisbon European Council, the heads of state and government promised to make the EU by 2010 'the most dynamic and competitive knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment'. If this statement was meant to inspire enthusiasm, it has failed. Over-commitment and unachievable goals have ridiculed European policy makers. Despite desirable objectives, national compliance with the Lisbon Strategy remains poor. The European Commission has explained this underperformance by 'a policy agenda, which has become overloaded, failing coordination and sometimes conflicting priorities'.¹ Yet, the official mid-term review did not explain the reasons for this coordination failure. It has exhorted governments 'to do more reforms', but few member states seem capable of achieving

¹ European Commission, 'Working together for Growth and Jobs. A New Start for the Lisbon Strategy', Communication to the Spring European Council, COM 24, 2005, at p. 4. Available at <http://ec.europa.eu/growthandjobs/pdf/COM2005_024_en.pdf>.

them and when they do so, the results are not as expected.

In 2005, five years after Lisbon and midway to the goal, the Commission has proclaimed a 'new departure' by focusing on a limited number of 'key actions that promise the highest and most immediate dividends',² namely investment, innovation and jobs. The new focus was primarily on the supply side. Ironically, as soon as this was declared, a mix of favorable demand for exports and domestic demand due to higher wages and improved consumer confidence after the German elections pulled the Euro area out of its stagnation.³ The question is, whether the growth spurt will be sustainable and for how long. Economic reforms under the 'new' Lisbon Strategy are intended to improve research and development, labour market flexibility and capital market integration. No doubt this would improve Europe's productive capacities. However, experience from the past has shown that, contrary to the American experience under Clinton, a favorable macroeconomic environment is in the EU usually short-lived. Two noticeable holes in the 'new' Strategy may endanger the recent growth performance: the absence of a macroeconomic policy strategy and the issue of governance. In fact, the new Lisbon Strategy is 'less, of the same.' It is *less*, because macroeconomic management and social cohesion have been dropped from the agenda. It is the *same*, because it does not address Europe's institutional imbalances. I will show that the EU's disappointing performance is due to a collective action problem, which applies to both, supply side reforms and macroeconomic management. Europe's economic difficulties cannot be separated from constitutional questions. The problem is 'governing without government',⁴ or more precisely 'governance with many governments'. I will first examine where the Lisbon Strategy is failing in its present arrangement, and then focus on the flawed macroeconomic framework, which requires constitutional reforms.

² J. M. Barroso, *Debate on the Preparation of the European Council*, European Parliament, 9 March 2005.

³ European Commission, *Quarterly Report on the Euro Area*, 5(4) Directorate General for Economic and Financial Affairs, 2006.

⁴ J. N. Rosenau, 'Governance, Order and Change in World Politics', in J. N. Rosenau and E. O. Czempiel (eds) *Governance without Government: Order and Change in World Politics*, Cambridge: Cambridge University Press, 1992 and R. A. W. Rhodes, 'The New Governance: Governing without Government', (1996) 44(3) *Political Studies*, pp. 652-667.

Where the Lisbon Strategy is failing

The Lisbon Strategy must be seen in its political context, which has dramatically changed since its inception and has shifted the emphasis on economic supply-side reforms. But even these reforms are not forthcoming because of collective action problems. The result is a disappointing performance.

The political context

Europe's Lisbon Strategy was inspired by the strong economic growth in the United States in the late 1990s. The Clinton administration had followed advice from the Federal Reserve Bank and consolidated public finances to bring interest rates down. The longest economic upswing in US history followed. The investment share in US GDP rose from 16 per cent in 1992 to 21 per cent in 2000 and unemployment fell to four per cent, the lowest level since the 1960s. New investment incorporated technological innovation in ITC industries raising productivity after a long period of stagnation. This was the envied model of America's 'new economy'. By contrast in Europe, growth and investment were low, unemployment high. The investment share, which stood at 27 per cent in the 1960s and early 1970s, had fallen to 20 per cent by 1996. Because investment was low, technological progress was not incorporated to the same degree as in the USA and human capital seemed to be deficient. In the late 1990s a sense of stagnation was all-pervasive.

The shift to a 'new' economy in America reflected a policy choice. Before 1992, the 'old' US economy had also been stagnating, with growth of real investment negative between 1985 and 1992 and widespread criticism of the American economic model.⁵ The US economy was deregulated in the early 1980's, but economic growth only came in the 1990s after macroeconomic policies changed. The Republican administrations of Reagan and Bush had maintained high fiscal deficits and interest rates; under Clinton, both came down - with the deficit even turning into a surplus. US real long term interest rates were one percentage point higher in 1985-91 than the synthetic

⁵ In the 1980s Japan and Germany were considered to be the superior model, given that these countries seemed to favour long term relations, while the US system was seen as too short-term oriented. In the 1990s this view was inverted; now flexibility was thought to be the trump card.

interest rate for Euroland, but over 1992-2004 they were 19 base points lower. This change in macroeconomic policy was instrumental in turning the US economy around.

The EU's unsatisfactory performance is not usually explained in terms of policy choices, but by structural factors, particularly in the labor market. It has often been affirmed that 'Eurosclerosis' due to protective national regulation and the insufficient integration of markets has been impeding economic growth in the EU. Yet, the rapid reversal of fortunes in the USA indicates that Europe's problems may depend more on policies than on institutions and structures. The Single Market has already removed many obstacles and was largely completed by the early 1990s. Nevertheless, the following decade was marked by stagnation and unemployment remained stubbornly high.

In response to this situation, different European Councils have doubled up on structural reforms by setting up so-called reform-'processes' without addressing the difficulty of conducting macroeconomic policy in the Euro area. The Luxembourg process set an agenda for labour market reforms in 1997. Procedures for the complete unification of the goods and capital market were put into place in Cardiff in 1998. Only in 1999 at the Cologne Council did macroeconomics appear on the European agenda by setting up a dialogue on the policy mix between wage bargainers, finance ministers and the European Central Bank (ECB). But these 'processes' did not produce the expected results. In fact, they were called *processes* because the European heads of state and government could not agree on substantial policies.

The Lisbon Strategy in 2000 was an attempt to overcome these difficulties. No longer a 'process', it was meant 'to load substance into the empty lorries of Cardiff, Luxembourg and Cologne'.⁶ The Lisbon Strategy sought to match supply-side reforms with responsible

⁶ This was the formulation frequently used by policy makers. At the time, the author was an active participant in the Guterres ESP-group and in charge of the Lisbon inter-ministerial policy coordination in the German government. For the theoretical foundation of the macroeconomic strategy behind the Cologne process and Lisbon Strategy, see S. Collignon, 'Unemployment, Wage Developments and the European Policy Mix in Europe', (1999) 26 *Empirica*, pp. 259-269.

demand management in order to increase growth. Higher welfare necessitated higher productivity and therefore innovation and knowledge to improve potential output. Formally, the Strategy addressed four policy areas: (1) Reforms to create a knowledge society, intended to help Europe catching up with the 'new economy' and improve productivity; (2) Optimal macroeconomic policies to ensure that the higher potential output would effectively be absorbed by demand in product markets without creating inflationary tensions; (3) Completing the integration of Europe's capital market to increase investment, especially by raising venture capital for innovation in small and medium-sized companies; and (4) Reformulating the European social model, not by dismantling the welfare state, but by putting social inclusion first and empowering governments to deal with the challenges of globalisation and an aging society.

The Lisbon agenda reflected the dominance of centre-left governments in Europe at the time and their commitment to macroeconomic policy. Portugal's Prime Minister Antonio Guterres had first designed its basic objectives in a working group of the European Socialist Party (ESP) aimed at reducing unemployment.⁷ A year later he used the EU presidency to put it into practice.

The focus of the Lisbon Strategy was economic growth. The creation of a 'Knowledge society' aimed at improving the supply side. But given that job creation requires actual GDP to grow faster than productivity⁸, macroeconomic policy was considered indispensable for creating higher employment, consolidating public finances and releasing resources for Europe's social model. The European Commission had previously calculated that the EU would reach full employment if GDP would grow at three per cent for one decade. The Portuguese EU-presidency now proposed the idea of setting a three per cent growth rate as a numerical policy target for Euroland. Given that the ECB had defined price stability as a rate of inflation 'below, but close to two,' it seems reasonable that the European Council could also set its growth target numerically. This approach

⁷ E. Kulahci, 'Theorizing party interaction within EPFs and their effects on the EU policy-making process', (2002) 6(16) *European integration on-line papers*, available at <<http://eiop.or.at/eiop/texte/2002-016a.htm>>.

⁸ S. Collignon, *Monetary Stability in Europe*, London, Routledge, 2002.

was justified by the Treaty on European Union. The ECB was committed to price stability as its 'primary objective' (Art. 105.2), but according to Art. 2 of the Treaty on European Union, it also was obliged 'to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance', provided price stability was assured. Thus, by specifying the numerical content of the Treaty Art. 2, the European Council would define clearly what kind of growth rate the ECB ought to support when price stability was achieved. For example, the ECB should have taken the more ambitious growth objective of three per cent, rather than 2.5 per cent, when setting the reference values for monetary aggregates. The numerical target for economic growth would also have strengthened the voice of finance ministers at the informal meetings of the Euro-group and improved the democratic legitimacy of European policy making. It might have prevented some of the ECB-bashers in later years. Furthermore with growth at three and inflation at two per cent, and with budget deficits capped at maximal three per cent, the debt/GDP ratio would have stabilised below 60 per cent, ensuring the long run sustainability of public finance. But in the end the option of fixing a numerical growth target was not adopted at Lisbon, because a member from an opt-out country insisted that more ambitious objectives would unleash entrepreneurial creativity. The three per cent target was replaced by the goal of becoming 'the world's most dynamic and competitive economy.' This formulation effectively prevented the institutional anchoring of macroeconomic policy into the Lisbon Strategy.

In the following years, right-wing governments swept back into power. The emphasis on macroeconomic policy and social inclusion was lost and a more narrow supply-side approach became dominant. With the growing political heterogeneity in the Council, agreement on binding policies became even more difficult. The Lisbon Strategy had to rely on the 'Open Method of Coordination' (OMC) with best-practice comparisons and peer pressure as instruments.⁹ With this

⁹ Historically, the OMC was an accident; it came about because several governments, and in particular the German chancellor, resisted having 'their hands tied', let alone

method it was not possible to conduct a coherent set of structural supply side reforms and a growth-supporting macroeconomic framework. Not surprisingly, the Lisbon Strategy never really took off.

The OMC and the collective action problem

The repeated coordination failure in economic policy has institutional causes. It is a consequence of collective action problems, which emerge when autonomous governments seek to maximise collective utilities in isolated constituencies. Governments are constrained by national debates and by the partial interests articulated within their home constituencies.¹⁰ In order to get (re-)elected, political leaders and parties must attempt to maximise the utility of their national constituency. As long as a European government does not exist, there is no European constituency and therefore no European-wide deliberation on collective policy preferences. Factional interests of national constituencies will then prevent the realisation of the collective utility optimum, as Madison has already shown more than 200 years ago.¹¹ This is exactly the problem in the EU. Policies are shaped by negotiations in a 'two-level-game',¹² where governments take the preferences within their constituency as given and negotiate compromises at the lowest common denominator in the European Council. The resulting Nash-equilibrium does not optimise welfare.

delegating power to the Commission. Guterres therefore sought to enroll member states into an open intergovernmental process of policy coordination, where 'open' meant 'unconstrained'. In essence, the OMC is equivalent to respecting member states' veto power. Nevertheless, governments were urged to commit to specific common policy objectives, while implementation was left to them. To safeguard against uncooperative behaviour, multilateral surveillance by the Commission and peer pressure through 'naming and shaming' of non-performers was considered sufficient. The OMC is therefore a stronger form of policy coordination than simple voluntary action, but it suffers from the same dilemma as previous coordination attempts: incentives for free-riding hamper unified action necessary for the provision of exclusive European collective goods.

¹⁰ By partial interests, I mean collective preferences that dominate some groups, but are in contradiction with the general preferences of all European citizens. Partial interests are therefore welfare lowering. The general welfare could be optimized, if they all citizens participated in the policy debate on issues that concern them all together.

¹¹ See Federalist Paper no. 9 and 10 in A. Hamilton, J. Jay and J. Madison, *The Federalist Papers*, Indianapolis, Liberty Fund, 2001.

¹² R. Putnam, 'Diplomacy and Domestic Politics: The Logic of Two-Level Games', (1988) Summer, *International Organisation*, pp. 427-61.

This is different from a 'normal' democracy, where formulating common policy preferences requires a deliberation process, which takes into account the interests of all European citizens and not only those of national factions. In the EU such democratic deliberation is institutionally impossible. The idea of 'policy processes', the OMC, etc. therefore expressed the less ambitious objective of going through a deliberation process amongst policy-making elites, so that governments would ultimately find solutions acceptable to all. However, this idea has underestimated the importance of vested interests articulated in national politics. Changing policy preferences through bureaucratic deliberation only works for technocratic issues, such as setting technical regulations for the single market. In areas of high politics, which is submitted to universal suffrage in national constituencies, the emergence of consensual policy preferences can take a very long time.¹³ Europe's economic governance therefore has become a mix of cheap talk about reforms and gridlock in decision-making.

In essence, the failure of the Lisbon Strategy is due to a collective action problem: Countries find it in their national interest not to stick to policies, which would maximize the overall collective European welfare, as long as everyone else pursued them. But because everyone has the same incentives, none will make the efforts necessary for achieving the common interest.¹⁴ Why would national governments agree to European policies that might constrain their actions at home? The somewhat naïve Europhile answer is that the

¹³ For monetary policy, e.g., it took three decades.

¹⁴ For a more extensive discussion see S. Collignon 'Is Europe Going Far Enough? Reflections on the Stability and Growth Pact, the Lisbon Strategy and the EU's economic governance', (2003) 1(2) *European Political Economy Review*, pp. 222-247. P. Jaquet and J. Pisani-Ferri 'Economic Policy Coordination in the Eurozone: What Has Been Achieved? What Should Be Done?', Sussex European Institute Working Paper No. 40, 2001, Brighton: Sussex European Institute, or M. Buti, D. Franco and H. Onega, 'Fiscal Discipline and Flexibility in EMU: The Implementation of the Stability and Growth Pact', (1998) 14(3) *Oxford Review of Economic Policy*, have argued that the answer to collective action problems in fiscal policy was the Stability and Growth Pact. However, this argument is based on the assumption that 'member states are at the same time willing to cooperate and reluctant to transfer further national sovereignty' (Jaquet and Pisani-Ferri, at p. 4). Yet, the whole point of collective action problems is that nation states are *not* willing to cooperate because they obtain higher benefits by not doing so.

existence of positive policy externalities creates incentives to cooperate. As the Kok report formulated:

Actions by any one Member State [...] would be all the more effective if all other Member States acted in concert; a jointly created economic tide would be even more powerful in its capacity to lift every European boat. The more the EU could develop its knowledge and market opening initiatives in tandem, the stronger and more competitive each Member State's economy would be.¹⁵

Along these lines, the European Commission has also been propagating for years that 'massive potential gains' were to be reaped from wider and deeper integration, while 'non-Europe' was a costly waste of resources. But the question remains, why these gains are not realised despite such obvious advantages for all. The answer is not simply lack of focus or insufficient support, as the Commission claims.¹⁶ It is rooted in the structure of political incentives.

The theory of collective action has clearly established that the existence of potential positive spillover effects is not enough to ensure cooperative behaviour.¹⁷ Collective action problems are caused by externalities that provide incentives for non-cooperative behavior. If the costs and benefits of actions are not properly matched for individual actors, cooperation failure is the result. These externalities can be linked to different types of public goods. Inclusive public goods, sometimes called club goods, are characterised by positive externalities as more members participate in a group. Because one can impose restrictions on access to the club, every individual member can be obliged to make the necessary efforts for the realisation of the common benefits. Thus, inclusive goods provide incentives for successful voluntary cooperation between independent utility maximising actors. It is, however,

¹⁵ W. Kok, 'Facing the Challenge', The Lisbon Strategy for Growth and Employment, Report from the High Level Group chaired by Wim Kok, Luxembourg, Office for Official Publications of the European Communities, 2004, available at <http://ec.europa.eu/growthandjobs/pdf/kok_report_en.pdf>.

¹⁶ European Commission, *supra*, note 2, at p. 5.

¹⁷ M. Olson, *The Logic of Collective Action. Public Goods and the Theory of Groups*, Cambridge, MA, Harvard University Press, 1971.

possible that asymmetric information could lock partners into suboptimal equilibria (prisoner dilemma). Procedures for improving the information flow are then required, possibly in the form of an independent and impartial authority. The 'regulatory mechanism' by which public goods are provided without formal and central authority is therefore dependent on the nature of externalities. A policy regime that allows the efficient provisions of inclusive public goods on the basis of voluntary cooperation has been called 'governance without government'.¹⁸

For along time, European integration has thrived in the domain of inclusive public goods. The existence of the European Commission has ensured that information asymmetries were overcome so that everyone knew what action was required. For example, successful political cooperation has created the single market in order to engender economies of scale. Network projects like the Galileo satellite navigation system or the Airbus project, provide high benefits from cooperation and the possibility of reaping them is clearly allocated to each contributing participant.¹⁹ Another typical club good phenomenon is participation in the European Monetary Union (EMU), which induced the convergence of macroeconomic policies, clearly a public good. The Maastricht criteria helped create low inflation, because (nearly) everyone wanted to share in the benefits from monetary union and the possibility of being excluded made governments comply. Convergence policies were therefore 'owned' by member states. The role of the Commission consisted in monitoring the process and overcoming information asymmetries to prevent blockages. Hence, the logic of inclusive public goods makes successful voluntary cooperation among governments possible, while the Commission has to provide formal procedures to facilitate the flow of information.

With the successful convergence to the Maastricht criteria as a model, the designers of the Lisbon Strategy thought that a list of structural indicators with clear goals and objectives for each member state would accelerate reforms, release synergies and ameliorate the EU's

¹⁸ Rosenau, *supra*, note 5; Rhodes, *supra*, note 5.

¹⁹ Nevertheless, the recent Airbus difficulties show that a club may still encounter difficulties in the provision of collective goods if its management is bad.

performance. However, the logic of self-sustained policy convergence does not work for 'exclusive public goods', which are also called common resource goods. Here it is impossible to prevent access to the consumption of the collective goods for any member of the group and therefore it is hard, if not impossible, to make them pay for the cost of producing them. Exclusive public goods therefore create incentives for free-riding.²⁰ A single member could benefit by deviating from the Strategy pursued by everyone else. As a consequence, nobody will wish to conform and voluntary cooperation cannot provide exclusive public goods optimally. The resulting collective action problem is known as 'the tragedy of the commons'.²¹ It can explain many aspects of the disappointing performance of the Lisbon process, because the intergovernmental governance with many national actors has no mechanism for coordinating the cooperative behaviour needed to provide exclusive goods.

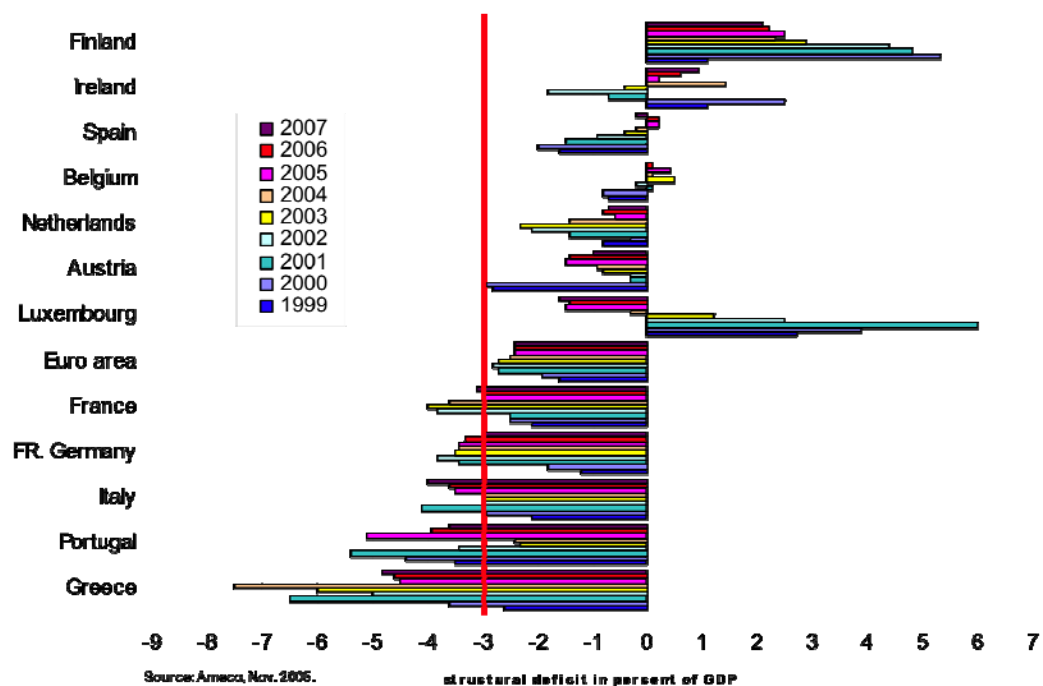


Figure 8.1: Structural deficit (based on potential GDP) in Euroland 1999-2007

²⁰ The common resource goods are called exclusive because the members of the club will want to keep new members out, as this would reduce their benefits.

²¹ G. Hardin, 'The Tragedy of the Commons', (1968) 162(3859) *Science*, New Series, pp. 1243-1248.

As European integration has deepened in recent decades, the range of exclusive public goods has increased. In a monetary union, most macroeconomic policy variables, such as inflation, nominal and real interest rates, exchange rates, economic growth and employment policies have become exclusive public goods. All members consume these goods collectively, but Europe’s ‘governance with many governments’ creates incentives for individual member states to free-ride on others. It can be shown that the incentive problems caused by the exclusive nature of public goods increase with the size of the EU.²² The free-riding problem applies to supply-side reforms as well as to macroeconomic policy. For example, member states are frequently criticised for not implementing EU legislation.²³

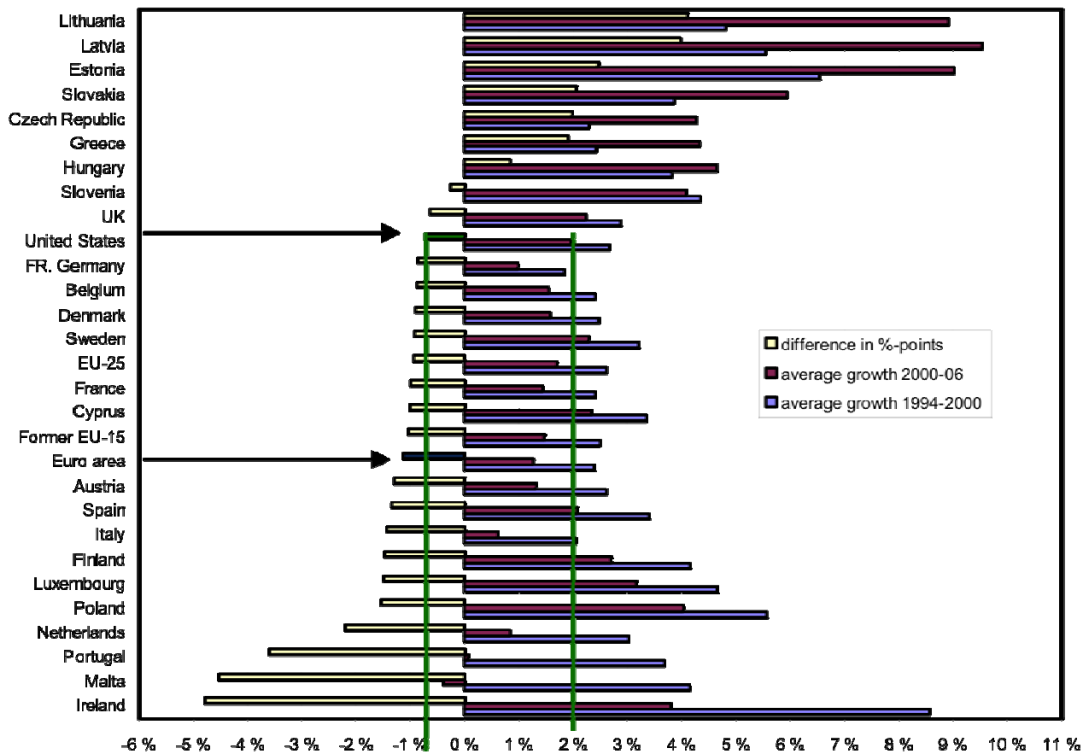


Figure 8.2: Average per capita growth rates and differentials, 2000-2006 vs. 1994-2000

The reason for the implementation failure can be a collective action

²² For a full elaboration of this argument and its underlying theory, see S. Collignon, *The European Republic*, London, The Federal Trust, 2003, Annex 2.

²³ The Commission, *supra*, note 2, at p. 8 writes: ‘In a number of Member States, key markets like telecoms, energy and transport are open only on paper – long after the expiry of the deadlines to which those Member States have signed up.’

problem: Although integrated production structures and supply chains would improve Europe's competitiveness in the world and are therefore in the interest of all member states, deviating behaviour by individual governments may yield partially higher benefits: if everyone else is liberalising markets, it may be advantageous for individual countries to keep restrictions in place at least temporarily when this allows gaining uncontested market power in the larger single market.²⁴ Thus, each country has an incentive to wait with its own reforms, while pushing others to do them soon.

The problem is even more severe for macroeconomic policy because of flawed institutional arrangements. Fiscal policy is permanently hampered by coordination failure, because capital funds in EMU are a common resource good and interest rates are their scarcity price. Given that it must maintain price stability, the ECB has to restrain the provision of liquidity, which is the 'common resource' in the financial system. But access to liquidity in the capital market is free for all. Higher structural public deficits will therefore, *ceteris paribus*, increase equilibrium interest rates and appreciate exchanges. This will lower economic growth. Recognising this problem, the Stability and Growth Pact (SGP) demands the balancing of cyclically adjusted budgets. Interest rates would then be low, but at low rates it is advantageous for each member state to borrow money rather than to incur the political cost of fiscal consolidation. Hence, there exists an incentive for individual governments not to respect the Pact, while publicly insisting that everyone else should. Not surprisingly, structural deficits are not 'in balance' (they are above two per cent of GDP for the whole of Euroland and even above three per cent for France, Germany, Italy, Portugal and Greece, see Figure 8.1). After the aggressive consolidation before 1999, structural deficits have deteriorated until 2002, while long-term interest rates remained high – despite the negative growth shocks in 2001 and 2002. Thus, consolidation fatigue rather than excessively tight monetary policy has kept interest rates from falling more than they did. I will discuss this claim in greater depth in the second part of this chapter.

The correct policy response would be either hard and constraining

²⁴ A sufficient condition for this logic to be valid is the existence of increasing returns to scale as emphasized by the New Trade Theory.

binding rules or policy delegation to a European institution in order to ensure a coherent and unified policy in the interest of the Union. Especially, when there is some need for discretionary policies, exclusive public goods require the governance of a government.²⁵ But delegating macroeconomic competences to a European institution poses a problem of legitimacy. Modern democracies are founded on the principle of 'No taxation without representation'. This must imply that citizens have some control over fiscal policy through elections. But if they cannot elect a European government, they only have the national channel for control. Hence fiscal policy is confronted by a dilemma: either national parliaments make budgets and are tempted by free-riding on others, or European rules are imposed on national policies, thereby hollowing out democratic processes. Decentralising decision-making to the nation state according to the subsidiarity principle reduces output-legitimacy; more centralisation to increase technocratic efficiency reduces input-legitimacy. The only solution is more democracy at the European level, so that the input by citizens determines the output they prefer.

It is now increasingly recognised that the economic governance of the EU has remained suboptimal due to inefficiencies, lack of credibility and eroding legitimacy. Unfortunately the logic underlying this failure is not. In its Communication to the Spring European Council, the Commission (2005) emphasised the need to create 'political ownership' for the Lisbon goals.²⁶ But once more, this was cheap talk. Ownership is not established by 'streamlining existing guidelines' and by appointing 'Mr. or Ms. Lisbon.' Ownership implies property rights. Who is to be the owner of European policies? Governments or the citizens? Ownership means rights to limit access and exclude non-performers. This is precisely how a modern democracy works: it gives citizens the right to select and reject governments as their agents. Ownership for Lisbon would imply the sovereignty of citizens and a proper European democracy. Europe's economic governance needs to be re-thought.

²⁵ Collignon, *supra*, note 15.

²⁶ European Commission, *supra*, note 2.

A disappointing performance Comparing Euroland to the USA

Has the Lisbon Strategy made a difference? Progress should be measured against the headline objective of a 'dynamic economy.'²⁷ The result is disappointing as shown per capita income growth in Figure 8.2. Instead of increasing in the six years following the Lisbon Council compared to the performance over the previous six years, it actually fell. Only in the six less developed new member states and Greece was it higher. This is the opposite of what Lisbon sought to achieve. Although growth has also slowed down in the United States under George W. Bush, in 16 EU countries out of 25 – including some of the biggest member states – per capita growth was less than in the USA. Only Sweden, Finland, Poland, Luxemburg, Ireland and Cyprus experienced higher growth. Interestingly, the EU25 as a whole does not perform dramatically different from the US; the problem is the Euro-area, where growth has been lagging significantly behind the American economy. The US growth rate is nearly 50 per cent higher than Euroland's.

How can the slow growth in Euroland be explained? Standard theory tells us that it can be decomposed into the growth rates for employment and for labour productivity. Given that the Lisbon Strategy seeks structural improvements, we are less interested in the short term fluctuations and focus on the long term trends. Figure 8.3 therefore shows employment growth trends in the Euro-area and the USA smoothed by a Hodrick-Prescott filter. Employment growth in America has had a downward trend since the 1970s, falling by more than half from over 2.1 to 0.9 per cent. In Europe, we notice the low growth rate in the 1960s and 1980s,²⁸ a clear increase in the second half of the 1990s and stabilisation above one per cent since then. Yet, in recent years the contribution from employment to growth has been higher in Europe than in the US. This is surprising, given that the labour market is often blamed for Europe's bad performance.

²⁷ All figures in this chapter refer to the European Commission's AMECO database, unless otherwise specified.

²⁸ The Euroland time series is without Belgium before 1985.

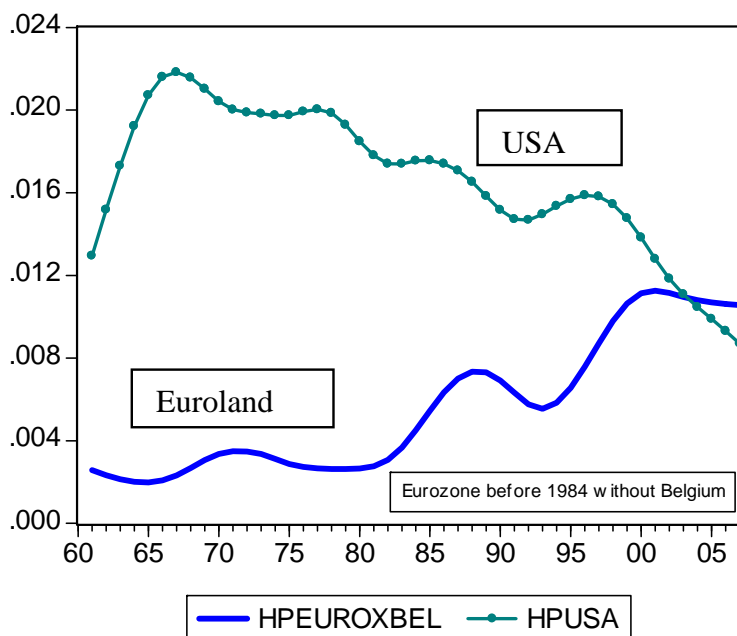


Figure 8.3: Employment growth trends

The main reason for the better US income performance is therefore essentially due to the higher growth in labour productivity. As Figure 8.4 shows, labour productivity improved from the 1980s on, while it first stagnated in Euroland and then deteriorated after 1990. Only since 1997 has the growth trend for labour productivity been higher in the United States than in Europe.

Explaining labour productivity is not uncontroversial, but we know that it can be further decomposed into (a) human and capital investment per unit of labour, i.e. the capital intensity of production (also called capital deepening), and (b) output produced per unit of human and capital investment, i.e. total factor productivity (TFP).

Total factor productivity in the USA has slowed down in the 1960s and 1970s, but gradually improved since the early 1990s. In Europe it accelerated in the 1980s when the single market was put in place, but it fell back again in the 1990s. See Figure 8.5. There are no indications that the Lisbon Council has made any difference to this development, although it may have slowed down the deceleration.

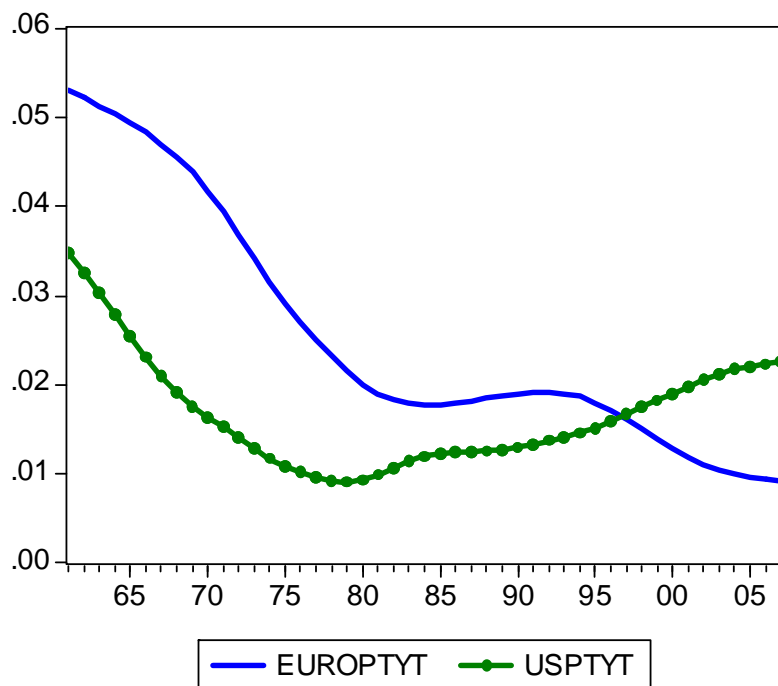


Figure 8.4: Labour productivity trends

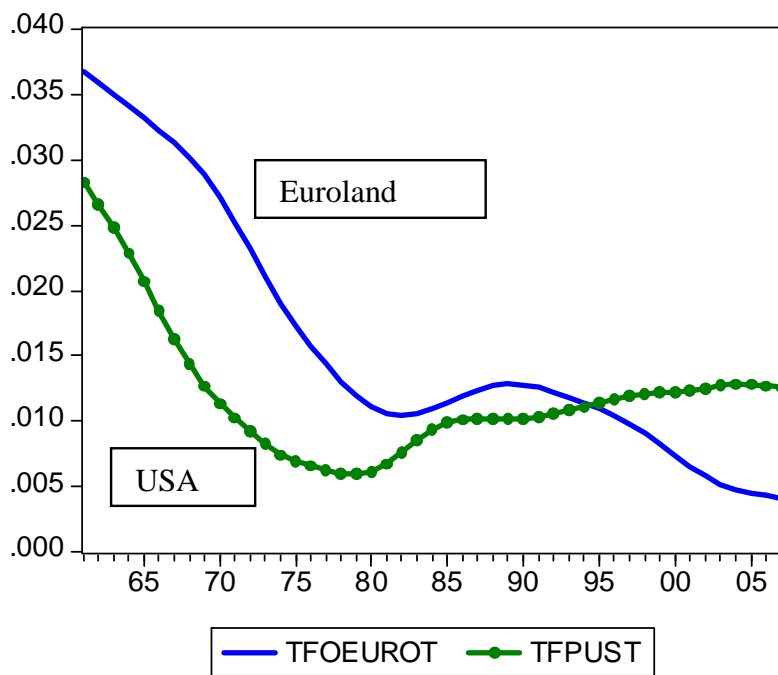


Figure 8.5: Total factor productivity growth trends

As is well known, growth in total-factor productivity represents output growth not accounted for by changes in inputs. It is therefore dependent on a wide range of qualitative factors, such as technological innovation, learning, social regulation etc. Europe's low performance is usually attributed to these factors and this is where the supply-side agenda of Lisbon has a role to play. For example, Kok argues that the US were leaders in technical innovation, accounting for 74 per cent of top 300 IT companies and 46 per cent of top 300 firms ranked by research and development spending, while Europe was falling behind.²⁹ However, while there is truth in this claim, as it would appear from Figure 8.5, one must not forget that innovation, knowledge, technology and skills must be incorporated into the stock of human and physical capital. Without investment, modern technology remains an abstract dream.

Figure 8.6 shows the trend performance of capital deepening. Here we find the most dramatic difference between Euroland and the United States. The US economy has gone through a process of rapid capital deepening since the early 1990s, beating all historic records; in Europe it is falling. Thus, Europe's problem is low investment.

The differences between Europe and America are striking. On both continents investment growth fell dramatically in the 1970s, but in the US it stabilised in mid-decade, while it nearly collapsed in Europe amidst the monetary chaos following the breakdown of Bretton Woods.³⁰ Investment recuperated in Europe in the mid-1980, but it remained at fairly low levels. In the USA, however, investment per unit of output accelerated at an unexpected rate during the Clinton/Greenspan years and seems to have settled at a permanently higher rate than in the Euro-area.

²⁹ Kok, *supra*, note 16, at p. 12.

³⁰ Collignon, *supra*, note 9.

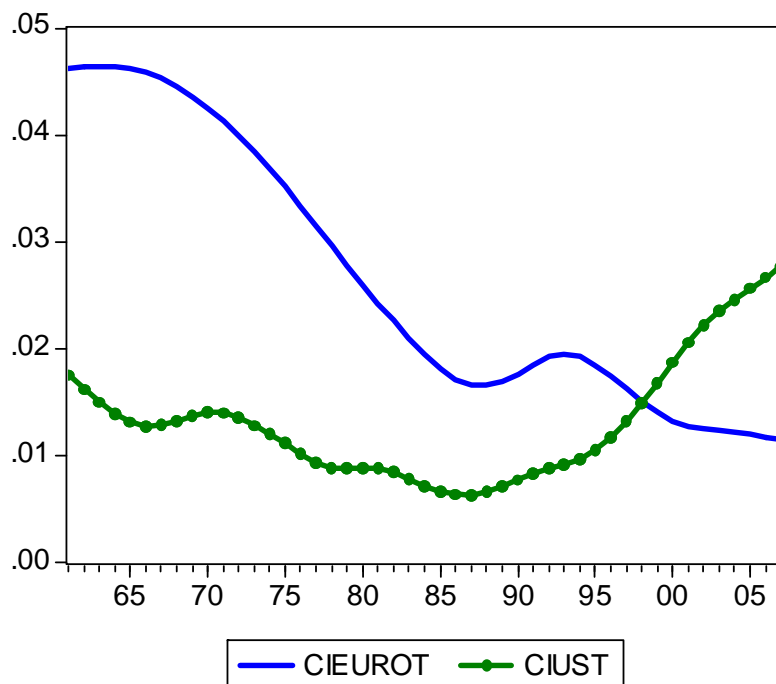


Figure 8.6: Capital deepening trends

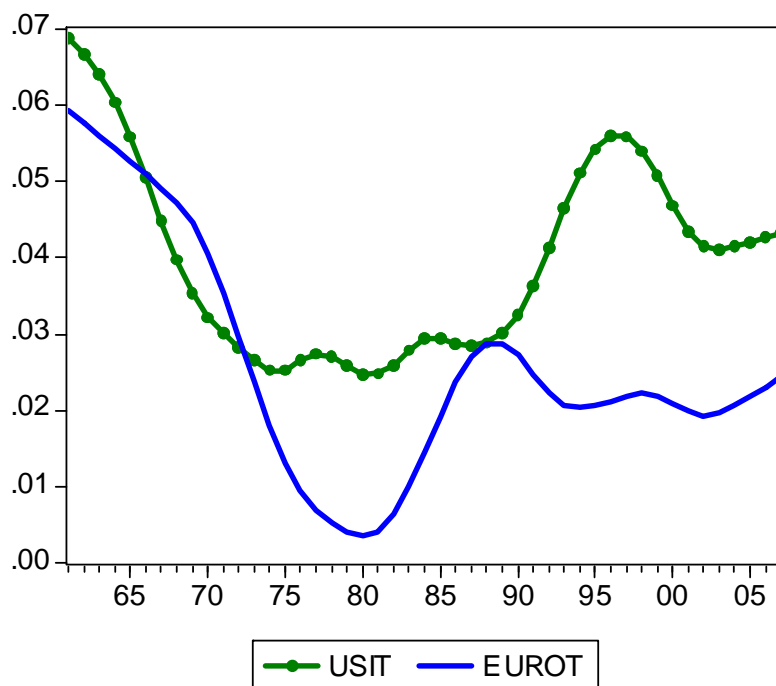


Figure 8.7: Gross investment trend growth

The question is then: why is the rate of investment so low in Euroland? While microeconomic factors are surely important at the firm level, aggregate investment must be related to the profits

entrepreneurs expect to make in their different markets. This is where aggregate demand – and therefore macroeconomics – matter.

The flawed macroeconomic and institutional framework

If Europe wants to become ‘one of the most dynamic economies in the world,’ it will have to improve its macroeconomic management. The policy debate on macroeconomics frequently focuses on short term micro-management, particularly the role of monetary and fiscal policy in minimising output volatility and stabilising the business cycle. However, the fiscal and monetary policy mix has also important implications for long-term economic growth. Critics have often accused the ECB of being too restrictive and thereby impeding investment and growth. I will show that this argument misses the more important coordination failure resulting from the flawed institutional set-up for fiscal policy. An improved macroeconomic framework would require substantial institutional reforms in Europe.

Macroeconomic stability and investment

How should we measure the impact of the monetary/fiscal policy mix on the growth rate? Conventional econometric models of regressing monetary and fiscal variables on output have produced ambivalent evidence.³¹ In particular, disentangling short term and long term effects is difficult. I will therefore attempt a different approach.

Supply-side reforms and macroeconomic management are the two major factors determining investment. Structural reforms can improve labour productivity and the elasticity of labour supply, thereby improving the potential rate of growth. But actual growth will only accelerate if aggregate demand stimulates investment. Firms create jobs when they see opportunities for profit. Lowering labour costs and implementing structural reforms may be a necessary for the competitiveness in international trade, but domestic demand

³¹ See for example D. Gros and A. Hobza, ‘Fiscal Policy Spillovers in the Euro Area: Where are they?’, CEPS Working Document No. 176, Centre for European Studies, 2001. A remarkable exception is P. Aghion and P. Howitt, ‘Appropriate Growth Policy: A Unifying Framework’, Lecture given at the 20th Congress of the European Economic Association, Amsterdam, 25 August 2005.

remains the key to the overall economic performance. Take the UK. While supply-side reforms under Thatcher and Major have revolutionised British society, GDP in Britain has increased on average 2.08 per cent between 1979 and 1996, hardly more than in Mitterrand's socialist France, where it grew at 2.05 per cent per annum. With Labour's new macroeconomic framework introduced in 1996, UK GDP increased on average by 2.68 after 1997, compared to 2.08 per cent in France. The reason was hardly that France reformed the supply side less than Britain; between 1999 and 2006, domestic demand contributed 3.1 per cent to U.K. growth and 1.8 per cent in France; foreign trade subtracted 0.5 per cent in the UK, and only 0.3 per cent in France. Investment contributed 0.55 per cent in Britain and 0.69 per cent in France. Or look at Germany. Under the Schröder government, an aggressive reform agenda has reduced unit labour costs by 10 percentage points below the Euroland average, far below any other country, but growth has remained elusive. While German exports exceeded those of all other countries in the world, GDP grew only by 1.1 per cent p.a. from 1999 to 2006, and 1.3 per cent p.a. in the seven years before. Under Schröder domestic demand contributed only 0.46 per cent to growth, foreign trade 0.76.³² Economic growth returned after consumer confidence was established after the German elections and wage settlements became more accommodating.

A widely believed proposition asserts that macroeconomic management does no longer work in the age of globalisation. This is wrong. After all, the USA or the UK also live in a globalised world. The share of the EU15 non-tradable value added is still above 43 per cent and may be even larger.³³ Hence, there is a significant part of Europe's economy where profits depend exclusively on domestic demand. Comparing the two biggest economies in the world, domestic demand has contributed 3.5 per cent to growth in the USA, but only 1.9 per cent in Euroland. Furthermore, macroeconomic management may also influence foreign demand through the exchange rate. What is needed to stimulate investment is therefore a policy where the interaction of monetary, fiscal and wage developments creates the incentive for firms to exploit profitable

³² Calculations from European Commission, AMECO, 2006, code CVGD.

³³ I assume industry and 50 per cent of services to be tradables, and the other 50 per cent of services plus agriculture and construction industry to be non-tradables. Data from European Commission AMECO.

market opportunities. These incentives require returns on real investment that are higher than interest rates and a framework of stability that reduces the risk premium on investment due to uncertain expectations.

During the 1970s, 1980s, and 1990s, Europe has suffered from monetary instability that followed the breakdown of Bretton Woods international system. With the creation of monetary union, Euroland has regained monetary stability, but it is still uncertain whether it can achieve a policy mix capable of sustaining accelerated capital accumulation, growth and higher employment. The first few years of EMU achieved a positive policy mix with historically unprecedented job creation (2.3 million in 1999, 2.4 million in 2000, 1.9 million in 2001, but only 280 thousand in 2003), although the experience was too short to make a significant impact on unemployment rates. We need to understand why. There are two possibilities: High volatility due to macroeconomic instability had deterred investment and created excess savings, or the steady macroeconomic environment had not encouraged investment because equilibrium interest rates are too high when compared to achievable rates of return on investment. In this section we focus on instability, in the next on the steady state.

When macroeconomic policy fails to stabilise shocks, the increased uncertainty will lead economic actors to ask for higher risk premia on the return on capital and this will lower investment. Therefore, stability of the macroeconomic environment matters for investment. If macroeconomic uncertainty can be modelled as the volatility (i.e. the conditional variance) of the growth rate of investment, we would expect a negative relation between uncertainty and the growth rate of investment.³⁴ The expected rate of investment would be a decreasing function of the conditional variance and the coefficient would measure the sensitivity of aggregate real investment to uncertainty. The time-varying equilibrium investment rate can be measured by an ARCH-M model,³⁵ where the expected growth rate of the capital stock depends on the volatility of investment, measured by the weighted sum of past squared surprises. In other words, firms feel

³⁴ Collignon, *supra*, note 9; Aghion and Howitt, *supra*, note 32.

³⁵ W. Enders, *Applied Econometric Time Series* (Second Edition), Hoboken, NJ, Wiley and sons, 2004.

uncertain about investment prospects to the degree that shocks in previous periods affect this period's market conditions and on their experience of how much they have misinterpreted market conditions in the past. Table 8.1 gives the results for Euroland and the United States.³⁶

Table 8.1. ARCH-M model for US and Euroland investment

<p>Estimation Equation</p> <p>Investment = C(1)*GARCH + C(2)</p> <p>GARCH = C(3) + C(4)*RESID(-1)^2 + C(5)*GARCH(-1)</p> <p>The RESID(-1)^2 term describes news about volatility from the previous period, measured as the lag of the squared residual from the mean equation The GARCH(-1) term is last period's forecast variance</p> <p><u>Estimated Coefficients for Euroland:</u></p> <p>EUROinvest = -0.272*GARCH + 0.0079</p> <p>GARCH = 0.0001 + 0.438*RESID(-1)^2 + 0.326* RESID(-2)^2</p> <p><u>Estimated Coefficients for USA:</u></p> <p>USinvest = -0.342*GARCH + 0.019</p> <p>GARCH = -1.31E-07 + 0.281*RESID(-1)^2 - 0.563 Resid(-2)^2 - 0.159 Resid(-3)^2 + 0.935*GARCH(-1)</p>

As expected, macroeconomic uncertainty (GARCH) reduces autonomous investment C(2). The rate of investment responds negatively to macroeconomic instability in both economies. Interestingly, the coefficient that measures the elasticity of this response is not dramatically different between the American and Euro-economy. It is -0.34 for the US, -0.27 for Euroland. However, the dynamics of uncertainty are different. In Europe uncertainty is strongly affected by cumulative expectation surprises in the last two quarters. Europeans seem to believe that when things are bad, they will get even worse. By contrast, in the USA, past surprises partially

³⁶ See also technical annex.

compensate each other. This may reflect optimism under conditions of more 'flexible' market structures or more activist macro-policies in the United States. However, the net effect of these expectation errors is long lasting in its impact on today's uncertainty. Thus, greater macroeconomic stability is likely to have a more persistent positive impact on investment. This may in part explain the remarkable performance of the US-economy during the Greenspan years. But it is an interesting fact that whatever causes uncertainty in economic expectations, the reaction by firms for undertaking real investment is fairly similar on either side of the Atlantic, with Europeans being slightly less responsive than Americans.

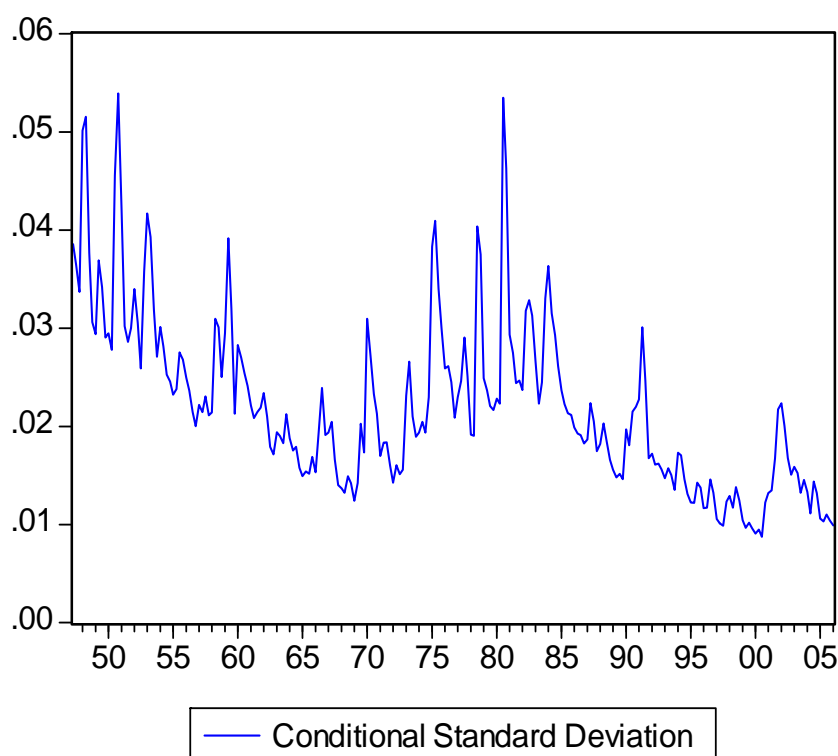


Figure 8.8: USA: Volatility in the growth of capital stock

In general, real investment is more volatile in the US than in the Euro area (see Figure 8.8). Our time series for the U.S.A. starts before 1950 and shows a period of diminishing volatility until the mid 1960s (during the Golden Age). A dramatic increase in uncertainty occurs during the break-up years of Bretton Woods and then a long period of returning to high economic stability during the Greenspan years. This trend is interrupted by the two Bush presidencies.

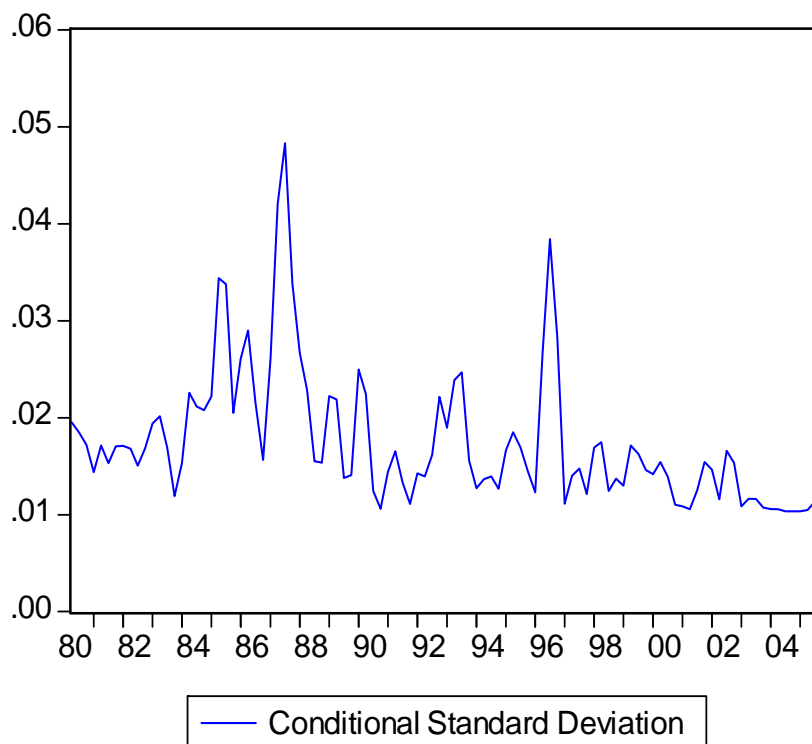


Figure 8.9: Euroland: Volatility in the growth of capital stock

For Euroland, our data series is shorter. After the set-up of the European monetary system, a higher degree of stability prevails at first, but is low in the second half of the 1980s. The 1990s are shocked by the ERM-crisis in 92/93 and financial instability in the mid-1990s. With the creation of the Euro a high degree of macroeconomic stability has been restored. This is an interesting result. It shows that European monetary union has attained its objective: stability. But why has the improved macro-environment not translated into higher growth? The answer is found in the low steady state investment growth in Euroland. Autonomous investment growth is more than twice as high in the U.S. (1.9 per cent) than in Europe (0.8 per cent). An explanation for this difference may be found in the long-term policy mix.

It's the Deficit, stupid!

In a large and fairly closed economy, the key to active demand management is the interaction between budget and monetary policy. This interaction may matter from a short-term perspective when excess savings prevent potential output from being absorbed by effective demand or from a growth perspective in the steady state.

The short-term effect occurs when individuals will not hold real capital unless its yield exceeds some minimum required return. Keynesian policies seek to reduce interest rates to make real investment more attractive relative to financial assets or to increase the government deficit to provide demand for the resources that would not otherwise be used. Such policies are adequate to tackle the problem of excess savings, but they do not solve the problems with low steady state growth, which is Europe's problem. As Feldstein has shown a long time ago, in an environment of low inflation and reasonable stability of savings, budget deficits will lower the accumulation of capital in the steady state.³⁷ One therefore has to distinguish between the short term effects for the fiscal-monetary policy mix, which are supposed to restore overall macroeconomic stability after shocks, and the long-term growth effects of different steady-state policy mixes.

From a theoretical point of view, the interaction between fiscal and monetary policy should have a negative trade-off if the economy is in equilibrium. This is evident from Figure 8.10. The downward sloping efficiency lines represents the set of all efficient policy mix points where the economy is in equilibrium, without inflation or rising unemployment. In other words, it reflects a zero output gap. Above the line, say at point A, the combination between fiscal and monetary policy is too tight and the economy is in a deflationary position with rising unemployment. Below the line, the mix is too loose and inflationary pressures occur. For simplicity we will assume that the efficiency-line is stable.³⁸ The argument for a negative slope of the efficiency line can be made in terms of long term interest rates in the government bond market,³⁹ or in terms of monetary policy adjustments in the short-term money market.⁴⁰

³⁷ M. Feldstein 'Fiscal Policies, Inflation, and Capital Formation', (1980) 70(4) *American Economic Review*.

³⁸ In a stochastic setting the shocks are i.i.d, and the efficiency-line would reflect the co-integrating vector. We cannot pursue this line of reasoning in this chapter.

³⁹ Feldstein, *supra*, note 38.

⁴⁰ Collignon, *supra*, note 23, Annex 3.

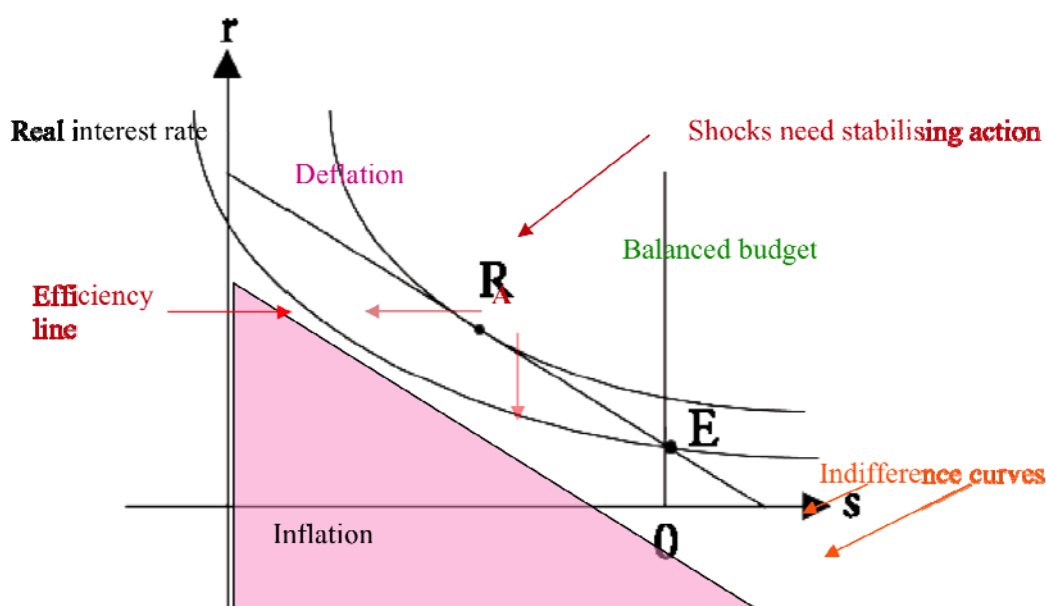


Figure 8.10. The optimal policy mix

A loosening of fiscal policy, i.e. higher deficits, would then imply tighter monetary policy, i.e. higher interest rates, to keep inflation at bay. Tighter fiscal policies should cause rates to come down. The specific combination along the trade-off curve represents a specific policy mix. For example, the Reagan/Volker policy mix in the 1980s reflected high deficits and high interest rates in the US. This is point R (Republican) in Figure 8.10. When Bill Clinton ran for President in 1992,⁴¹ he promised to bring the deficit down in order to stimulate growth and employment by lower interest rates.⁴² Thus, the Democratic policy mix is somewhere near point E. Low interest rates will stimulate investment. Not surprisingly, the Clinton/Greenspan mix of the late 1990s was characterised by budget surpluses and low interest rates, high growth and macroeconomic stability.

Equilibrium positions on the policy mix trade-off curve reflect collective time preferences for intergenerational tax burden sharing. The choices can be represented by an indifference curve that picks an optimal policy mix out of the infinite possibilities assembled on the

⁴¹ His motto was 'It's the economy, stupid!'

⁴² B. Woodward, *Maestro: Greenspan's Fed and the American Boom*, New York: Simon and Schuster, 2000.

efficiency line. The public choice of a policy mix is the implicit result of electoral decisions and reflects the consensual preferences among a majority of citizens. These preferences emerge gradually from collective deliberation and political debates. These debates are intensified during electoral campaigns when competing parties bundle policies into specific programs and voters have to make up their mind what to choose. Of course, citizens do not debate in abstract terms: 'What is our optimal policy mix?'. But when parties and candidates propose a tax cut without saying where they intend to reduce expenditure, they implicitly suggest higher deficits and therefore higher interest rates. Choosing such a candidate implies choosing a policy mix. During the 1992 US elections, the budget deficit was widely discussed, due to the independent candidate Ross Perot. Clinton won as he captured the median voter. In 2000 Republicans promised to 'return' the budget surplus to tax payers, while Al Gore sought to use it for improving health care. The implicit choice of a policy mix within a broader bundle of policies is therefore at the core of any democratic society.

In Europe, the conduct of fiscal policy is more complicated and less democratic. From an economic point of view, what matters for the policy mix in the same currency area is the aggregate fiscal stance for the whole of Euroland that interacts with the single monetary stance of the ECB. Yet, in Europe's 'governance without a European government', fiscal policy is determined autonomously by 12 national governments. As discussed above, this creates collective action problems. Adhering to the Stability and Growth Pact would guarantee reasonably low equilibrium interest rates. But as Figure 8.1 has shown, the SGP rule is not implemented.⁴³ We have explained the failure to implement the SGP (balanced structural budgets) by 'Europe's governance with many governments' that cannot deal efficiently with exclusive public goods. Fiscal policy is such a good. I now will show that Euroland's fiscal policy arrangement creates a bias for high equilibrium interest rates and therefore for lower steady state investment.

⁴³ Figure 8.12 provides, however some evidence that the excessive deficit procedure under the Maastricht Treaty, which is associated with penalties, has more binding power.

The SGP has often been criticised for being insufficiently flexible. However, it is not sufficiently understood that the Pact imposes effectively two forms of inflexibility: it constrains effective stabilisation policy in the short run, except for a limited range of automatic stabilisers,⁴⁴ and in the long run, it impedes democratic choices regarding the intergenerational justice of tax burdens because it imposes a balanced structural deficit. The SGP is therefore incompatible with alternative choices on the efficiency line, such as the implicit shift from Reagan/Volker to the Clinton/Greenspan policy mix in America. It imposes point E on the efficiency line once and for all for each member state. The question is which of these two inflexibilities dominates Euroland? Given that macroeconomic instability has disappeared, as we saw in the last section, short-term inflexibility does not seem to be a major issue. The main problem with Euroland's economy must be the equilibrium position of the policy mix.

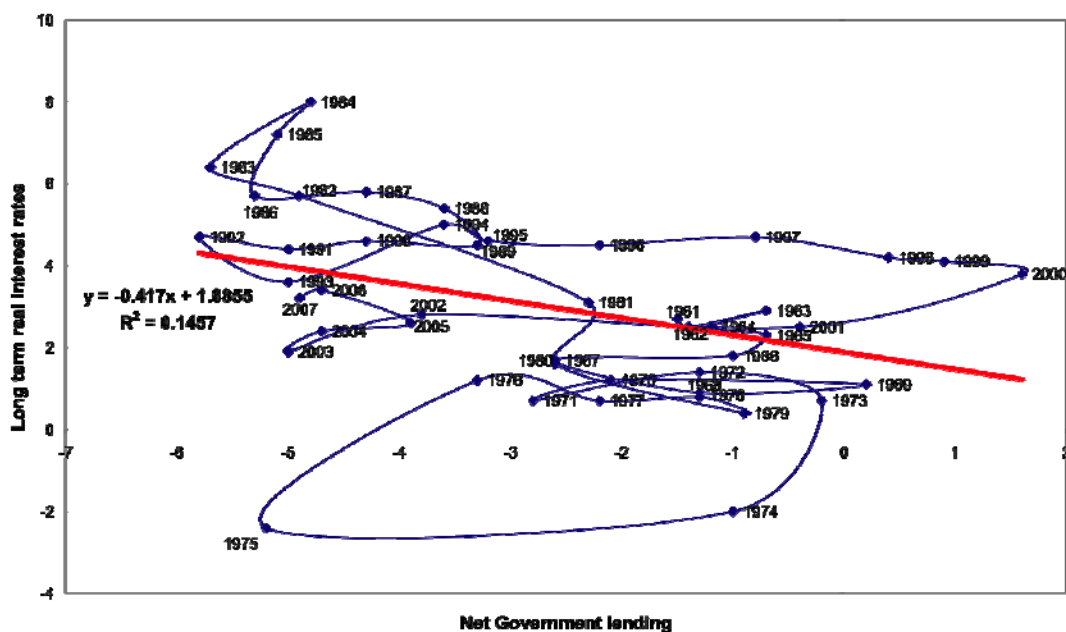


Figure 8.11: Policy mix USA

Figures 8.11 and 8.12 show the interacting movements between fiscal

⁴⁴ It is sometime argued that there is an adjustment problem for countries, which have started EMU with high debt and deficits, thereby constraining their automatic stabilizers. Nearly 10 years after the EMU-decision was taken, this line of argument seems daring. If France or Italy still has large budget deficits, it is a matter of political choice and not of business cycle.

and monetary policies for the USA and Euroland. The long-term trend line reflects a negative trade-off. This is what theory would let us expect.⁴⁵ The trend-line has a slope of -0.417 in the United States and -0.473 in Euroland. Thus, the two economies operate in a remarkably similar fashion. The structural improvement of the aggregate budget position by one percentage point of GDP will lower the equilibrium interest rate by 41.7 base points in the US and by 47.3 base-points in Europe. If Euroland would stick to the Stability and Growth Pact, the equilibrium interest rate in the capital market would be a full percentage point lower.⁴⁶

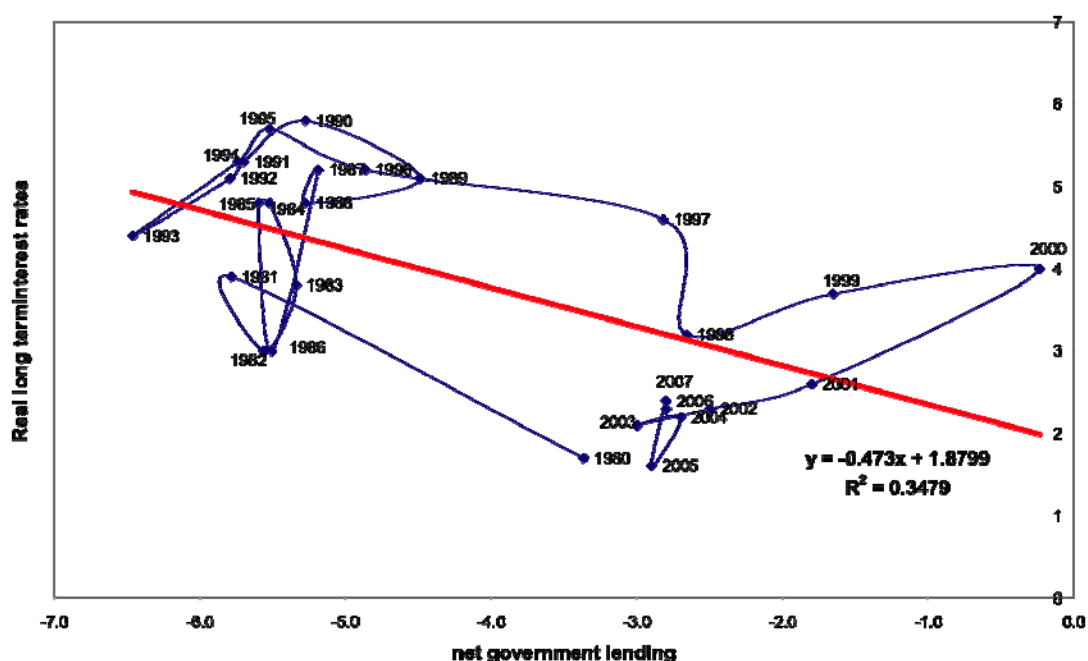


Figure 8.12: Euroland policy mix

Shifts along the optimal policy mix curve seem frequent in the USA, see Figure 8.11. The inflationary period (below the line) of the late 1960s and 1970s is clearly perceptible; the same applies for the Bush Jr. presidency 2001-07. The late 1980s suffered from overly restrictive policy mixes and high deficits and high equilibrium interest rates. It is interesting that the fiscal consolidation of the Clinton years has

⁴⁵ The assimilation of the trend-line with the efficiency-line is justified if we assume that in the long run output gaps should balance out.

⁴⁶ Thus balancing budgets would achieve the 'euthanasia of rentiers' so famously advocated by Keynes.

reduced the equilibrium interest rate by nearly 200 base points, but took place in the context of a relatively restrictive macroeconomic environment. The overall message is clear: balancing budgets lowers equilibrium interest rates.

In Euroland a clear shift has taken place after the introduction of the euro. Figure 8.12 shows the cluster of excessively tight European policy mixes in the early 1990s. Deficits were high at that time, with an implicit maximum limit of six per cent. But monetary policy was excessively restrictive, when Bundesbank dominated Europe, and repeated currency crises in the European monetary system caused high risk premia in financial markets. After the ECB had taken over, Euroland's policy mix has become more accommodating, even if the ECB at first needed to establish its reputation as an inflation fighter. However, fiscal consolidation fatigue after 2000 has pushed the steady state policy mix back to the left again. This move can be explained by the collective action problem in designing a coherent aggregate fiscal policy stance.

Here is why: Assume we start in equilibrium and one government decides to borrow at the low prevailing rates. This is a demand shock that pushes the whole system into an inflationary disequilibrium and requires monetary tightening. However, because the aggregate budget position is determined as the random outcome of each member state's policy, fiscal policy cannot be used as a stabilisation policy instrument for the integrated Euro-area. In other words, no other country will change its own policy stance and consolidate in order to keep the aggregate policy mix in equilibrium. Only monetary policy has the flexibility to respond at the European level. If uncoordinated national policies increase the aggregate deficit, euro-interest rates need to go up. Thus, the apparent monetary tightness of the ECB is the product of Europe's 'governance with many governments'. The higher equilibrium interest rates may affect economic growth in all member states negatively, so that as a consequence of one member state's deviating behaviour, all national budgets are falling into deficits. A picture of fiscal indiscipline emerges, which may push the ECB raise interest rates even further. These countries will now complain that interest rates are 'too high', although the ECB has simply restored macroeconomic equilibrium. The new equilibrium, caused by the free-riding behaviour of one

actor, reflects a higher aggregate structural deficit and higher interest rates for all. Because Euroland's citizens cannot democratically determine the aggregate policy mix along a stable trade-off curve, the central bank has a persistent bias for conservatism.

Increasing the efficiency of the policy mix would require turning the aggregate budget stance into a policy tool for stabilisation policy and at the same time imposing strict discipline on individual member states to stick to the defined policy. Thus, the correct reform of the SGP would be more flexibility for the aggregate fiscal policy position and less discretion for individual member states. The 'reform' of the SGP in 2005 has achieved exactly the opposite: individual countries have now more leeway to justify higher deficits, while the aggregate position is the random outcome of uncoordinated free-riding. The consequences are higher equilibrium interest rates, lower growth and more unemployment. Europe will remain the least dynamic region in the industrialised world economy.

One may object that after eliminating the exchange rate as an adjustment tool, national budgets must absorb asymmetric shocks in EMU. However, the likelihood and intensity of asymmetric shocks has greatly fallen in Euroland and economic growth has become more uniform. The standard deviation of the 12 euro-member states' growth rates in 2005 is only one third of what it was in 1999. Euroland is converging – although to a low common growth rate. This fact highlights the increased importance of the policy mix for the whole of Euroland, while national discretion in fiscal policy has become counterproductive and damaging.

Moreover, there are some simple ideas in the public debate about how to design coherent, yet flexible, institutional arrangements for fiscal policy in Euroland (see Amato 2002; Casella 2001; Collignon 2004b).⁴⁷ For example, one may define the optimal aggregate fiscal

⁴⁷ See G. Amato, 'Verso un DPEF Europeo', (2002) No. 4 luglio, *Nuova Economia Nuova Società (NENS)*, pp. 15-19; A. Casella, 'Trade-able Deficit Permits' in A. Brumila, M. Buti, and D. Franco (eds) *The Stability and Growth Pact, the Architecture of Fiscal Policy in EMU*, London, Palgrave, 2001; S. Collignon, 'Fiscal policy and Democracy', paper presented at Monetary Workshop, Österreichische Nationalbank, Vienna, 2004, published as ÖNB Discussion paper No. 4, November, available at <www.stefancollignon.eu>.

stance at the Euro-level by transforming the Broad Economic Policy Guidelines into a 'DPEF europeo'.⁴⁸ This would give flexibility in reacting to macroeconomic shocks. The aggregate stance would then need to be broken down into national (and even regional) deficit quota for which each jurisdiction would obtain deficit permits. If one jurisdiction does not use its quota, it would be allowed to sell the permits to another authority that wishes to borrow more. This system, inspired by tradable pollution permits, would achieve vertical flexibility reflecting fundamental preferences for borrowing and taxes, and horizontal flexibility between different jurisdictions and overall coherence in the fiscal position.

The question of democracy

However, setting up the improved institutional framework for macroeconomic policy faces the same problem as the Lisbon supply-side agenda: potential benefits are huge, but national governments stand in the way of achieving them. The issue of improved policy coordination is ultimately dependent to the issue of democratic legitimacy. Therefore, Europe needs to tackle the core issue of its governance: democracy.

I have discussed the issue of fiscal policy and democratic legitimacy in separate papers.⁴⁹ The problem is the following. According to the classical definition, a democratic constitutional state is a political order 'created by the people themselves and legitimated by their opinion and will-formation, which allows the addressees of law to regard themselves at the same time as the authors of the law'.⁵⁰ Thus, voting for a government is the political act that allows citizens to regard themselves as the ultimate authors of laws, i.e. as the sovereign. But prior to the vote, political debate is the necessary condition for collective will-formation.

⁴⁸ See Amato, *supra*, note 48. Documento di Programmazione Economico-Finanziaria (DPEF - Document of Economic and Financial Programming) is the Italian macroeconomic framework law, which gets voted before the finance minister can put forward his annual budget. France's Vth Republic introduced a similar tool to overcome the budgetary inconsistencies of the IV Republic.

⁴⁹ S. Collignon, 'The three sources of legitimacy for European Fiscal Policy', (2007) 28(2) *International Political Science Review*, pp. 155-184; *id.*, *supra*, note 48.

⁵⁰ J. Habermas, *The Postnational Constellation. Political Essays*, Oxford, Polity Press, 2001.

However, in the European Union, policy decisions are not democratic in this sense. Certainly, citizens are able to revoke national governments at national elections after a national debate has produced the collective will within this constituency. But, with respect to European public goods, national governments can never represent all European citizens; they act as the agent of a 'principal' that is only a faction of the European population. These national agents then decide policies at the European level that affect all European citizens, although they represent only the will of some European citizens. This is different from democracy in a national setting, where members of parliament are responsible to their constituency *and* for achieving the collective good.⁵¹ The democratic will formation in one country has externalities for all other national constituencies. With respect to stabilisation policy, this externality is a consequence of unifying the monetary system and having a single interest rate determined by the ECB. In general, policy compromises negotiated at the European level are superimposed on a majority of citizens who were not involved in the process of collective will formation and therefore do not consider themselves as 'authors of law'. As this process is repeated for every individual country, European policy decisions will never command the same degree of democratic legitimacy as national decisions.

Moravcsik has denied the existence of a 'democratic deficit' in Europe, arguing that the EU simply operates like any 'advanced industrial democracy', because technical functions of low electoral salience are often delegated to specialised institutions.⁵² Thus, output legitimacy (good results) trumps input legitimacy (the right to choose). This view may have been justified when the scope of European integration was relatively narrow. It may be valid for inclusive public goods, which can be regulated by 'governance

⁵¹ In representative democracies members of parliament are elected after a national debate, which is structured by the campaigns of political parties. The MP therefore has an interest to secure a majority for his party. In the EU, there is no constituency transcending institution like parties. The campaigns are also constitutive elements of will formation. The *Council operates more like an eternal parliament that replaces its members exclusively through by-elections*, but no campaign takes place because none is accountable to the whole European constituency.

⁵² A. Moravcsik, 'In Defence of the "Democratic Deficit": Reassessing Legitimacy in the European Union', (2002) 40(4) *Journal of Common Market Studies*, pp. 603-24.

without government'. But when European policies such as monetary policy or the Lisbon agenda touch every European citizen's way of life, and when fiscal coordination reaches the sacrosanct domain of 'no taxation without representation', it is a matter of the normative coherence of modern society that European citizens must have a right to choose collectively. Yet, the only institutional channel through which they can express their choices is national and not European democracy. Hence, national interests dominate the European interest and collective action problems prevent efficient policies. The only logical solution of the dilemma is setting up a European government that is elected by all European citizens and responsible for the administration of the European exclusive goods, which affect them all. The coherence of input and output legitimacy is then restored, the cooperation failure is overcome and economic and political efficiencies are reduced.⁵³

Conclusion

The prospects for Europe's future are bleak, but not hopeless. If Europe continues with the undemocratic intergovernmental approach of Lisbon, it takes little imagination to see that after 50 years of European unification, the European Union will die a slow death by gridlock, economic stagnation and un-kept promises. Nor can we exclude a more violent crisis with extreme right wing parties coming into power. The results of the constitutional referendum in France and the Netherlands gave an early taste of re-emerging nationalism. Alternatively, Europe takes a leap forward and creates a proper democracy, where all European citizens choose their common government for the administration of European public goods. European policy choices are then the outcome of democratic debates. I have called such a democratic system for the EU 'the European Republic';⁵⁴ the Belgian Prime Minister Guy Verhofstadt has referred to the old idea of the 'United States of Europe'.⁵⁵ However, the fundamental dilemma remains: which national government will wish to set up a European democracy if it loses its own power? Perhaps

⁵³ See Collignon, *supra*, note 23, for a more extended analysis of the centralization/decentralisation trade-off and the dilemma of what call there type I and II inefficiencies.

⁵⁴ Collignon, *supra*, note 23, *id.* *Vive la République européenne*, Paris, Éditions de La Martinière, 2004.

⁵⁵ G. Verhofstadt, *The United States of Europe*, London, Federal Trust, 2006.

the only way forward is that citizens mobilise themselves and work through political parties in Europe. After the collective trans-European deliberation, which follows from party competition, a new democratic consensus might emerge and impose citizens' preferences for democracy on resistant national governments.

Annex

Euroland Quarterly

Dependent Variable: EURO_QUARTER

Method: ML - ARCH (Marquardt) - Normal distribution

Date: 06/04/06 Time: 13:26

Sample: 1980Q2 2005Q4

Included observations: 103

Convergence achieved after 23 iterations

Variance backcast: ON

GARCH = C(3) + C(4)*RESID(-1)^2 + C(5)*RESID(-2)^2

	Coefficient	Std. Error	z-Statistic	Prob.
@SQRT(GARCH)	-0.272058	0.371735	-0.731859	0.4643
C	0.007970	0.005570	1.430964	0.1524
Variance Equation				
C	0.000106	3.92E-05	2.690469	0.0071
RESID(-1)^2	0.438561	0.229310	1.912523	0.0558
RESID(-2)^2	0.326469	0.239623	1.362426	0.1731
R-squared	-0.040404	Mean dependent var		0.004731
Adjusted R-squared	-0.082870	S.D. dependent var		0.017706
S.E. of regression	0.018425	Akaike info criterion		-5.283531
Sum squared resid	0.033269	Schwarz criterion		-5.155631
Log likelihood	277.1018	Durbin-Watson stat		2.295435

US Quarterly

Dependent Variable: GR_FI_US

Method: ML - ARCH

Date: 06/02/06 Time: 18:08

Sample (adjusted): 1947Q2 2006Q1

Included observations: 236 after adjustments

Convergence achieved after 39 iterations

Variance backcast: ON

$$\text{GARCH} = C(3) + C(4) \cdot \text{RESID}(-1)^2 + C(5) \cdot \text{RESID}(-2)^2 + C(6) \cdot \text{RESID}(-3)^2 + C(7) \cdot \text{GARCH}(-1)$$

	Coefficient	Std. Error	z-Statistic	Prob.
@SQRT(GARCH)	-0.342548	0.209732	-1.633266	0.1024
C	0.019016	0.003665	5.188743	0.0000
Variance Equation				
C	-1.31E-07	4.04E-06	-0.032425	0.9741
RESID(-1)^2	0.281047	0.102087	2.753017	0.0059
RESID(-2)^2	-0.056367	0.119778	-0.470595	0.6379
RESID(-3)^2	-0.159850	0.069779	-2.290807	0.0220
GARCH(-1)	0.935525	0.033684	27.77359	0.0000
R-squared	-0.024989	Mean dependent var		0.010338
Adjusted R-squared	-0.051845	S.D. dependent var		0.022270
S.E. of regression	0.022840	Akaike info criterion		-4.868640
Sum squared resid	0.119458	Schwarz criterion		-4.765899
Log likelihood	581.4995	Durbin-Watson stat		1.264102

Chapter 9

The labour constitution of the European Union

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European constitution and social order

The prevalent project to conceptualise of European primary law as constitutional law¹ is conceptually challenging. It implies a loosening of the traditionally close link between the concept of a constitution and the notion of the nation state. This move allows conceiving constitutions and constitutional law even beyond the state;² at the

* Preliminary Remark: The following chapter was written for publication in A. von Bogdandy and J. Bast (eds) *Principles of European Constitutional Law*, 2nd ed., Oxford, Hart Publishing, 2009. It does therefore not use the RECON terminology and does not apply the three models which are guiding the RECON research in general. However, the conceptual framework developed here has very direct links with the RECON models. The first RECON model, reconstitution of democracy at national level, corresponds with the original situation in Europe discussed in the chapter, when hardly any constitutional provision in the Treaties was about labour. The chapter discusses then the conceptual option of a full-fledged labour constitution established at European level. This option speaks to the second RECON model of a democratic reconstitution at European level. Finally, the chapter develops and recommends the idea of an 'association of labour constitutions' where only specific functions are allocated at European level. This idea represents, in my view, one fruitful articulation of RECON's third model for the field of labour law.

¹ See in particular von Bogdandy and Bast, *supra*, note 1.

² C. Möllers, 'Pouvoir Constituant - Constitution - Constitutionalisation', in A. von Bogdandy and J. Bast (eds) *Principles of European Constitutional Law*, 2nd ed., Oxford, Hart Publishing, 2009, at p. 163.

same time, it signifies that the established dichotomy between confederation (*Staatenbund*) and federal state (*Bundesstaat*)³ has become obsolete as far as constitutional law is concerned. Therefore, the concept of a federal union (*Bund*) has recently gained renewed attention, as it represents a legal entity that has its very own constitution, besides and above that of the state.⁴ The main feature of a supra-statal federation is its ability to generate autonomous law, which takes precedence over the laws of its member states but does not abolish the autonomy of their legal systems. Hence, the European Union conceived as such a federation can have a constitution that is independent of member state constitutions but at the same time legally affiliated with them.⁵

The term 'constitution' is here ambitiously defined as the legal justification and constitution of public authority.⁶ But the modern conception of constitution does not end with these functions, as a constitution establishes both public authority and social order; it generates a 'constitution of society' (*Gesellschaftsverfassung*) or an 'all-encompassing societal constitution' (*gesellschaftliche Gesamtverfassung*).⁷ In particular, the restriction of public authority by basic rights concomitantly establishes a societal space and provides it with particular normative structures. Being part of classical constitutional doctrine, concepts such as the horizontal effect of constitutional rights⁸ or the notion of institutional guarantees of constitutions⁹

³ P. Kirchhof, 'The Legal Structure of the European Union as a Union of States', in A. von Bogdandy and J. Bast (eds) *Principles of European Constitutional Law*, 2nd ed., Oxford, Hart Publishing, 2009, at p. 715.

⁴ C. Schönberger, 'Die Europäische Union als Bund', (2004) 129 *Archiv des öffentlichen Rechts* 81.

⁵ I. Pernice, 'Bestandssicherung der Verfassungen', in R. Bieber and U. Widmer (eds) *Der europäische Verfassungsraum*, Zürich, Schulthess, 1995, at p. 261ff; see also S. Oeter, 'Federalism and Democracy', in A. von Bogdandy and J. Bast (eds) *Principles of European Constitutional Law*, 2nd ed., Oxford, Hart Publishing, 2009, at p. 53 ('composite constitution').

⁶ See Möllers, *supra*, note 2.

⁷ R. Scholz, 'Koalitionsfreiheit', in J. Isensee and P. Kirchhof (eds) *Handbuch des Staatsrecht*, Heidelberg, Müller, 2001, vol VI, par. 151, Art. II. (pars 21–35) ('*Gesellschaftsverfassung*'); H. Ridder, *Die soziale Ordnung des Grundgesetzes*, Opladen, Westdeutscher Verlag, 1975, at p. 40 ('*gesellschaftliche Gesamtverfassung*'); the term labour constitution as developed below, focuses on a relevant aspect of '*gesellschaftliche Gesamtverfassung*'.

⁸ H. J. Papier, 'Drittwirkung der Grundrechte', in D. Marten and H. J. Papier (eds) *Handbuch der Grundrechte*, Heidelberg, Müller, 2006, vol II, par. 55.

highlight this social dimension of state constitutions. Hence, the challenge for European constitutional theory and constitutional law is to separate the notion of a constitution also in the sense of a constitution of social order from the established framework of the state and to reformulate it in a multi-level context for a *Verfassungsverbund* (i.e., a 'composite constitution' or 'association of constitutions'). However, a central idea of the constitution of public authority in Europe, namely the division of sovereignty between the member state and the European level,¹⁰ cannot be applied to a multi-level constitution of social order, as the implied notion of a societal sphere that is split into a European and member state part would hardly make sense. Rather, a theory of European constitution has to be able to explain how the interplay of member state and Union constitutions establishes a *single* social sphere, and it has to reflect the latter's particular normative structure.

At present, the idea underlying a societal overall-constitution of the EU represents nothing less than the central problématique of the integration process. It appears as an amplified demand for a 'social Europe', uttered in the meantime by so many citizens that the persistence of a pro-European majority promoting integration appears to be at risk.¹¹ This demand rests on the empirically substantiated diagnosis that the economic benefits of market integration come at the expense of an increasing social inequality. Whereas in the era of relatively closed national economies, from the end of World War II until the 1970s, the factors of (domestic) growth and increasing (domestic) income were linked, they are now visibly detached through processes of European and global market integration. This 'golden era' of modern statehood¹² enabled most old member states to establish a social compromise between capital and

⁹ M. Kloepfer, 'Einrichtungsgarantien', in D. Marten and H. J. Papier (eds) *Handbuch der Grundrechte*, Heidelberg, Müller, 2006, vol II, par. 43.

¹⁰ See Oeter, *supra*, note 5.

¹¹ The constitutional treaty failed following the French referendum, as it was not able both to take up these demands visibly and convincingly, and to accommodate them substantively.

¹² The term 'golden era' of statehood can be found in S. Leibfried and M. Zürn, 'Von der nationalen zur post-nationalen Konstellation', in S. Leibfried and M. Zürn (eds) *Transformation des Staates*, Frankfurt a. M., Suhrkamp, 2006, at p. 23. The authors refer to E. Hobsbawm, *The Age of Extremes*, London, Joseph, 1994, at p. 225ff. Hobsbawm has coined the term 'golden age' for the period from 1950–1975.

labour, which left economic property rights untouched but gave employees their fair share of the growing wealth in return. From the 1970s onwards, the foundations of these compromises were eroded step by step. Hence, for many the positive vision of a 'social Europe' is to re-establish such a social compromise at the European level, although its institutional contours remain rather vague. The social acceptance of the Union as a legitimate order and, hence, the future of European integration itself probably depends upon successfully providing the current chiffre of a 'social Europe' with a distinct content.¹³

In this respect, the matter of a societal overall-constitution in general and a European labour constitution in particular is part and parcel of a socio-political quest, which aims to reveal the relevant constitutional framework and its realistic potential for future development. However, such a project immediately faces the objection that labour constitutions¹⁴ have thus far only played a marginal role in the legal debate.¹⁵ This applies to the disciplines of labour law¹⁶ and of constitutional law¹⁷ alike. Too often 'labour constitution' is only used as an ostentatious title or magniloquent catch phrase. Therefore, the term has to be briefly explicated first.

¹³ See also U. Haltern, 'On Finality', in A. von Bogdandy and J. Bast (eds) *Principles of European Constitutional Law*, 2nd ed., Oxford, Hart Publishing, 2009, at p. 199.

¹⁴ This approach taken by critical legal studies assumes that the form of a field of law provides a basis for criticising legal reality. For an example focusing on private law, see F. Rödl, 'Normativität und Kritik des Zivilrechts', (2007) *Archiv für Rechts- und Sozialphilosophie*, at pp. 114 and 167.

¹⁵ In the German *Grundgesetz*, the labour constitution has been discovered significantly later than the economic constitution (Scholz, *supra*, note 7, par. 24). The first monograph dealing with the labour constitution of the *Grundgesetz* was published in 1965 (D. Conrad, *Freiheitsrechte und Arbeitsverfassung*, Berlin, Duncker and Humblot, 1965). The pertinent volume 'Die Wirtschafts- und Arbeitsverfassung', edited by K. Bettermann and F. Neumann, as part of a compendium (*Die Grundrechte*, Berlin, Duncker and Humblot, vol III/1, 1958) only mentioned it in its title.

¹⁶ The exception is R. Richardi, *Kollektivgewalt und Individualwille bei der Gestaltung des Arbeitsverhältnisses*, München, Beck, 1968; id., (ed.), *Arbeitsrecht als Teil freiheitlicher Ordnung*, Baden-Baden, Nomos, 2002; E. Picker, *Die Tarifautonomie in der deutschen Arbeitsverfassung*, Köln, Wirtschaftsverlag Bachem, 2000.

¹⁷ The exception is R. Scholz, *Die Koalitionsfreiheit als Verfassungsproblem*, München, Beck, 1971; id, *Pressefreiheit und Arbeitsverfassung*, Berlin, Duncker und Humblot, 1979; id, *Die Aussperrung im System von Arbeitsverfassung und kollektivem Arbeitsrecht*, Berlin, Duncker und Humblot, 1980.

The concept of a labour constitution

The term 'labour constitution' can be traced back to the Weimar labour lawyer Hugo Sinzheimer. In his view, the labour constitution stands side by side with the contract of employment.¹⁸ While the contract of employment provides the basis for labour performance, the function of the labour constitution is to establish a community of employer and employees that jointly exercises the employer's property rights.¹⁹ Hence, the labour constitution comprises the collective dimension of labour law, i.e. the level of establishment and company management and the level of collective bargaining, which includes the law governing collective agreements, industrial conflicts and mediation.

Thus, Sinzheimer's reference to a labour constitution primarily has a substantive meaning, even if the foundation for a collective labour law could be found in the Weimar Constitution itself (Arts 159, 162.1 and 162.2 Weimar Constitution). The collective dimension of labour law is the labour constitution, not because it can be found in the written constitution itself, but because, from a substantive point of view, its formal foundations have a constitutional function. The powerful position of employers is subject to the constitution due to their ownership of the means of production. In Sinzheimer's understanding, ownership of the means of production not only constitutes a position of control over property but, since it is unequally distributed, also dominion over people.²⁰ The constitutionalisation of the owners' control over property and people is the functional equivalent of the shaping of public authority.²¹ Similar to the merely structuring state constitution which impinges little upon the rule of the sovereign and only limits the exercise of sovereignty through juridification, the labour constitution should also not infringe the status of employers as proprietors, i.e. as concerns the ownership and use of property; rather, it is only meant to submit the administration of property to the control of a community of employers and employees.²²

¹⁸ H. Sinzheimer, *Grundzüge des Arbeitsrechts*, Jena, Fischer, 1927, at p. 107. Both combined constitute the 'labour association' (*Arbeitsverband*).

¹⁹ *Ibid.*

²⁰ *Ibid.*, at p. 22ff.

²¹ Möllers, *supra*, note 2.

²² Sinzheimer, *supra*, note 18, at p. 208ff.

However, this Sinzheimerian concept turns the labour constitution into a mere conceptual complement of a liberal, free market, economic constitution,²³ centring on the guarantee of ownership of the means of production. This perspective changes as soon as one includes, in contrast to Sinzheimer, the constitutional fundamental of individual employment in the definition of the labour constitution, so that the interdependence of both the orders of economy and labour becomes apparent. The labour constitution then not only restrains the power of the private owner-employer, rather it constitutes the social actors themselves within the social field of labour and determines their relationship. According to such an understanding, the guarantees of private property and freedom of contract provide not only cornerstones of a liberal economic constitution, but, with the guarantee of ownership of the means of production and freedom of contract of employment,²⁴ simultaneously the central element of a liberal labour constitution.²⁵

Given the backdrop of the present question, it further seems appropriate to limit considerations to a formal understanding of the term 'constitution'. While Sinzheimer's concern was mainly with the restriction of the power of proprietors, the analysis here is concerned with the constitutionally stabilised (European) order of social conditions. Thus, the concept of labour constitution, as it will be employed in the following, encompasses all norms of constitutional

²³ Nevertheless, the popularity the term 'labour constitution' enjoyed in national socialist labour law is remarkable – for instance A. B. Krause, *Die Arbeitsverfassung im neuen Reich*, Stuttgart, Berlin, Kohlhammer, 1934; W. Siebert, 'Die deutsche Arbeitsverfassung', in E. R. Huber (ed.), *Idee und Ordnung des Reichs*, vol II, Hamburg, Hanseatische Verlagsanstalt, 1943. Its application should apparently signify the departure from a liberal paradigm of individual and collective labour law. On this contrast, see M. Becker, *Arbeitsvertrag und Arbeitsverhältnis während der Weimarer Republik und in der Zeit des Nationalsozialismus*, Juristische Abhandlungen Bd. 44, 2005, at p. 382ff.

²⁴ The coincidence of private ownership of the means of production with freedom of contract is certainly not imperative. Freedom of contract can be replaced by slavery, peonage and forced labour, as history shows.

²⁵ In Austrian labour law, such a narrow conception of 'labour constitution' as the unity of all collective labour law has remained in existence until the present day. See the Austrian labour-constitutional law of 14 December 1973, österr. BGBl. [Austrian law gazette] No 22/1974, and the definition by the Austrian T. Mayer-Maly, entry 'Arbeitsverfassung', in A. Klose, W. Mantl and V. Zsifkovits (eds), *Katholisches Soziallexikon*, Innsbruck, Wien, München, Tyrolia, 1980, at p. 126.

rank that represent fundamental decisions on the makeup of social forces and their interrelation in the societal sphere of employment.

The individual and collective rights of social actors constitute the foundation of the labour constitution. Logically prior are those individual rights that define social actors in their social roles. Under liberal conditions, these are the guarantee of private ownership of the means of production, on the one hand, and freedom of contract of employment, on the other hand; both constitute the roles of the employer and the employee. In addition, there are collective rights in the sphere of workers' participation, which restrict the employer's power of disposal procedurally. Finally, those rights are part of the labour constitution that regulate the collective representation of employees regarding their contractual working conditions, i.e. the constitutional guarantee of free collective bargaining.

Besides these fundamental rights, labour-constitutional 'guiding norms' (*Leitnormen*) exist. The term 'guiding norms' encompasses all constitutional norms, which can affect the legal structures of the field of employment and, hence, includes principles as well as norms determining state goals and tasks. The most important example of a guiding norm in the German constitution is the principle of social statehood (*Sozialstaatlichkeit*) (Art. 20.1 German Basic Law).²⁶

Finally, the labour constitution also includes the legislative competences in the area of labour law and judicial competences regarding labour disputes, for as is the case for all constitutional norms, the rights and guiding norms of the labour constitution also require 'articulation'. In the given context, this term shall be understood as the concretisation of fundamental rights and guiding norms in different historical contexts and for specific social constellations,²⁷ which can be generated by the legislature and courts alike. The term articulation, hence, encompasses both legislative and judicial acts. It is of fundamental importance for the effect and

²⁶ For a definition that includes principles authoritative for labour law, see Scholz, *supra*, note 7, par. 24.

²⁷ The term 'articulation' emphasizes the creative moment of the adjudication of fundamental rights, in contrast to a merely deductive approach, yet without abandoning the idea that fundamental rights remain a yardstick for such creative achievements.

dynamic of a norm to what extent and under what circumstances the legislature and courts are competent to articulate it and to shape, with this, the social field of labour; the respective competence norms are thus part of the labour constitution itself.

To sum up: The concept of a labour constitution, which informs the following, includes the individual and collective fundamental rights of social actors in the field of employment, the constitutional guiding norms governing the contractual relationship between employers and employees and, finally, the competences of the legislature and courts to articulate these constitutional norms.²⁸

The EEC labour constitution and the social compromise for integration

The original labour constitution of the EEC provides not only a historical starting point for the following considerations. Rather, the explanation of the concrete shape of the EEC labour constitution allows reconstructing the social function of a European labour constitution that remains significant for the present. Accordingly, the essential norms of the EEC labour constitution are at first outlined in the following section. It is then explained that the norms of the EEC labour constitution can be derived from their function to realise a 'social compromise for integration', which enabled the establishment of the European integration process in the first place. On that basis, implications for the form and shape of the current European labour constitution can be developed.

The basic norms of the EEC labour constitution

The central norm of the EEC labour constitution was Art. 117, TEEC (Treaty establishing the European Economic Community, Rome, 1957). It stated:

²⁸ The concept of a labour constitution contains a blind spot, which cannot be explored here for constraints of time and space. This blind spot is the eminently relevant impact of public administration by way of controlling labour immigration on the constitution of social power relations (for an account of the social function of controlling labour immigration, see K. Dohse, *Ausländische Arbeiter und bürgerlicher Staat*, Berlin, Express Edition, 1981, at p. 412. This topic has become particularly contested in the EU, see e. g. C.-U. Schierup, P. Hansen and S. Castles, *Migration, Citizenship, and the European Welfare State; A European Dilemma*, Oxford, Oxford University Press, 2006, at p. 48ff.

Member states hereby agree upon the need to promote improved working conditions and an improved standard of living for workers so as to make possible their harmonisation while the improvement is being maintained. They believe that such a development will ensue not only from the functioning of the common market, which will favour the harmonisation of social systems, but also from the procedures provided for in this Treaty and from the approximation of provisions laid down by law, regulation or administrative action.

(Art. 117 TEEC)

Primarily, this norm entails a social promise, namely progression towards more equal living and working conditions for workers. This is linked to the prediction that such improvements come as a consequence of the Common Market. Additionally, the 'procedures provided for in this Treaty' should play a role, which refers to, e.g., the European Social Fund (Arts 123–128 TEEC) or the European cooperation of member states (Arts 118 TEEC)²⁹ and which transcend the field of a labour constitution developed here.³⁰ Finally, the approximation of legal and administrative provisions was meant to come to bear. However, the TEEC did not provide any competences for the approximation of member state labour laws in the subsequent chapter 'Social Provisions' (Arts 117–122 TEEC). Hence, the subset refers to provisions in other parts of the Treaty and especially to the competence under Art. 100 TEEC, which generally authorises the European level to harmonise legal provisions, provided that the establishing or functioning of the Common Market requires so. The approximation of member state labour laws was therefore no aim *per se*, rather European labour law should only come to the fore sporadically, justified by the functioning of the Market. Consequently, the Common Market and not a comprehensive European labour constitution was meant to function as the actual guarantor of the promised social progress.

²⁹ J. Pipkorn, in H. von der Groeben, J. Thiesing, C.-D. Ehlermann and A. Bardenhewer, *Kommentar zum EWG-Vertrag*, 3rd ed., Baden-Baden, Nomos, 1983, pre Art. 117–122 TEEC par. 7ff.

³⁰ For the notion of a post-regulatory labour constitution whose backbone is constituted by 'soft' political coordination, see below.

Art. 117 TEEC can be considered the central norm of the EEC labour constitution, as it represents the basic decision that there is no need for a similarly integrated labour constitution besides the European economic constitution. In addition to this, the TEEC only entailed two further norms which can be considered part of its labour constitution and which in essence persist unchanged to date. The first one is the free movement of workers, Art. 48 TEEC (Art. 39 Treaty establishing the European Community [TEC], 1967, Art. 45 Treaty on the Functioning of the European Union [TFEU], 2007). It introduced the fundamental right for all citizens of the member states to freely exercise their profession community-wide after a transitional period (until end of 1969). This right also touches upon the sphere regulated by the labour constitution, insofar as Art. 48.2 TEEC grants protection against direct and indirect discrimination regarding the legislature, the parties of collective agreements and individual employers.³¹ The second norm, Art. 119 TEEC demanded provisions guaranteeing equal remuneration of men and women (Art. 141 TEC, Art. 157 TFEU). As its wording addresses the member states, it did not take the European Court of Justice long to interpret it as a right to equal pay with horizontal effect on private employers.³²

Out of the large number of possible labour-constitutional provisions, Arts 48 and 119 TEEC alone have found their way into the EEC labour constitution. That however is not a coincidence. Rather, they are part of the programme of Art. 117 TEEC: Art. 48 TEEC served to establish the Common Market, namely a European Market for labour. Art. 119 TEEC served to eliminate the competitive advantages of those companies in the European Market that did not offer equal pay to women on account of legal provisions, collective agreements or contracts. The core of the EEC labour constitution thus comprises a

³¹ It is not entirely clear whether the non-discrimination principle of Art. 48 TEEC/Art. 39 TEC directly binds the so-called 'social partners' and private employers. However, such binding effect is constituted for collective agreements and individual labour contracts by Art. 7.4 Council Reg 1612/68 on the free movement of workers within the Community, [1968] OJ L 257, 2. Accordingly, the ECJ has extended the horizontal effect of the non-discrimination principle to private employers in Case C-281/98, *Angonese* [2000] ECR I-4139. In turn, the ECJ seems to apply a lower standard for justification (par. 42); see A. Randelzhofer and U. Forsthoff, in E. Grabitz and M. Hilf, *Das Recht der EU*, München, Beck (Looseleaf, January 2008), pre Art. 39-55 TEC par. 80.

³² Case C-43/75, *Defrenne II* [1976] ECR 455, par. 80ff.

coherent ensemble of provisions including the programmatic principle of Art. 117 TEEC, the market-functional rights of Art. 48 and 119 TEEC and the equally market-related competence norm of Art. 100 TEEC.

The foundation and function of the EEC labour constitution

The promise of neoclassical economics

With its promise of a progressive harmonisation of workers' living and working conditions, Art. 117 TEEC took up and condensed an economic narrative common in the prevailing neoclassical variant of the 'pure theory of international trade' at the time. It can be found in an expert report of the International Labour Organisation (ILO)³³ – which proved to be instrumental for the shape of the EEC labour constitution, as will be explained further below.

Even prior to the founding of the EEC, there were concerns that transborder free trade would economically disadvantage those enterprises in member states with better working conditions and, hence, that this would jeopardise those social standards already achieved in these member states.³⁴ The worry was that companies in other member states could produce the same goods cheaper due to their inferior working conditions, which would render domestic production non-competitive at home and abroad. Neoclassical economics made three fundamental assertions regarding these concerns about the social effects of a common European market. According to the first assertion, existing differences in average labour costs would cause no competitive advantage for companies in countries with lower costs: as the difference of average labour costs would merely mirror the difference of the average productivity of labour, which depended upon available resources, the qualification of employees and the available capital in the respective member states, whereas the average actual labour costs, in which different levels of productivity are included ('unit labour costs'), were rather equal in

³³ International Labour Organisation, 'Social Aspects of European Economic Co-operation: Report of a Group of Experts', Studies and Reports, New Series, No 46, 1956.

³⁴ International Labour Organisation, 'Social Aspects of European Economic Co-operation: Report by a Group of Experts (Summary)', (1956) 74 *International Labour Review*, at p. 99.

all member states.³⁵ Such an argument would prospectively apply under the assumption that the mobility of capital remained low despite the Common Market.³⁶ In case differences in actual labour costs were to arise in exceptional cases due to structural economic change, it would be the task of national central banks to adjust the exchange rate of their own currency according to their long-term goal of an even trade balance (see Art. 104 TEEC).³⁷

This first assertion was able to dispel doubts about social regress triggered by the Common Market. However, the neoclassical theory of international trade made a second assertion that seemingly challenged this message. It stated that the real earned income would drop in those countries where wages were higher before the opening of the borders. This prediction was rooted in the neoclassical theory of international trade's essential theoretical refinement vis-à-vis its classical antecedent; it concerned the explanation of the 'comparative cost advantages', which were meant to be central for the increase of welfare by free trade. In Ricardo's classical theory, domestic labour productivity was the foundation for 'comparative cost advantages'.³⁸ Different labour productivity is reflected differently in different products (in Ricardo's seminal example its impact is higher on English cloth than on Portuguese wine), which constitutes comparative in contrast to absolute cost advantages and, hence, even renders the free trade between two countries beneficial, of which one cannot produce a single product absolutely cheaper than the other. Neo-classical theory additionally argued that even a different supply of production factors (i.e., land, capital and labour) among states could constitute comparative cost advantages.³⁹ As the factor supply differs from state to state, their prices differ as well, which is reflected differently in products depending on their specific composition of factors. In these cases, the consequence of free trade is that the relative factor prices, i.e. the relationship of factor prices in one country, would converge in those countries involved (so-called factor

³⁵ International Labour Organisation, *supra*, note 33, par. 99.

³⁶ *Ibid.*, par. 261ff.

³⁷ *Ibid.*

³⁸ D. Ricardo, *On the Principles of Political Economy and Taxation*, Hildesheim, Olms, 1977 ([1817], at p. 114ff.

³⁹ B. Ohlin, *Interregional and International Trade*, Cambridge, Harvard University Press, 1933.

price equalisation theorem)⁴⁰. This means that the factor labour becomes cheaper, where it had been more expensive before. This implies a drop of real income in the involved countries with previously higher wages.

Finally, it was averred that the Common Market would enable an intensified transborder division of labour, the positive economies of scale of which would lead to substantial welfare growth in all economies involved.⁴¹ Due to the social ambitions of the member state governments and the strength of national trade unions, trade benefits would be redistributed internally in such a way that it would increase the living and working condition of employees.⁴² This argument turned the critical implications of the factor price equalisation theorem into the merry promise of Art. 117 TEEC: progressive harmonisation as a consequence of the Common Market.

The social compromise for integration

The interrelation between the neoclassical predictions regarding the social effects of the Common Market and the actual shape of the EEC labour constitution explicated above is in no way of historical interest only. It represents a social compromise that not only enabled the project of European integration, but also provides an indispensable element of its development and future trajectory.

As has been shown, the exact wording of Art. 117 TEEC can only be understood against the backdrop of a neoclassical theory of international trade. It follows that these economic theories have been given constitutional relevance by anchoring their prognostic element into the Treaty itself. Nevertheless, this thesis finds support not only in the wording of the Treaty itself but also in the Spaak report of 1956.⁴³ At the conference of Messina in 1955, the ECSC founding states commissioned Belgian foreign minister Paul-Henri Spaak to chair a committee, whose report was meant to become, and indeed became, the foundation for the shape of further economic

⁴⁰ Most lucidly explained in P. A. Samuelson, 'International Trade and the Equalization of Factor Prices', (1948) 58 *Economic Journal*, at p. 163.

⁴¹ International Labour Organisation, *supra*, note 33, par. 210.

⁴² *Ibid.*

⁴³ The Spaak report ('Rapport des chefs de délégation aux Ministres des Affaires étrangères: Comité intergouvernemental créé par la Conférence de Messine', Brussels, The Secretariat, 1956).

integration.⁴⁴ For this reason, the Spaak report represents something close to the preparatory materials of the TEEC, which have to be consulted in order to extract the deeper meaning of its provisions. Concerning the social effects of the Common Market, the Spaak report itself referred to a report of the ILO.⁴⁵ In turn, the ILO expert committee was chaired by Bertil Ohlin, who was at this time not only the most prominent proponent of the neoclassical theory of international trade⁴⁶ but also the chairman of the Swedish Liberal People's Party, whose general political orientation was social-liberal. The Ohlin report was bound to be highly socially credible and acceptable, given that it was issued by a tripartite organisation, encompassing unions, companies and states, compiled by a committee chaired by a man of the (then) political centre ground and because it met the highest scientific standards. In conjunction with its role as a substantial preliminary work for the Spaak report, which corroborated the founding of the integration project, the Ohlin report did not just represent the opinion of a few random experts, but instead was a legitimising cornerstone of the project of economic integration.

Yet another aspect underlines the constitutional relevance of these neoclassical promises. The shape of the EEC labour constitution is frequently also described as the result of a compromise between the German and French delegations. The French demanded a more comprehensive convergence of the member states' labour and social provisions as a precondition for market integration, while the Germans dismissed such claims. In the compromise reached, the French side at least obtained the inclusion of the provision on equal remuneration (Art. 119 TEEC), a declaration of intent regarding member state labour and holiday regulations (Art. 120 TEEC) as well as the reference to the general harmonisation competence in Art. 100 TEEC.⁴⁷ But although, according to this description, this result reflects

⁴⁴ R. Streinz, *Europarecht*, Heidelberg, C. F. Müller, 2008, par. 20.

⁴⁵ See for example Comité The Spaak report, *supra*, note 43, at p. 233ff; P. Davies, 'The Emergence of European Employment Law', in W. McCarthy (ed.), *Legal Intervention in Industrial Relations*, Oxford, Blackwell, 1993, at p. 318ff.

⁴⁶ See Ohlin's main work as cited *supra*, note 39. In 1977 Ohlin received, to honour his contribution to the theory of international trade, the Nobel Prize for economics.

⁴⁷ Pipkorn, *supra*, note 29, Art. 117 TEEC par. 18ff. The introduction of the German pension system turned out to be an important trailblazer (see A. S. Milward, *The European Rescue of the Nation-State*, London, Routledge, 2000, at p. 212ff.).

the outcome of a political bargain, the inclusion of these provisions into the TEEC mirrors exactly the position of the Ohlin report. Indeed, the report had argued that the opening up of the market did not require a convergence of labour and social regulations and it had recommended minimizing the gap between working hours, banning gender wage discrimination as distortions of competition and, finally, introducing a harmonisation competence for individual distortions of competition.⁴⁸ The Ohlin report therefore provided said compromise, itself being the decisive political breakthrough, with substantive rationality.

At this point it to be clarified what the exact constitutional significance of the established nexus between the neoclassical predictions and the shape of the EEC labour constitution is; after all, economic predictions are only confirmed or refuted by real-life developments, without their constitutional aspects being able to exert any influence in this respect. Constitutional meaning can however be derived from the fact that the project of a comprehensive European economic integration could not have been set off without the neoclassical predictions; that this is historically true is indicated by their anchoring in Art. 117 TEEC, their prominence in the constitutional materials of the Spaak report and their role as a rational foundation for the Franco-German bargain. From such a perspective, the neoclassical promise can and has to take a turn into the normative.

Taken normatively, the neoclassical thesis stating that member states differences in labour costs constitute no competitive factor implies nothing less than that the competition triggered by the Common Market is not allowed to play out on the basis of labour costs. As labour costs derive from wages and other working conditions, which are themselves the result of social and political struggles which are enabled and pre-shaped by member state labour constitutions, this implies at a second level that the functioning of member state labour constitutions is not allowed to be affected by the Common Market. The member state labour constitution shall thus remain both legally autonomous from the constitution of the Common Market and factually autonomous from its effects. At a third level, the exclusion of labour cost competition and the autonomy of member state labour

⁴⁸ International Labour Organisation, *supra*, note 33, at pp. 107, 110 and 113.

constitutions finally imply that the economic integration of Europe is not allowed to shift the social balance of power between labour and capital in a partisan manner in favour of the latter.

This is the normative substance of the historical interrelation between the neoclassical theory of international trade and the EEC labour constitution, and it represents – in a term deliberately referring to the talk of constitutional compromises of the Weimar Republic and the German *Grundgesetz* in constitutional theory⁴⁹ – the *social compromise for integration* underlying the European project.

The form of the European labour constitution and social change

The social compromise for integration, described above, not only explains the historical shape of the EEC but also provides, as an extralegal, social foundation of the European integration project, the normative yardstick for the present and future labour constitution of the Union. It is the very purpose of the European labour constitution to realise the social compromise for integration, and the concrete shape of the labour constitution can be critically judged by whether and to what extent it is able to realise this goal.

According to neoclassical predictions, the social compromise for integration had to be legally institutionalised in form of the EEC labour constitution. The three essential empirical assertions of these predictions have however become completely outdated, provided they were at all valid in the first place:⁵⁰ the enduring correlation of

⁴⁹ For the Weimar Republic, see H. Heller, 'Grundrechte und Grundpflichten', in id., *Gesammelte Schriften*, vol II, Leiden, Sijthoff, 1971, at p. 312; id., 'Genie und Funktionär in der Politik', in id., *Gesammelte Schriften*, vol II, Leiden, Sijthoff, 1971, at p. 621; F. Neumann, 'Die soziale Bedeutung der Grundrechte in der Weimarer Verfassung' (1930), in id., *Wirtschaft, Staat, Demokratie*, Frankfurt a. M., Suhrkamp, 1978, at p. 57; id., 'Der Funktionswandel des Gesetzes im Recht der Bürgerlichen Gesellschaft', in id., *Demokratischer und autoritärer Staat*, Hamburg, Europäische Verlagsanstalt, 1968, at p. 55. For an account of the German *Grundgesetz*, see W. Abendroth, 'Zum Begriff des demokratischen und sozialen Rechtsstaates', in id., *Antagonistische Gesellschaft und politische Demokratie*, Neuwied, Luchterhand, 1972, at pp. 125ff. and 139ff.

⁵⁰ In this context, criticism of the exuberant promises of the neoclassical foreign trade theory by the neoclassical 'New Theory of International Trade' (P. R. Krugman and M. Obstfeld, *International Economics. Theory and Policy*, Boston, Addison-Wesley, 2008) has to be omitted; the same applies to the critique of the neoclassical paradigm of

labour costs and productivity requires a low mobility of capital and a system of fixed adaptable exchange rates. At present, the intra-European freedom of capital is used effectively, both in form of investment capital (Art. 56ff. TEC, Art. 63ff. TFEU) and fixed capital (as a shift of production sites, Art. 43ff. TEC, Art. 49ff. TFEU). The currencies which were once adaptable to the respective levels of productivity ceased to exist in 1999 with the introduction of the Euro through the European Monetary Union. Finally, the domestic redistribution of trade benefits required socially ambitious governments and strong unions, which might have been a justified expectation at the end of the 1950s, at the prime of Keynesian-Fordist macro economic governance. But this nexus was valid only as long as its underlying governance paradigm was, which lost its appeal at the latest from the 1980s onwards.⁵¹

The corollary of this, however, is that the EEC labour constitution does not provide the appropriate institutionalisation of the social compromise for integration. Hence, it was and is the task of critical European constitutional law to analyse the change of the European labour constitution and of European labour law in light of the social compromise for integration. In this context, it might be empirically established that the compromise cannot be completely realised any more due to the changing socio-economic circumstances. Companies from the member states are now able to operate on a European level without any substantial problems. The free movement of goods, services and capital enables them to combine high productivity with low labour-costs.⁵² The actual state of mobility for the production factors labour and capital makes it impossible to abolish competition based on labour-costs completely, a fact which represents a fundamental shift in the power relation between capital and labour.⁵³

international trade in general. For the latter, see M. Heine and H. Herr, *Volkswirtschaftslehre*, München, Oldenbourg Wissenschaftsverlag, 2003, at p. 615ff.

⁵¹ B. Jessop, 'Die Zukunft des Nationalstaates. Erosion oder Reorganisation? Grundsätzliche Überlegungen zu Westeuropa', in S. Becker (ed.), *Jenseits der Nationalökonomie? Weltwirtschaft und Nationalstaat zwischen Globalisierung und Regionalisierung*, Hamburg, Argument Verlag, 1997, at p. 60ff; Milward, *supra*, note 47, at p. 439ff.

⁵² H. Flassbeck and F. Spieker, 'Die Irrlehre vom Lohnverzicht', (2005) *Blätter für deutsche und internationale Politik*, at p. 1071.

⁵³ As evidenced by, among other things, the growing disparity of income distribution (see U. Klammer, 'Armut und Verteilung in Deutschland und Europa', (2008) 3 *WSI-Mitteilungen*, at p. 19) and the decrease of the share of labour in national incomes in

However, this state of affairs certainly does not diminish the normative relevance of the social compromise for integration. On the contrary, it strengthens the need to achieve whatever remains possible under given circumstances.

The current state of the EU labour constitution

After portraying the labour-constitutional norms of the EEC as an instantiation of the social compromise for integration, the following section offers an overview of the current EU labour constitution.⁵⁴ Thereafter, the central problem of these norms is explicated, namely the lack of congruence between rights and guiding norms on the one hand and competences on the other hand.

A survey of the relevant norms

Rights

As in the past, the freedom of movement and the abolition of discrimination (Arts 39.1 and 39.2 TEC)⁵⁵ for member state citizens as well as the legal guarantee of equal pay for men and women (Art. 141.1 TEC)⁵⁶ belong to the fundamental norms of the EU labour constitution. Other than that, no further individual or collective legal position has to date been included in the primary law of the Treaties.⁵⁷ This situation only changed with the EU Charter of

Europe (see F. Breuss, 'Globalization, EU Enlargement and Income Distribution', WiFo Working Paper 296, 2007, available at <www.wifo.ac.at/wwa/jsp/index.jsp> - itself arguably based on neoclassical economics).

⁵⁴ What follows is the state of European constitutional law before a potential entering into force of the Treaty of Lisbon. For the relevant changes, see below.

⁵⁵ The freedom of movement and the abolition of discrimination, pursuant to Art. 39 TEC, is *lex specialis* both to Art. 18 TEC (M. Hilf, in E. Grabitz and M. Hilf, *Das Recht der EU*, München, Beck, 2008 (Art. 18 TEC par. 5) and Art. 12 TEC (Case C-131/96, *Romero* [1997] ECR I-3659, pars 10-12).

⁵⁶ Art. 141.3, 141.4 TEC furthermore assume a general principle of equal treatment under labour law (S. Krebber, in C. Calliess and M. Ruffert (eds), *EUV/EGV*, München, Beck, 2007, Art. 141 TEC pars 75ff.). In its ruling in Case C-144/04, *Mangold* [2005] ECR I-9981, pars 74ff., the European Court of Justice established the general principle (Art. 6.2 TEU) of the prohibition of age discrimination in Community law.

⁵⁷ Some studies of European labour law stress social dialogue (Art. 138 and 139 TEC) under the subheading of collective labour law (M. Fuchs and F. Marhold, *Europäisches Arbeitsrecht*, Wien, Springer, 2006, at p. 202ff; D. Krimphove, *Europäisches Arbeitsrecht*, München, Beck, 2001, par. 599ff; E. Szyszczak, *EC Labour Law*, Harlow, Longman, 2000, at p. 31ff; R. Blanpain, *European Labour Law*, The Hague, Kluwer Law International, 2006, at p. 643ff.). This social dialogue grants European trade unions

Fundamental Rights (hereinafter: the Charter), which in the meantime has been utilised by the Court of Justice as a source for the recognition of fundamental rights as general principles of Community law (Art. 6.2 Treaty on European Union [TEU], Maastricht, 1992, Art. 6.3 Treaty on the Functioning of the European Union [TFEU], Lisbon).⁵⁸ Relevant to the labour constitution are especially the provisions regarding the right to property (Art. 17.1 of the Charter), the freedom to choose an occupation (Art. 15.1 of the Charter), the protection in the event of unjustified dismissal (Art. 30 of the Charter), the right to fair and just working conditions (Art. 31.1 of the Charter), the right to industrial co-determination (Art. 27 of the Charter) as well as the right to collective bargaining and collective action (Arts 12.1 and 28 of the Charter).⁵⁹

The guarantee of central collective rights (Arts 27 and 28 of the Charter) and of dismissal protection (Art. 30 of the Charter), both essential for the social balance of power, is provided 'in accordance with Union law and national laws and practices'. Thus far, the meaning of this wording has not been clarified. Three positions have emerged. According to the first, the respective rights would be nearly

and employer associations particular privileges within European legislation, among those the remarkable right of negotiated legislation (see O. Deinert, 'Partizipation europäischer Sozialpartner an der Gemeinschaftsrechtssetzung', (2004) *Recht der Arbeit*, at p. 211). These rights have however no impact on the balance of power between the involved parties, especially as negotiations on legislation cannot be exposed to collective action (E. Eichenhofer, in R. Streinz (ed.), *EUV/EGV*, München, Beck, 2003, Art. 139 TEC par. 9; B. Bercusson, *European Labour Law*, London, Butterworths, 1996, at p. 542; K. W. Wedderburn, 'Consultation and Collective Bargaining in Europe: Success or Ideology?', (1997) 26(1) *Industrial Law Journal*, at p. 29ff. As to whether Art. 139.1, 139.2 TEC already establish the freedom to collective bargaining at the European level, see *infra*, note 184.

⁵⁸ Case C-303/05, *Advocaten voor de Wereld* [2007] ECR I-3633, par. 46; Case C-432/05, *Unibet* [2007] ECR I-2271, par. 37; Case C-540/03, *Parliament v Council* [2006] ECR I-5769, par. 38. For the changed situation due to the fact that the Charter has been formally anchored in the Treaty of Lisbon, see J. Kühling 'Fundamental Rights', in A. von Bogdandy and J. Bast (eds) *Principles of European Constitutional Law*, 2nd ed., Oxford, Hart Publishing, 2009, at p. 465.

⁵⁹ The Charter includes a number of further concrete, individual rights, for instance the right to limitation of maximum working hours (Art. 31.2 of the Charter) and a right to paid maternity leave (Art. 33.2 of the Charter). With a few exceptions, they reflect subject matters of the current *acquis* of secondary law in European individual labour law - which can however create problems for the normative scope of fundamental rights (for an instructive example, see E. Riedel, in J. Meyer (ed.), *Charta der Grundrechte der Europäischen Union*, Baden-Baden, Nomos, 2006, Art. 31 pars 19ff.

completely deprived of an autonomous substance by the caveat;⁶⁰ they are watered down to a 'teleological interpretative directive'⁶¹ for other provisions in European law. According to the second position, the caveat signals that the right needs further concretisation (*Ausgestaltungsvorbehalt*), while such concretisation has to respect the autonomous guarantee of the fundamental right.⁶² Based on this position, a normative core has to be distilled out of the respective fundamental rights;⁶³ this type of right is well known in German constitutional law, not at least from Art. 9.3 German Basic Law.⁶⁴ According to the third position, it is a limiting regulation (*Schrankenregelung*), which competes with the general limiting provision in Art. 52.1 of the Charter. The competition should be resolved by establishing which limiting regulation offers the superior protection of fundamental rights, as only this would do justice to the coexistence of two limitations.⁶⁵

It seems correct, however, to suggest that the cited reference to Union and national law and practices leaves the normative substance of the respective fundamental right untouched; it rather refers to the distribution of competences between the European and member state level for the enabling and limiting articulation of those rights. Regarding the sensitive area of collective rights and dismissal protection it is again stressed – in addition to the already redundant

⁶⁰ Krebber, *supra*, note 56, Art. 27 of the Charter, par. 5; P. Goldsmith, 'A Charter of Rights, Freedoms and Principles', (2001) 38 *Common Market Law Review*, at p. 1212ff; E. Pache, 'Die Europäische Grundrechtscharta ein Rückschritt für den Grundrechtsschutz in Europa?', (2001) *Europarecht*, at p. 481.

⁶¹ H. Lang, in P. Tettinger and K. Stern (eds), *Kölner Gemeinschaftskommentar zur Europäischen Grundrechte-Charta*, München, Beck, 2006, Art. 27 par. 8.

⁶² S. Rixen, in P. Tettinger and K. Stern (eds), *Kölner Gemeinschaftskommentar zur Europäischen Grundrechte-Charta*, München, Beck, 2006, Art. 28 par. 14; for the extraordinary discretion of the national legislature, see R. Rebhahn, 'Überlegungen zur Bedeutung der Charta der Grundrechte der EU für den Streik und die kollektive Rechtsgestaltung', in A. Söllner, (ed), *Gedächtnisschrift für Meinhard Heinze*, München, Beck, 2005, at p. 654ff; see also Kühling, *supra*, note 58.

⁶³ For initial indications of such an argument, see C. Hilbrandt, in F. S. M. Heselhaus and C. Nowak (eds) *Handbuch der Europäischen Grundrechte*, München, Beck, 2006, pars 35 and 42ff.

⁶⁴ *Entscheidungen des Bundesverfassungsgerichts* 84, at p. 225; *Entscheidungen des Bundesverfassungsgerichts* 92, at p. 393ff; W. Höfling, in M. Sachs (ed.), *Grundgesetz*, München, Beck, 2007, Art. 9 par. 71ff; H. Otto, *Arbeitskampf- und Schlichtungsrecht*, München, Beck, 2006, pars 4 and 20ff.

⁶⁵ S. Peers, 'Taking Rights Away?', in S. Peers and A. Ward (eds) *The EU Charter of Fundamental Rights*, Oxford, Hart, 2004, at p. 165: 'higher standard approach'.

array of references in Arts 51.1 and 51.2 of the Charter (and Art. 52.6 of the Charter according to its Lisbon version) – that the new European guarantees of these rights do not overwrite the distribution of competences between the European and the member state level. According to the justifications significant in the deliberations of the Fundamental Rights Convention, the arrangement of competences was crucial for the inclusion of this reference,⁶⁶ while nobody submitted that the rights should only guarantee a core content or even nothing at all. This interpretation as a reiteration of the preservation of competences is also supported by the explanations of the chair of the Fundamental Rights Convention; they contain no indication that the reference to the responsible legal level has a different meaning other than clarifying competences, especially one that would limit its normative substance.⁶⁷ Consequently, this means that all restrictions, including those of member states, must be measured against Art. 52.1 of the Charter.

Such scrutiny remains, however, under the significant general precondition that a given case falls within the scope of application of the Charter (Art. 51.1 of the Charter). And this, as must be noted with emphasis, constitutes the genuine problem of all labour-constitutional rights in the Charter (see below).

Guiding norms

As stated at the beginning, guiding norms are here conceived as those constitutional norms beyond the constitutive basic rights of social actors that can exert juridical effect in the field of labour. In current European constitutional law, there is no lack of principles concerned with the social dimension of Europe. Yet, only a few refer directly to the field of labour relations. In Art. 136.1 TEC not only the members States but also the Community commits itself to the improvement of working conditions and to social dialogue. Art. 2 TEU states as a

⁶⁶ CHARTE 4192/00 CONVENT 18, available at: <www.europarl.europa.eu/charta/activities/docs/pdf/convent18_fr.pdf>; see also the contribution of the Convention member Jürgen Meyer, who was instrumental to the inclusion of social rights, arguing that the reference was equivalent to Art. 51ff. of the Charter and hence redundant; N. Bernsdorff and M. Borowsky (eds) *Die Charta der Grundrechte der Europäischen Union*, Baden-Baden, Nomos, 2002, at p. 370; see also: Riedel, *supra*, note 59, par. 9ff.

⁶⁷ CHARTE 4473/00 CONVENT 49, available at <www.europarl.europa.eu/charter/pdf/04473_de.pdf>, at p. 26ff.

general aim of the Union the furtherance of social progress, which should also have some impact on labour relations.

While the labour-constitutional importance of the German reference norm, the principle of social statehood in Art. 20.1 German Basic Law, has ever since possessed clear contours,⁶⁸ the normative effect of the European social principles has generally not been unravelled yet.⁶⁹ As far as the literature discusses the overarching European legal principle of solidarity,⁷⁰ it focuses on characterising the mutual relationship of member states as solidary but does not consider solidarity as pertains to a European society as a whole.

Competences

An overview of the current legal competences of the Union in the field of its labour constitution must differentiate. On the one hand, there are those competences that explicitly concern the field of employment. This includes competences pursuant to Arts 137.2b and 137.1 TEC, which, in referring to the aims of the principle contained in Art. 136 TEC, allows the Union to establish minimum standards in the fields of technical and social occupational health and safety, working conditions, dismissal protection, information and consultation of employees and representation of collective interests. Further competences are established by Art. 141.3 TEC in the sphere of gender discrimination⁷¹ and by Art. 40 TEC in the field of freedom of movement within the EU. The established competences normally have to go through the co-decision procedure (Art. 251 TEC). An important exception are the competences in the area of dismissal protection and collective interest representation; in these cases the consultation procedure applies, which requires unanimity in the Council.

⁶⁸ See A. Hueck, 'Der Sozialstaatsgedanke in der Rechtsprechung des Bundesarbeitsgerichts', in E. Forsthoﬀ (ed.) *Rechtsstaatlichkeit und Sozialstaatlichkeit*, Darmstadt, Wissenschaftliche Buchgesellschaft, 1968, at p. 411.

⁶⁹ In selected cases Art. 136 TEC has explicitly gained relevance, see e.g. Case C-43/75, *supra*, note 32 (adjustment in the case of wage discrimination).

⁷⁰ See A. von Bogdandy, 'Founding Principles', in A. von Bogdandy and J. Bast (eds) *Principles of European Constitutional Law*, 2nd ed., Oxford, Hart Publishing, 2009, at p. 9.

⁷¹ In addition to Art. 141.3 TEC, Art. 137.1i TEC has no autonomous substance and is hence actually redundant: Eichenhofer, *supra*, note 57, Art. 137 TEC par. 21.

Besides the mentioned autonomous competences under labour law, other competences of the Treaty can also be employed. In light of previous European legislation, the following competences have to be highlighted: anti-discrimination measures (Art. 13 TEC), market related legal approximation (Arts 94 and 95.1 TEC), regulations concerning the exercise of other market freedoms (Arts 44, 47 and 55 TEC) and conflict of labour laws (Art. 65c TEC), as well as the residual provision (Art. 308 TEC). Here, the co-decision procedure only applies to market related labour law; all other competences are employed via the consultation procedure and unanimous Council decisions.

With these competences in mind, the significance of the exclusionary proviso in Art. 137.5 TEC has to be discussed in more detail. Art. 137.5 TEC blocks the competences established in Art. 137.2b TEC for the issues of remuneration, association and industrial conflict. This prevents, for instance, that a unitary European minimum wage is introduced on the basis of the competence for minimum working conditions (Art. 137.1b TEC). It remains unclear what effect this norm has for the employment of competences beyond Art. 137.2b TEC. On the one hand, one could conceive the exclusionary proviso as a negative competence norm prior to all competences,⁷² which would however contradict its own clear wording ('The provisions of this article shall not apply [...]').⁷³ On the other hand, one can regard the restricting norm merely as a negative criterion of Art. 137.2b TEC and therefore deny any impact on other competences.⁷⁴ A third position assumes that the exclusion bears on the interpretation of other competences.⁷⁵ This can be rendered more precisely as follows: legislation regarding the subject matters of Art. 137.5 TEC may be

⁷² In a similar vein, C. W. Hergenröder, in H. Oetker and U. Preis, *Europäisches Arbeits- und Sozialrecht* (Looseleaf, July 2000), Heidelberg, Forkel, 1994, B 8400, pars 39 and 41, at least in relation to Art. 94, 308 TEC.

⁷³ A. von Bogdandy and J. Bast, in E. Grabitz and M. Hilf, *Das Recht der EU*, München, Beck, 1994, Art. 5 TEC par. 27. The suggestion of a European legislation on collective bargaining on the basis of Art. 308 TEC by R. Kowanz rests on a similar position (see R. Kowanz, *Europäische Kollektivvertragsordnung*, Baden-Baden, Nomos, 1999, at p. 313ff.).

⁷⁴ Von Bogdandy and Bast, *supra*, note 73, argue that the Community law does in general not constitute a 'bipolar' order of competences.

⁷⁵ C. Langenfeld and M. Benecke, in E. Grabitz and M. Hilf, *Das Recht der EU*, München, Beck, 1994, Art. 137 TEC par. 97; R. Rebhahn, in J. Schwarze (ed.) *EU-Kommentar*, Baden-Baden, Nomos, 2000, Art. 137 TEC par. 22.

based on competences other than Art. 137.2b TEC if their regulation is necessarily linked to regulations of the actual subject matter which belongs to the competence in question.⁷⁶ This understanding of Art. 137.5 TEC results from a historical and teleological interpretation of the provision. Art. 137 TEC was intended to extend the competences of the EU in the area of labour legislation, while Art. 137.5 TEC at the same time excluded certain matters. Both can be explained by the fact that the matters of Art. 137 TEC were – following the compromise of social integration – not intended to be regulated by the EU at all. Therefore Art 137.5 TEC makes explicit a structure of competences underlying the EC as a whole, which had solely become necessary because of the introduction of Art 137 TEC. The semantic openness of other competences and of the wording of the proviso itself suggest that Art 137.5 TEC does not function as a negative competence norm, but rather affects the other competences in the manner mentioned above. Therefore European legislation in the areas of minimum wages, labour relations and collective bargaining is only admissible selectively and as an exception. The Treaty of Lisbon, if in force, will not change this.

The core problem of missing congruence

The labour constitution of the Union thus encompasses a comprehensive catalogue of labour-constitutional rights,⁷⁷ some principles and a range of competences. Therefore, one could assume that it is in no way inferior to the labour constitutions of the member states. Its central problem, however, is the lack of congruence regarding the labour-constitutional Union norms.⁷⁸ The array of constitutional rights and principles in the EU indicates that there is also the content of an EU labour constitution, which is seemingly modelled after member state labour constitutions. Yet, the EU constitutional competences contradict such an impression. As explicitly stated at the outset, a labour constitution does not only

⁷⁶ In this vein, AG Mengozzi in Case C-341/05, *Laval* [2007] ECR I-0000, par. 57.

⁷⁷ This is the case if the Charter is put on par with formally binding Community law, which can be justified through the Charter's role as a source of insight into the basic principles of the Community law (see *supra*, note 58), even though the Charter itself is not legally binding.

⁷⁸ In the broad frame of the European social model, also R. Blanpain, 'The EU Competence Regarding Social Policies', in R. Blanpain, M. Colucci, V. D'Antonio, F. Hendricks, P. Ponzano (eds) *The European Social Model*, Antwerpen, Intersentia, 2006, at p. 82ff.

consist of its rights and principles, but also of the competences for their articulation. In constitutional nation states, the relevant competences of the national legislature and of the courts are in general unproblematic, which is why their possible congruence is not an issue of debate. Matters are different in the case of the Union, where the European level can only become active on the basis of individually granted competences.⁷⁹

This problematique shall at first be explicated for the European legislature. The European fundamental rights include essential rights of a modern labour constitution: the individual freedom of exercise of profession, collective participation rights, collective bargaining rights and the freedom of collective action. This collection of rights, which are supposed to appear as European rights due to their anchoring in the Charter, is however not represented in a congruent way in the order of competences of the European legislature; rather, this order represents a kind of negative climax. For the articulation of the individual freedom of exercising one's profession, the competence for minimum working requirements together with dismissal protection (Art. 137.1b TEC)⁸⁰ exists, the latter requiring unanimous decisions in the Council. For the collective co-determination of employees a competence exists (Arts 137.1e and 137.1f TEC), which also requires a unanimous Council decision. Finally, for the regulative realisation of collective bargaining rights at most only a competence for selective legislation exists by virtue of a necessary factual connection.⁸¹ In total, a whole range of European labour-constitutional rights can be found, yet essential rights cannot be articulated at all or can only be articulated under qualified conditions by the European legislature.

In addition, the ECJ could also articulate the norms of the EU labour constitution. This happens, firstly, in competition with the European

⁷⁹ Of course, it could be the same with federal states. But assumingly it is not a coincidence but a result of the intrinsic logic of the development of modern welfare states (such as Germany or the USA) that the competence for labour legislation is located at the union level.

⁸⁰ Here, the individual labour law is conceived of as the concretising articulation of the freedom of contract and the freedom of the exercise of profession. On the classification of the freedom of contract in Art. 12 German Basic Law see *Entscheidungen des Bundesverfassungsgerichts* 81, at p. 254; also R. Scholz, in T. Maunz and G. Dürig, *Kommentar zum Grundgesetz* (Looseleaf, June 2007), München, Beck, 2007, Art. 12 par. 58.

⁸¹ For the scope of the restricting effect of Art. 137.5 TEC, see above.

legislature to the extent that the Court rules on the interpretation and validity of legislative acts on the basis of labour-constitutional fundamental rights. Although such a constellation can occur, as the past has shown,⁸² the ability of the ECJ to expound such rights does not much exceed that of the European legislature.⁸³ Moreover, the Court of Justice cannot replace the European legislature, which remains without competences, in the way national courts would (have to) replace an inactive national legislature. It is true that in the course of the preliminary ruling procedure (Art. 234 TEC), legal disputes might be decided which directly touch upon labour-constitutional rights included in the Charter. But leaving aside the cases referring to secondary law just mentioned, the Court can only enforce these Charter rights within the scope of application of EC law.⁸⁴ This however restricts from the outset the potential articulation of labour-constitutional fundamental rights by the ECJ to transnational labour relations. Purely domestic individual and collective labour relations can therefore not be affected by the jurisprudence of the Court due to its limited possibilities of legal

⁸² E.g., the Directive 96/71/EC of the European Parliament and of the Council concerning the posting of workers in the framework of the provision of services ([1997] OJ L 18, 1) constitutes an infringement of member state rights to collective action according to a surprising interpretation by the ECJ (Case C-341/05, *supra*, note 76). Therefore, the Court should have taken Art. 52.1 of the Charter as a yardstick for this Directive. However, it simply refrained from doing so.

⁸³ This possibility of articulation does not correspond exactly, but has a broader scope since national law that once also served the implementation of an only partially harmonised directive is as a whole subject to European fundamental rights scrutiny (exemplary Case C-144/04, *supra*, note 56, par. 75: The unrestricted possibility to conclude without objective justification a fixed-term contract with employees older than 52 years is to be measured against the European standard of equal treatment, because the national law regulating part time-work and fixed-term contracts (*Teilzeit- und Befristungsgesetz*) transposed a European directive). Whether or not this expansion of protection by European fundamental rights represents a positive development remains to be seen at this point. For a positive account see Kühling *supra*, note 58; for a critical account see T. Kingreen, in C. Calliess and M. Ruffert (eds), *EUV/EGV*, München, Beck, 2007, Art. 51 pars 11 and 16; U. Haltern, *Europarecht*, Tübingen, Mohr, 2007, pars 1090ff; and C. Franzius, 'Der Vertrag von Lissabon am Verfassungstag: Erweiterung oder Ersatz der Grundrechte', ZERP-Diskussionspapiere 4/2008, available at <www.zerp.uni-bremen.de>. However, this selective control of national legal norms does not pave the way towards a unitary articulation of European rights.

⁸⁴ The same matter is reconsidered in the debate about the binding effect of Community fundamental rights on member states, see G. de Búrca and P. Craig, *EU Law*, Oxford, Oxford University Press, 2008, at p. 395. See also J. Kühling, *supra*, note 58.

particularisation at European level. Thus, the Court will equally not be able to create an integrated European labour constitution.

In conclusion, the labour-constitutional rights and principles give the impression of a fully-fledged labour constitution on the European level, which could be comparable to the labour constitutions framed by member states' constitutional law.⁸⁵ But this impression turns out to be false considering the missing congruence between these rights and guiding norms and the possibility of articulating them through the European legislature and the European Court.

The form of the European labour constitution

It now has to be shown in how far and in which respect the EU labour constitution adequately gives effect to the social compromise for integration. The decline of the main preconditions for the realisation of the social compromise for integration in shape of the EEC labour constitution mentioned earlier is reflected in the legal change culminating in the current EU labour constitution. The latter apparently departs from the market-functional labour constitution of the EEC, yet a clear indication of the shape of the EU labour constitution cannot be recognised. The following section deals with the largely obvious notion that the current EU labour constitution is an evolutionary step towards a unitary European labour constitution, which integrates and corresponds to member state labour constitutions. Subsequently, alternative concepts are discussed.

⁸⁵ Strengthening the justificatory basis for restrictions of fundamental freedoms by the member states has been described as one possible function of social fundamental rights (the same could count for the guiding norms): see J. E. Fossum and A. J. Menéndez, 'Still Adrift in the Rubicon? The Constitutional Treaty Assessed', in E. O. Eriksen, J. E. Fossum, M. Kumm and A. J. Menéndez, *The European Constitution. The Rubicon Crossed?*, ARENA Report No. 05/3, Oslo, ARENA, 2005, at p. 135ff; O. de Schutter, 'La garantie des droits et principes sociaux dans la Charte des droits fondamentaux de l'Union Européenne', in J. Y. Carlier and O. de Schutter (eds) *La Charte des droits fondamentaux de l'Union Européenne*, Bruxelles, Bruylant, 2002, at p. 119ff. A lot of work has to be done in this field. Until now the European Court of Justice has been depriving the social fundamental rights of any overshooting potential by deforming them into mere institutions for the realisation of common interests. For an example see Case C-438/05, *Viking* [2007] ECR I-0000, par. 77.

An integrated European labour constitution ‘in the making’?
 It was just mentioned that the EU labour constitution appears to be an integrated European labour constitution but ultimately fails to make that promise good. One might therefore ask whether this phenomenon is the harbinger of some future reality or, put differently, whether the current EU labour constitution is an integrated European labour constitution in ‘the making’. In addressing this question, a glance at the constitutional development is helpful, which has played out differently in the three categories of labour-constitutional norms.

Milestones in the development of the EU labour constitution

The introduction of autonomous labour-Constitutional competences

The Single European Act and the Social Agreement of Maastricht

For a long time the European legislature was able to cope with the competence contained in Art. 100 TEEC (Art. 94 TEC, Art. 115 TFEU) also in the field of labour law legislation. This was until the Single European Act (1987), the motive of which was to revive economic integration.⁸⁶ The Act’s central feature was to subject only essential issues of market regulation to qualified majority decisions (Art. 100a TEEC, Art. 95 TEC, Art. 114 TFEU). By that time, it was recognised that such a move would reduce European integration to the Single Market project, which in turn would increase the pressure on workers.⁸⁷ Nevertheless, Art. 100a(2) TEEC excluded the ‘rights and interests of employed persons’ from the newly introduced procedural facilitation of harmonisation based on the functioning of the market; in this respect the unanimity rule of Art. 100 TEEC (Art. 94 TEC) remained in force. In turn, Art. 118a TEEC (Art. 137.1a TEC) was established as the first formally autonomous labour law Community competence dealing with technical and social aspects of workers’ health and safety. This was actually a counter-exception to the restricting norm of Art. 100a(2) TEEC, which is emphasised by the application of the same decision procedures in the case of Art. 100a(1) and 118a TEEC: ‘rights and interests’ of employees were excluded

⁸⁶ See C. D. Ehlermann, ‘The Internal Market Following the Single European Act’, (1987) 24 *Common Market Law Review*, at p. 361.

⁸⁷ The Single European Act remained a residual project vis-à-vis the more ambitious Treaty on the European Union, then already envisaged by the Parliament. See the so-called Spinelli Plan, [1984] OJ C 77, 34. See A. J. Menéndez (ed.) *Altiero Spinelli: From Ventotene to the European Constitution*, RECON Report No. 1, Oslo, ARENA, 2007, available at <www.reconproject.eu/projectweb/portalproject/Report1_Spinelli.html>.

from facilitated harmonisation, unless issues of technical or social occupational safety and health were concerned. The application of the new competence in Art. 118a TEEC did indeed not need proof of the market-functionality of the rule; yet it was not based on a new constitutional decision leading towards a gradually integrated labour constitution.⁸⁸ Rather, the formal validity of the legal foundation derived from Art. 100 TEEC has been challenged in the past, although the adoption at European level as such remained uncontested.⁸⁹

The shape of the labour constitution did not change until the Treaty of Maastricht came into effect (1993). The Treaty deepened economic integration by complementing the Single Market with the Economic and Monetary Union. Previously and during Treaty negotiations much effort was put into strengthening the social dimension materially and making such endeavours public.⁹⁰ The most important element was meant to be the comprehensive extension of labour law competences. But this plan failed due to a veto by the United Kingdom. The initially intended new competence norms could only be put into an agreement between the eleven other member states, which was then formally linked to the Maastricht Treaty via the 'Protocol on Social Policy'.⁹¹

Apart from the integration of the European social partners into the process of European legislation,⁹² the Social Agreement mainly contained two innovations. The first innovation was the extension of autonomous competences for labour law beyond health and safety at work. According to the Social Agreement, the competences encompassed the subject matters which are also presently covered, and excluded the issues of pay, the right of association, the right to strike or to impose lock-outs. They were linked to the same procedures that apply today (Art. 2.2 Maastricht Social Agreement; Art. 137.2 TEC, Art. 153 TFEU). The second innovation was the determination of the form of the possible European regulation as

⁸⁸ J. Curall, in H. von der Groeben, *Kommentar zum EWG-Vertrag*, 4th ed., Baden-Baden, Nomos, 1991, Art. 118 TEEC, par. 62.

⁸⁹ J. Pipkorn, in H. von der Groeben, *Kommentar zum EWG-Vertrag*, 4th ed., Baden-Baden, Nomos, 1991, Art. 118a TEEC par. 2.

⁹⁰ J. Kenner, *EU Employment Law*, Oxford, Hart, 2003, at p. 219ff.

⁹¹ *Ibid.*, at p. 223; see also D. Thym, *Ungleichzeitigkeit und europäisches Verfassungsrecht*, Baden-Baden, Nomos, 2004, at p. 194ff.

⁹² See *supra*, note 57.

minimum standards.⁹³ Until then, the market-functional regulation of provisions under labour law in Art. 100 TEEC gave no formal guidance. Therefore, the Article (Art. 95 TEC, Art. 114 TFEU) still provides for maximum standards and full harmonisation, if the European market so requires. This change assumed, at the level of constitutional law, that national labour standards would need European support given the pressures of the Single Market and the Economic and Monetary Union. This is a very different justification for European labour law than the market-functional one given for the convergence of standards in order to eliminate competitive distortions. In this respect, the insertion of autonomous competences to enact minimum provisions under labour law documents the departure from the market-functional paradigm of the EEC labour constitution, which was again confirmed by the inclusion of the Social Agreement into the text of the Amsterdam Treaty.⁹⁴

The Constitutionalisation of rights

The Community Charter of the Fundamental Social Rights of Workers and the EU Charter of Fundamental Rights

Even before the Monetary Union, namely in the run-up to the passing of the Single European Act, many European actors considered the social dimension of European integration to be underdeveloped.⁹⁵ In this context, the for many still influential notion emerged that the representation of this social dimension should be achieved by constitutionalizing social rights.⁹⁶ This found its first expression in the

⁹³ A. Lyon-Caen and S. Simitis, 'Community Labour Law', in P. Davies, A. Lyon-Caen, S. Sciarra, S. Simitis (eds), *European Community Labour Law*, Oxford, Clarendon, 1996, at p. 8; S. Giubboni, *Social Rights and Market Freedoms the European Constitution*, Cambridge, Cambridge University Press, 2006, at p. 238 (Art. 118a TEEC authorises only the establishment of minimum standards).

⁹⁴ The Treaty of Nice provided the opportunity to move to a procedure of co-decision via qualified majority in the Council (Art. 137.2 TEC) in the fields of employment protection and the collective interest representation of employees without altering the Treaty. However, the matter remained unchanged.

⁹⁵ J. Curall, *supra*, note 88; J. Pipkorn, *supra*, note 89; pre Art. 117–128 TEEC, par. 38; for a statement by an institution, see Opinion of the Economic and Social Committee on the Social Aspects of the Internal Market (European Social Area), CES(87) 1069.

⁹⁶ Taken up by the Commission in European Commission, Social Dimension of the Internal Market, Working Paper, SEC(88) 1148, available at <http://aei.pitt.edu/1346/01/social_internal_market_SEC_88_1148.pdf>. See W. Däubler, 'Sozialstaat EG? Notwendigkeit und Inhalte einer Europäischen Grundrechtsakte', in id., (ed.), *Sozialstaat EG?*, Gütersloh, Verlag der Bertelsmann-Stiftung, 1983, at p. 35.

Community Charter of the Fundamental Social Rights of Workers (1989),⁹⁷ which was proclaimed by the member states in 1989, initially excluding the United Kingdom.

Although the Community Charter of Fundamental Social Rights (hereinafter: the Community Charter) possesses no binding effect, it adopts the language of individual and collective rights. In its first part, it enumerates a number of essential rights, especially the individual freedom to choose and engage in an occupation (Art. 4 of the Community Charter), and even a right to 'fair remuneration' (Art. 5 of the Community Charter). Collective rights include participation (Arts 17 and 18 of the Community Charter) as well as the freedom of association and collective bargaining and collective action (Arts 11–13 of the Community Charter). With regard to the articulation of these rights, the Community Charter however explicitly supported the division of competences under primary law at the time: the guarantee of the fundamental rights in the Community Charter was primarily the task of the member states (Art. 27 of the Community Charter). Irrespective of this matter, the Commission was instructed to submit – within the competence of the European level – initiatives concerning the effective implementation of the rights of the Community Charter (Art. 28 of this Charter).

And this is what happened: the social action programme of the Commission⁹⁸ following the Community Charter sparked an extraordinary phase of legislative activity in the European field of labour law. For the legislative implementation of the programme, however, the European institutions were dependent on those competences provided for in the Single European Act of 1987 (Arts 100a and 118a TEEC), at least until the Maastricht Treaty together with the Social Agreement came into force.⁹⁹

⁹⁷ European Commission (ed.), *Social Europe 1/90*. The United Kingdom signed the Community Charter of Fundamental Social Rights in 1998.

⁹⁸ Communication from the Commission concerning its Action Programme relating to the implementation of the Community Charter of fundamental social rights for workers, COM(1989) 568.

⁹⁹ M. Rhodes, 'A Regulatory Conundrum: Industrial Relations and the Social Dimension', in S. Leibfried and P. Pierson, *European Social Policy*, Washington, D.C., Brookings Institution, 1995, at p. 78.

After the implementation of the Commission's social action programme, the political potential of the legally non-binding Community Charter was exhausted.¹⁰⁰ This encouraged in particular legal scholars to inquire into different ways to come to legally binding social rights at the European level.¹⁰¹ Thereafter social rights became more prominent through the amendment of the old Art. 117 TEEC (now Art. 136 TEC) by the Amsterdam Treaty. The goals of Art. 117 TEEC should in future be pursued 'having in mind fundamental social rights' following the Council of Europe's European Social Charter of 1961¹⁰² as well as the Community Charter. This still seemed not enough, as the aim was and remained to establish a constitutional stockpile of social rights.¹⁰³ This endeavour tied in with a general process intended to give the free-floating fundamental rights jurisprudence of the Court of Justice a positivist legal foundation. Although the ECJ mentioned social rights guaranteed under international law only as a source of inspiration in its case-law and had not declared any European social rights as general legal principles of the Community law relevant for decisions,¹⁰⁴ it remained certain that the EU Charter of Fundamental Rights would contain not only civil and democratic but also social fundamental rights, considering the continuously felt social asymmetry of the integration process.¹⁰⁵ Many therefore welcomed the proclamation of the EU Charter of Fundamental Rights in 2001 due to its codified social rights. As outlined above, it does indeed list a number of important individual and collective labour-constitutional rights. For

¹⁰⁰ Giubboni, *supra*, note 93, at p. 102; M. Rodríguez-Pinero and E. Casas, 'In Support of a European Social Constitution', in P. Davies et al. (*supra*, note 93), (eds), *European Community Labour Law*, London, Clarendon, 1996, at p. 35.

¹⁰¹ Lyon-Caen and Simitis, *supra*, note 93, at p. 14; R. Blanpain, B. Hepple, S. Sciarra and M. Weiß, *Fundamental Social Rights: Proposals for the European Union*, Leuven, Peters, 1996; B. Bercusson, S. Deakin, P. Koistinen, Y. Kravaritou, U. Mückenberger, A. Supiot and B. Veneziani, 'A Manifesto for Social Europe', Brussels, European Trade Union Institute, 1996.

¹⁰² European Social Charter (1961), ETS No 035.

¹⁰³ Giubboni, *supra*, note 93, at p. 105ff.

¹⁰⁴ E. Szyszczak, 'Social Rights as General Principles of Community Law', in N. A. Neuwahl and A. Rosas (eds), *The European Union and Human Rights*, The Hague, Nijhoff, 1995, at p. 211.

¹⁰⁵ Such was the general tenor of two expert reports of the Commission: European Commission (GD V), *For a Europe of Civic and Social Rights*, Report by the Comité des Sages (1996) and European Commission (GD V), *Affirming Fundamental Rights in the European Union*, Report of the Expert Group on Fundamental Rights, 1999, ('Simitis Report').

many pundits, however, its fault until today lies (solely) in its legally non-binding nature.¹⁰⁶

The proliferation of guiding norms

The social agreement of Maastricht and the Amsterdam

As previously outlined, Art. 117 TEEC is the labour-constitutional principle of the founding Treaty. In this respect, the Single European Act involved no changes. The establishing of the EU in Maastricht entailed in Art. B TEU the commitment of the Union to foster the harmonious, balanced and sustainable development of social progress. Art. 117 TEEC was amended in the Social Protocol and not earlier in the Maastricht Treaty. According to Art. 1 Social Protocol, the aims of Art. 117 TEEC are not only conceived as a shared concern of the member states, but also as an aim of the Community itself. In addition, 'social dialogue' was introduced as a new, labour-constitutionally significant aim. Since Amsterdam (1999), all subject matters named in Art. 136.1 TEC are framed as mutual goals of the Community and the member states. Incidentally, no further amendments were made - neither here nor in the Nice Treaty.

Innovations of in the Treaty of Lisbon

The labour-constitutional amendments of the Treaty of Lisbon can be outlined quickly. Again, there are no changes at the level of competences, both with regard to subject matters and decision-making procedures. The EU Charter of Fundamental Rights will be incorporated into the written constitutional law of the Union (Art. 6.1 Treaty on European Union, Lisbon).¹⁰⁷ Significant changes can only be found at the level of labour-constitutional guiding norms, the assortment of which will be diversified and extended. Art. 136 TEC however remains unchanged as Art. 151 TFEU. Concerning the goals of the Union and combining Art. 2 TEC and Art. 2 TEU, Art. 3.3 TFEU still includes the aspiration of social progress, which now is qualified by the aim to work towards 'a highly competitive social market

¹⁰⁶ E.g., M. Weiß, 'Grundrechte-Charta der Europäischen Union auch für Arbeitnehmer?', (2001) *Arbeit und Recht*, at p. 378; U. Zachert, 'Die Arbeitnehmergrundrechte in einer Europäischen Gemeinschaftscharta', (2001) *Neue Zeitschrift für Arbeitsrecht*, at p. 1046.

¹⁰⁷ For an account of the protocol regarding the application of the Charta on Poland and the UK see C. Möllers, *supra*, note 2; J. Kühling, *supra*, note 58.

economy'¹⁰⁸ (Arts 3.3 and 3.1 TFEU); moreover, the Union shall now also promote social justice (Arts 2.3 and 2.2 TFEU). A new norm concerning the values of the Union (Art. 2 TFEU) is introduced, where the principle of 'solidarity', although not included in those values fundamental to the Union, is nonetheless listed as one of those principles characterising European society.¹⁰⁹

A historically and politico-economically hardened asymmetry

Since the revision of the Amsterdam Treaty, the significance of labour-constitutional rights and principles has continuously increased. In the field of rights, their formal anchoring in the Treaty of Lisbon would arguably conclude the project of their constitutionalisation. Similar observations can be made about labour-constitutional guiding norms. Their extension began with the Social Agreement of Maastricht, continued to a rather modest extent in Amsterdam and experienced a new heyday in the Lisbon Treaty. Ultimately, the number of similar principles could be increased *ad infinitum*; yet, it can also be said that the project to commit the EU to duties, goals and principles that at least correspond with the intention of the welfare state principle has largely been achieved by now. Contrary to the expansion of rights and principles of a European labour constitution, the autonomous competences under labour law stagnated after the Social Agreement of Maastricht.¹¹⁰ The Social Agreement is the first and only extension of European legal competences in the field of the labour constitution; and this applies all the more if one takes the Lisbon Treaty into account. Hence, the labour-constitutional development of the EU since Maastricht can be characterised by the asymmetric development of the expansion of rights and principles on the one hand, and the stagnation of competences on the other; the historical trajectory implies that this will hardly change in the future: initiatives for more comprehensive competences under labour law were tabled at all Treaty conferences, but with the exception of Maastricht they all failed. Even in the European Convention the extension of competences was beyond

¹⁰⁸ On this curiosity, see F. Rödl, 'Europäisches Verfassungsziel „Soziale Marktwirtschaft“', (2005) *Integration*, at p. 150.

¹⁰⁹ C. Calliess, in C. Calliess and M. Ruffert, *Verfassung der Europäischen Union*, München, Beck, 2006, Art. I-2 CT par. 34.

¹¹⁰ This is also the focus of a tartly phrased analysis by W. Streeck, 'Vom Binnenmarkt zum Bundesstaat?', in S. Leibfried and P. Pierson (eds), *Standort Europa*, Frankfurt a. M., Suhrkamp, 1998, at p. 369.

reach, even though it probably offered the most fruitful terrain for such fundamental initiatives.¹¹¹

However, some might have counted on the fact that an integrated European labour constitution can be established on the basis of those competences already in effect since Maastricht. This assertion presupposed that the dynamics of European legislation interpreted their formal competences in a wide sense and their functions in a creative manner, transcending the very boundaries intended by the framers of the Treaties, supported and encouraged even by the social rights of the EU Charter of Fundamental Rights and by the newly introduced guiding norms. The prototype for such expectations was the Community Charter of 1989, which indeed triggered an ambitious legislative program, thereby using already existing competences in a creative manner. Factually, the social fundamental rights of the EU Charter did in contrast not trigger any comparable legislative activity.¹¹² Rather, the extent of labour law legislation continuously decreased since the Treaty of Amsterdam, and the new autonomous competences of Art. 137 TEC have furthermore hardly been used in this time. The Commission also plans no relevant legislative activity in the field of labour law for the next years.¹¹³ Retrospectively, the hopes for a catalytic effect of the social rights of the EU Charter were in vain.

Both the stagnation of competences *per se* and its perception by the legislator are however not (solely) the result of contingent political compromises but are rather caused by socio-political factors. For the particularly relevant matter of pure labour costs, it should be considered that differences in labour costs encompass differences in

¹¹¹ See the final report of the working group 'Social Europe': CONV 516/1/3 REV 1, available at <www.european-convention.eu.int>.

¹¹² See also B. de Witte, 'The Trajectory of Fundamental Rights in the EU', in G. de Búrca and B. de Witte, *Social Rights in Europe*, Oxford, Oxford University Press, 2005, at p. 166ff.

¹¹³ See the Green Paper of the European Commission: 'Modernising Labour Law to Meet the Challenges of the 21st Century', COM(2006) 708, and the Social Agenda 2005–2010 [2006] OJ C 117, 256. An exception will be the Directive of the European Parliament and of the Council on improving the portability of supplementary pension rights (COM(2007) 603), which refers to the freedom of movement and competition, and hence to Art. 42, 94 TEC.

productivity.¹¹⁴ For example, unitary European minimum wages can not be agreed upon: if they conformed to the member state with the lowest wage level, they would be ineffective for all other member states; if they conformed to the member state with the highest wage level, they would turn into competitive disadvantages for all others; if they assumed a middle position, both effects would be caused.¹¹⁵ Therefore, almost all member states would be concerned to be disadvantaged.

Moreover, European welfare states have been characterised as complex systems, which follow different basic models.¹¹⁶ As internal regulatory arrangements and their numerous interdependencies are typical for these models, it becomes problematic for the superimposed European level to intervene in particular areas in order to harmonise standards. The norms of national individual and collective labour law interact in numerous ways with other social and public regulations (e.g. those relating to social insurance, employment promotion, social welfare, vocational training) and these in turn are linked to the national production regime,¹¹⁷ so that extensive European forays into national labour law on account of an integrated European labour constitution can be expected to have disintegrative and dysfunctional effects.¹¹⁸

¹¹⁴ This theorem of the Ohlin report remains valid, despite its outdated economic and legal implications (see *supra*, note 39).

¹¹⁵ F. Scharpf, *Regieren in Europa: Effektiv und demokratisch?*, Frankfurt a. M., Campus, 1999, at p. 76ff; K. Busch, 'Perspektiven des Europäischen Sozialmodells', HBS Working Paper 92, 2005, at p. 44, available at <www.boeckler.de/pdf/p_arbp_092.pdf>.

¹¹⁶ The fundamental work by Esping-Andersen identifies three basic models: G. Esping-Andersen, *The Three Worlds of Welfare Capitalism*, Cambridge, Polity Press, 1990, the critical discussion by Ferrera four models: M. Ferrera, 'A New Social Contract? The Four Social Europes', RSCAS Working Paper 36, 1996. The Eastern enlargement constitutes at least a fifth model.

¹¹⁷ P. Hall and D. Soskice, 'An Introduction to Varieties of Capitalism', in id., (eds), *Varieties of Capitalism*, Oxford, Oxford University Press, 2001, at p. 38ff. With particular reference to the regime of industrial relations, T. Blanke and J. Hoffmann, 'Auf dem Weg zu einem Europäischen Sozialmodell', (2006) *Kritische Justiz*, at p. 141ff.

¹¹⁸ W. Streeck, 'Industrial Citizenship Under Regime Competition', (1997) 4 *Journal of European Public Policy*, at p. 643; C. Offe, 'Demokratie und Wohlfahrtsstaat: Eine europäische Regimeform unter dem Stress der Integration', in W. Streeck (ed.), *Internationale Wirtschaft, nationale Demokratie*, Frankfurt a. M., Campus, 1998, at p. 99.

In contrast to the image of a slow but continuous progress, the previous account highlights that there was only one truly dynamic phase in the history of the European labour constitution. Taking into account its antecedent and descendant, it is a phase that stretches from the Single European Act to the inclusion of the Social Agreement in the Amsterdam Treaty, i.e. from 1986 to 1996.¹¹⁹ This dynamic supported those fundamental changes in European constitutional law brought about by the start of the Single Market project in 1986 and the introduction of the Monetary Union in 1993. Both steps were quantum leaps in economic integration that required substantial and legitimatory counterbalance in the field of labour and social constitutional law. But such compensation remained small for politico-economic reasons, and so all attempts failed to remedy the situation in Amsterdam, Nice and also in the Constitutional Treaty/Treaty of Lisbon. Comparable revolutionary changes in the constitution of economic integration, which could increase political pressure for compensation, cannot be expected for quite some time.

The notion that the EU labour constitution represents an integrated European labour constitution in the making therefore requires an alternative. For this purpose, there are two choices: the notion of a post-regulatory labour constitution of the Union and the new notion of a European association of labour constitutions, which has to be elaborated here.

A post-regulatory labour constitution for the EU?

Apart from the inclusion of the United Kingdom into the provisions of the Social Agreement in the fields of labour and social policy, the amendments to the Treaty of Amsterdam entailed above all a new chapter on employment (Arts 125–130 TEC, Arts 145–150 TFEU). The chapter contains no labour-constitutional norms in the outlined sense, i.e. rights, principles and competences constituting and shaping the power relations between capital and labour; rather, they relate to the coordination of member state employment policies (see Art. 126.2 TEC, Art. 146 TFEU) and are therefore not immediately relevant in the present context. Nevertheless, the employment chapter was for

¹¹⁹ Even more critical W. Streeck, who already identifies this phase as a 'decline of the social dimension', Streeck, *supra*, note 118, at p. 377ff.

many the first indication that the social dimension of European integration was strengthened in addition to the economic one.¹²⁰

The coordination of employment policy follows a fixed cycle of European employment guidelines, member states' annual reports, examination of these reports and legally non-binding recommendations to member states as well as a Community employment report (Art. 128 TEC, Art. 148 TFEU). Thereby the European level can foster member state cooperation through initiatives 'aimed at developing exchanges of information and best practices, providing comparative analysis and advice as well as promoting innovative approaches and evaluating experiences' (Art. 129 TEC, Art. 149 TFEU). These two features are seen by many as a new and groundbreaking *modus operandi* of the European level, raising high normative expectations.¹²¹ With the Lisbon European Council, it was extended to several areas of social policy¹²² and acquired the now common label of 'open method of coordination'.

At this point, the open method of coordination in the area of employment and labour law¹²³ deserves attention, because, given the backdrop of socio-political and economic differences among the member states, it is seen by some as a real alternative to a comprehensive EU labour constitution, as a post-regulatory¹²⁴

¹²⁰ For instance, I. Pernice, 'Multilevel Constitutionalism and the Treaty of Amsterdam', (1999) 36 *Common Market Law Review*, at p. 733ff. For the political genesis of the employment chapter, see J. Goetschy, 'The European Employment Strategy: Genesis and Development', (1999) 5 *European Journal of Industrial Relations*, at p. 117.

¹²¹ For instance, C. de la Porte and P. Pochet (eds), *Building Social Europe Through the Open Method of Coordination*, Bruxelles, PIE Lang, 2002; J. Zeitlin and D. M. Trubek (eds), *Governing Work and Welfare in a New Economy: European and American Experiments*, Oxford, Oxford University Press, 2003; C. F. Sabel and J. Zeitlin, 'Learning From Difference: the New Architecture of Experimentalist Governance in the European Union', (2008) 14 *European Law Journal*, at p. 271.

¹²² European Council, Presidency Conclusions of the Lisbon European Council 23 and 24 March 2000, pars 37-40, available at <www.europarl.europa.eu/summits/lis1_de.htm> (accessed 11 August 2009); prominently included by the Commission in European Commission, White Paper: European Governance, COM(2001) 428, at p. 28ff.

¹²³ See also Art. 137.2a TEC, introduced by the Treaty of Nice, whose potential lags behind Art. 140 TEC (previously Art. 118 TEEC); see Krebber, *supra*, note 56, Art. 137 TEC par. 36.

¹²⁴ See C. de la Porte, Ph. Pochet, G. Room, 'Social Benchmarking, Policy Making and New Governance in the EU', (2001) 11 *Journal of European Social Policy*, at p. 293.

renewal of the social promise of European integration. One labour law perspective, which is somewhat typical in its style and contents, can be summarised as follows:¹²⁵ the open method of coordination opens up a space in which the member states learn from each other in the areas of employment law and employment policies through deliberative debate; this process is normatively guided by the relevant social rights. On the basis of common goals, specific solutions for the member states are sought that reflect the characteristics of the traditional member state constitution of industrial relations.

There is, however, much that contradicts the view that this is an accurate description of the present or at least a future reality. First, coordinating procedures, which supposedly constitute the entirely new integration mode of the open method of coordination, have been in place for labour law (even including collective labour law) and employment since the founding of the EEC (Art. 118 TEEC), but this coordination mandate has not produced any relevant results that have gained much public attention. In this respect, this begs the question why comparable coordination powers of the European level should today lead to totally different results. The thesis that the open method of coordination documents the lacking willingness of member states to subject their own systems to changes initiated by the European level seems much more plausible.¹²⁶ Second, the description is based on the erroneous notion that the main problem in the area of labour law and employment policies is inadequate knowledge, which could be remedied through deliberative learning processes.¹²⁷ Instead, both areas are to a high degree shaped by normative conceptions, and at the same time social and political forces pre-structure the ways for their political handling. A real

¹²⁵ Giubboni, *supra*, note 93, at pp. 245ff., 266ff. and 277ff.

¹²⁶ A. Schäfer, *Die neue Unverbindlichkeit*, Frankfurt a. M., Campus, 2005, at pp. 179ff. and 215.

¹²⁷ Important proponents of the concept of European politics as a process of experimental learning, in which social contradictions and underlying forces play no role, are J. Cohen, C. Sabel and J. Zeitlin. See, e.g., J. Cohen and C. Sabel, 'Directly-Deliberative Polyarchy', (1997) 3 *European Law Journal*, at p. 313; J. Zeitlin, 'Introduction: Governing Work and Welfare in a New Economy', in J. Zeitlin and D. M. Trubek (eds), *Governing Work and Welfare in a New Economy: European and American Experiments*, Oxford, Oxford University Press, 2003, at p. 5. For a critical account see C. Offe, 'The European Model of "Social" Capitalism: Can it Survive European Integration?', (2003) 11 *Journal of Political Philosophy*, at p. 462ff.

problem therefore emerges, with high ideological potential, if the open method of coordination does not create European arenas for social and political debate, but only spaces for, at best, a mutual learning of national labour bureaucracies. Finally, the claim that social rights should normatively guide the coordination processes of labour law and employment policy remains completely unfounded. Since such normative guidance is not carried out in a legally binding and controlled manner, such notions are at best wishful thinking.¹²⁸

The notion of a post-regulative labour constitution seems hence to be fundamentally misguided.¹²⁹

The EU labour constitution in an association of labour constitutions

As indicated in the introduction, the concept of 'multilevel constitutionalism' (*Verfassungsverbund*) developed for the constitution of public authority shall here be applied to the labour constitution. The analysis of the EEC labour constitution shows that the basic function of the Union level of the European association of labour constitutions is to realise the social compromise for integration under changing social and economic conditions. Here, the social compromise for integration consists of the fact that there is no competition in the Single Market on the basis of labour costs, that the labour constitutions of the member states remain autonomous in determining national labour costs and that European economic

¹²⁸ The optimistic distortions of the OMC seem to hamper down-to-earth insights: European employment policy is characterised by a turn from the paradigm of 'full employment' to the paradigm of 'employability' (for an explication of this difference, see R. Salais, 'Reforming the European Social Model and the Politics of Indicators', in M. Jepsen and A. Serrano (eds), *Unwrapping the European Social Model*, Bristol, Policy Press, 2006, at p. 189. This turn is caused by the structures of the European labour and social constitution themselves: the Union provides for almost no instruments for an autonomous full employment policy and the European coordination of member state full employment policies is unfeasible due to political and socio-economical differences. Individual employability remains a matter that can be taken up at the European level (Offe, *supra*, note 127, at p. 457ff; A. Somek, 'Concordantia Catholica: Exploring the Context of European Anti-Discrimination Law and Policy', (2005) 15 *Transnational Law and Contemporary Problems*, at p. 982ff.).

¹²⁹ Ideas of 'post-regulatory' politics produce a problematic de-juridification, which undermines the endeavour for constitutional ties beyond the nation state. However, a more detailed discussion of this problem is omitted at this point. For a critical account see C. Joerges, 'Integration through De-Legalisation', (2008) 33 *European Law Review*, at p. 291.

integration does not deliberately shift the balance of social power towards capital. Against this backdrop, it is argued in the following that the EU labour constitution can today perform three functions: first, it legally supports the autonomy of member state labour constitutions. Second, it harmonises national labour laws, if and in so far their differences constitute in individual cases labour cost related competitive distortions. Third, it ensures that the scope of social rights of workers in Europe does not limp behind the full spectrum of companies' activities. Put in labour-constitutional terms, the EU labour constitution legally supports the effective development of member state competences in the labour-constitutional field; it has legal competences for market-functional harmonisation; and guarantees the transnational dimension of the labour-constitutional rights of workers.

Protection of member state labour constitution autonomy

The social compromise for integration requires that those competences are effectively exercised that have remained with the member states for good reason. This means above all that the norms of the member states generated on a labour-constitutional basis shall not be threatened by restrictions that did not exist before the beginning of the European integration project. What is therefore needed is an effective protection of the autonomy of member state labour constitutions. This protection of member state autonomy is required in two directions; on the one hand, in a horizontal direction in relation to other member states and, on the other hand, in a vertical direction in relation to the Union.

Horizontal protection: conflict of labour laws and fundamental freedoms

The opening of intra-European borders for goods (Art. 28 TEC, Art. 34 TFEU), persons (Arts 39 and 49 TEC, Arts 45 and 56 TFEU) and capital (Arts 43 and 56 TEC, Arts 49 and 63 TFEU) raises the question of the transnational scope of application of member state labour law and of the horizontal range of member state labour constitutions. Put differently, the matter is whether and to what extent goods, persons and capital can carry over the law of labour relations, by way of exercise of fundamental freedoms, from one member state to another. Via the fundamental freedoms, a conflict ultimately ensues about the respective scope of member state labour constitutions in their

interrelation.¹³⁰ In the association of labour constitutions, it is the function of the EU level to regulate this horizontal conflict through a superior conflict of laws in a way that does justice to the social compromise for integration.

The European level can indeed cope with this function both with the aid of legal provisions allowing for justified restrictions to fundamental freedoms and the European international law concerning contracts of employment. The integration compromise also specifies the main substance of the European conflict of labour laws: in order to avoid labour cost competition, the law of the place where required labour is performed has to be applied, so that remuneration is the same for the same work at the same place. Art. 8 of the new Rome I Regulation¹³¹ (which corresponds to Art. 6 Rome Convention)¹³² technically implements this principle in form of the so-called principle of favourability which guarantees employees the standard of working conditions that exists at their place of employment, but allows more favourable working conditions pursuant to a law chosen by the involved parties.

For those national labour law norms that do not belong to the law governing the employment contract, including not only the overriding mandatory provisions (see Art. 9.2 Rome I Regulation) but also the norms of collective and public labour law, the fundamental freedoms provide the conflict of laws that solves the horizontal conflicts and protects autonomy. It has in fact been argued that the validity of national labour law is excluded *ab initio* from the scope of application of fundamental freedoms;¹³³ and this suggestion accords to the guarantee of member state autonomy concerning labour constitutions as averred here. But the ECJ ruled differently and subjected the norms of national labour law to the usual test for national restrictions of fundamental freedoms. This does, however,

¹³⁰ See F. Rödl, *Weltbürgerliches Kollisionsrecht*, PhD Thesis EUI Florence, 2008, at p. 225ff.

¹³¹ Parliament and Council Reg 593/2008, Rome I, [2008] OJ L 177, 6.

¹³² Convention on the Law Applicable to Contractual Obligations (Rome Convention) ([1980] OJ L 226, 1), an international treaty between member states not based in Community law.

¹³³ B. Hepple, *Labour Laws and Global Trade*, Oxford, Hart, 2005, at p. 214ff; S. Deakin, 'Labour Law as Market Regulation', in P. Davies, A. Lyon-Caen, S. Sciarra, S. Simitis (eds), *European Community Labour Law*, Oxford, Hart, 1996, at p. 73.

not reject the view presented here. Rather, the examination according to the test serves only the aim of preventing the abuse of member state labour law for protectionist purposes. National labour law is subject to said test, but since the protection of workers, itself the basic function of all labour law, provides an aim which justifies the restriction of fundamental freedoms,¹³⁴ the further examination of proportionality and adequacy only ensures that the protection of workers is not used as a pretext. Only in very exceptional cases¹³⁵ would the test lead to significant intrusions into national law.

In this context, the posting of workers provides an important illustration. In the case of the temporary posting of workers, the usual place of employment, significant for the applicable contract law under Art. 8 Rome I Regulation, lies not in the host country but in the home country (Art. 8.2.2 Rome I Regulation), so that the posting of workers provides the opportunity for pure labour cost competition. In the aftermath of the second enlargement of the Union through the accession of Portugal and Spain in 1986, concerned member states opposed this development in the form of national laws on posted workers, and stipulated that their labour laws also apply to posted workers. Beginning with its ruling in *Rush Portuguesa*, the Court of Justice held that these laws are essentially compatible with the freedom to provide services.¹³⁶

However, at least for a certain period of the legal integration process, the autonomy of national labour constitutions came under pressure due to an instrumentalisation of fundamental freedoms adverse to public labour law. In the area of the free movement of goods, cases of reference are the rulings in *Nachtbackverbot*¹³⁷ concerning the German ban on night baking in bakeries and cafés and *Conforama*¹³⁸ concerning the ban on Sunday work under French law. In both cases,

¹³⁴ Case 279/80, *Webb* [1981] ECR 3305, par. 19.

¹³⁵ This concerns mainly cases in which companies carry a double burden that, notably, cannot be justified by the social compromise for integration, for instance Cases C-369/96 and C-376/96, *Arblade* [1999] ECR I-8498, par. 34, and Case C-165/98, *Mazzoleni*, [2001] ECR I-2213, par. 25.

¹³⁶ Case C-113/89, *Rush Portuguesa* [1990] ECR I-1417, par. 18; confirmed e. g. by Case C-164/99, *Portugaia Construções* [2002] ECR I-787, par. 21.

¹³⁷ Case 155/80, *Oebel* [1981] ECR I-1993.

¹³⁸ Case C-312/89, *Conforama* [1991] ECR I-1021; see also Case C-332/89, *Merchanidse* [1991] ECR I-1027, treating a comparable ban in Belgian law.

the ECJ saw the working time regulations as justified.¹³⁹ Even the free movement of workers was mobilised in order to restrict member state autonomy. But this attempt also failed:¹⁴⁰ in the case of *Graf*,¹⁴¹ an Austrian regulation had to be considered, which concerned the deprivation of the claim to a redundancy payment in the case of workers leaving their job voluntarily. Only the deprivation renders the payment an instrument of dismissals protection. To declare it a breach of European law would have overridden this purpose and transformed it into a (as such pointless) termination bonus. Although its compliance with the fundamental freedoms should also have been examined, the Court of Justice found this rule not even apt to restrict the free movement of workers so that it needed no further justification.

Although national labour law was not exempted from the examination of compatibility with the fundamental freedoms, thus far it has survived these particular examinations largely unscathed. Up to this point, it is hence plausible to interpret the function of the compatibility test as a mere control against concealed protectionism. It was the ruling in *Viking*¹⁴² that brought a clear break. The Court had to judge upon the question of whether collective action taken by Finnish trade unions, and connected activities by an international trade union federation, against an employer who wanted to lower labour costs by way of re-flagging a vessel from Finland to Estonia violate the freedom of establishment. In its answer, the Court grandiloquently acknowledged the right to strike as a European fundamental right.¹⁴³ But then, having seemingly dissolved any limits

¹³⁹ Before the Maastricht Treaty and the Social Protocol came into force, the Court, referring not to the 'protection of workers' but to a more competence-related vocabulary, argued that it was the responsibility of the member states to regulate working hours. The free movement of goods was also subject to Case C-188/84, *Commission v France*, [1986] ECR I-419, which was concerned with technical health and safety regulations as hindrance for the import of goods.

¹⁴⁰ S. Roloff, *Das Beschränkungsverbot des Art. 39 EG (Freizügigkeit) und seine Auswirkungen auf das nationale Arbeitsrecht*, Berlin, Duncker und Humblot, 2003, at p. 149ff.

¹⁴¹ Case C-190/98, *Graf* [2000] ECR I-493. For a convincing critical view, from a perspective of the doctrine of fundamental freedoms, see T. Kingreen, 'Fundamental Freedoms', in A. von Bogdandy and J. Bast (eds) *Principles of European Constitutional Law*, 2nd ed., Oxford, Hart Publishing, 2009, at p. 501.

¹⁴² Case C- 438/05, above n 85.

¹⁴³ The relevant considerations of the ECJ however show some problematic reductions of the fundamental right to strike. See C Joerges and F Rödl, 'Informal

of the horizontal effect of fundamental freedoms,¹⁴⁴ the ECJ submitted its exercise to the principle of proportionality with regard to the fundamental freedoms affected. This principle is unknown to many Member State labour constitutions.¹⁴⁵ Even in Member States where this principle does exist as a constraint on collective action,¹⁴⁶ the reference to the fundamental freedoms plays out as additional support for employers. With this, the social balance of power, constituted by Member States' labour constitutions, is directly shifted in favour of employers. This is nothing else than open disrespect of the social compromise for integration.

Vertical protection: European competition law and secondary law

The member states' labour constitutions, especially the effective exercise of member state competences, require not only horizontal protection, but also vertical protection against the substantive secondary law of the Union, including European competition law.¹⁴⁷

In this context, the systematic problem is caused by the primacy of Community law. Although the primacy of the superior legal level is well known from federal constitutional law,¹⁴⁸ its unquestioned application to the relation of member state and Union is precarious where the latter acts upon the basis of limited and diligently chosen competences. Many provisions of primary and secondary EU law concern areas of society for which they are not responsible according to the prescribed competences. In these constellations,¹⁴⁹ the mere enforcement of primacy equals the extension of the functionalist

Politics, Formalised Law and the 'Social Deficit' of European Integration', (2009) 15 *ELJ* 1.

¹⁴⁴ See T. Kingreen, *supra*, note 141.

¹⁴⁵ E.g. in the UK, see N Countouris, 'La Corte di giustizia e il vaso di Pandora del diritto sindacale europeo', in A Vimercati (ed), *Il conflitto sbilanciato*, forthcoming.

¹⁴⁶ E.g. in Germany, see *Bundesarbeitsgericht* (Federal Labour Court), Decision of 21 April 1971, Case GS 1/68.

¹⁴⁷ For the irregular constitutional status of European competition law, see J. Bast, 'The Constitutional Treaty as a Reflexive Constitution', (2005) 6 *German Law Journal*, at p. 1441.

¹⁴⁸ See Art. 31 German Basic Law: 'federal law shall take precedence over Land law' - characterised by the Federal Constitutional Court as a fundamental norm of the 'Grundgesetz': *Entscheidungen des Bundesverfassungsgerichts* 36, at p. 365ff.

¹⁴⁹ For these constellations, C. Joerges coined the term 'diagonal conflicts'; see, for instance, C. Joerges, 'Der Europäisierungsprozess als Herausforderung des Privatrechts: Plädoyer für eine neue Rechts-Disziplin', in A. Furrer (ed.), *Europäisches Privatrecht im wissenschaftlichen Diskurs*, Bern, Stämpfli, 2006, at p. 133.

societal blueprint that underlies Union law and competences (viz. competition and Single Market) to the detriment of the functionalist designs which are to be drawn up by the member states according to the order of competences.

This fundamental problem has particular repercussions for the labour constitution. Under primary law, it was especially the European competition rules whose range had to be determined in relation to member state labour constitutions. Accordingly, the Court of Justice ruled that exemptions in national labour law do not constitute notifiable state aid under Art. 88.3 TEC (Art. 108 TFEU).¹⁵⁰ The central conflict between European competition law and member state labour constitutions is exemplified in the *Albany* case.¹⁵¹ The dispute concerned statutory membership in an occupational pension fund established by collective bargaining. In this context, the ECJ also had to tackle the question of whether the underlying collective agreement was in breach of Art. 81 TEC (Art. 101 TFEU). This was negated by the Court at a fundamental level: labour agreements that serve the social objectives of the TEC are *per se* not covered by the ban of anticompetitive agreements.¹⁵² The same applies in case of a declaration of universal applicability of collective agreements.¹⁵³

The outcome of the case could not correctly have been otherwise. It would be unthinkable to interpret national collective agreements as agreements under Art. 81 TEC, which would then only be valid if they exceptionally did not affect the Common Market. It would have meant a blatant revocation of the social compromise for integration, which would have demolished the European integration project politically, if the Court of Justice had annihilated the foundation of every national labour constitution by way of attacking collective agreements. In doctrinal terms, the Court derived its conclusion solely from the wording of Community law and referred in a methodologically rather loose manner to the principles of Arts 2, 3j and 136 TEC, as well as the norms determining competences and

¹⁵⁰ Case C-189/91, *Kirsammer-Hack* [1993] ECR I-6185, concerning the exemption of small enterprises from the general dismissals protection, and Cases C-72/91 and C-73/91, *Sloman Neptun* [1993] ECR I-887, concerning the law on conflict of laws with regard to the German *Flaggenrechtsgesetz* ('Law of the Flag Act').

¹⁵¹ Case C-67/96, *Albany* [1999] ECR I-5751.

¹⁵² *Ibid.*, par. 60.

¹⁵³ *Ibid.*, par. 66.

tasks in Arts 137 and 138 TEC (at that point still in the shape of the rules of the Maastricht Social Protocol).¹⁵⁴

More controversial than the primacy of national collective bargaining law over European competition law in *Albany* is the resolution of conflicts between member state labour constitutions and European secondary law, especially in the form of directives. The situation came close to boiling point in the *Laval* case,¹⁵⁵ in which a Latvian company demanded Swedish unions to pay compensation for damages caused by industrial action. A decisive issue for the outcome of the proceedings was the question what the regulatory content of the Posted Workers Directive 96/71 was.¹⁵⁶ The Directive was filed on the basis of Arts 55 and 47.2 TEC (Arts 62 and 53.1 TFEU), i.e., on the basis of the competence for the coordination of member state legal and administrative regulations concerning the provision of services. Referring to the jurisprudence mentioned above beginning with *Rush Portuguesa*, the Directive stated the obligation of member states to extend both minimum legal working requirements in general and general collective agreements to the posting of workers in the construction industry, in so far as they touch upon a core area of working conditions (see Art. 3 Posted Workers Directive). In the *Laval* case, the ECJ surprisingly turned the Posted Workers Directive into a Right-to-Strike-Restriction Directive. The Court saw in it a full harmonisation of national laws of cross-border labour disputes vis-à-vis foreign service providers, which gives unions the possibility of collective action only under very restrictive conditions.

The ruling in *Laval* is thus a flagrant breach of the principle of the protection of member state labour constitutions against European law, which is functionally committed to other objectives and ideas. The damage of the decision in terms of diminishing political legitimacy can still not be fully assessed.¹⁵⁷ In any case, it appears an urgent desideratum of European constitutional law to afford those

¹⁵⁴ At this point, it may be assumed that the ruling in *Albany* fostered the view that the social dimension of Europe can be strengthened with the aid of norms determining values, goals and tasks.

¹⁵⁵ Case C-341/05, *supra*, note 82.

¹⁵⁶ See *supra*, note 82.

¹⁵⁷ The following ruling appears to be a downright deliberate aggravation of the situation, Case C-346/06, *Rüffert* [2008] ECR I-0000, concerning the inadmissibility of wage-related social clauses in public procurement.

competence provisions reflecting the social compromise for integration of the Community their justified priority over the technical primacy of European law.¹⁵⁸

Competences for a market-functional substantive labour law

According to the EEC labour constitution, substantive European labour law should be nothing more than market-functional labour law.¹⁵⁹ As the account of its historical development and politico-economic circumstances has shown, it can hardly be otherwise in the current situation. Thus, the second achievement of the EU level in the association of labour constitutions is creating market-functional labour law on the basis of the relevant competences. Four categories can be devised. The first consists of those parts of anti-discrimination law that concern European labour law, the second forms the European harmonisation of standards under labour law required for the functioning of specific markets, the third encompasses health and safety regulations, and the fourth consists of standards in the field of co-determination which are a necessary annex to European company law.

Anti-discrimination law

Anti-discrimination law provides, comparatively speaking, the biggest part of substantive European labour law. The market functionality of anti-discrimination law under labour law has already been explained, as far as it relates to pay discrimination: discrimination implies undervaluation of work and thus provides the basis for a pure labour cost related and hence unfair competitive advantage. This point of view is therefore the foundation for all European anti-discrimination legislation,¹⁶⁰ inasmuch as it concerns pay, the costs of social security and other cost related working

¹⁵⁸ The principle of subsidiarity can seemingly not achieve this function – contrary to the view still advanced by *Thomas Oppermann* in 1999 (T. Oppermann, *Europarecht*, 2nd ed., München, Beck, 1999, par. 624). In this context it appears to be quite helpful to remember a more moderate approach to justify the restricting impact of European directives, as previously held by the ECJ, see A. Furrer, *Die Sperrwirkung des sekundären Gemeinschaftsrechts auf die nationalen Rechtsordnungen*, Baden-Baden, Nomos, 1994, at p. 90ff.

¹⁵⁹ See above 'The basic norms of the EEC labour constitution', at p. 8ff.

¹⁶⁰ Parliament and Council Dir 2006/54, equal opportunities and equal treatment of men and women, [2006] OJ L 204, 23; Council Dir 2000/78, general framework for equal treatment in employment and occupation, [2000] OJ L 303, 16; Council Dir 2000/43, equal treatment irrespective of racial and ethnic origin, [2000] OJ L 180, 22.

conditions. The same applies to the directives concerning part-time work and fixed-term employments, which are also designed to prevent the undervaluation of work in atypical working relations. Compared with the original EEC-labour constitution, only the array of prohibited discrimination features has been expanded until today.

Despite the classification of anti-discrimination law as law functional to the market it is important to be aware of the fact that European anti-discrimination law fulfils another function, which is important with regard to the labour constitution. To put it briefly, anti-discrimination law is a corrective against a dominant culture¹⁶¹ characterised by the socio-cultural primacy of the national, white and male, which is often embedded in member states' corporate models. Fulfilling this function, anti-discrimination law serves the employees by preventing segmentation of the workforce along the lines of the dominant culture just mentioned. It can be doubted that all member states would have implemented comparable anti-discrimination laws under their own steam.¹⁶²

The harmonisation of machinery, production material and facility sites
There are particular markets in which standards set by labour law constitute basic conditions in a different way than for ordinary markets for goods and services. The most important examples are on the one hand the markets for machinery and production materials, and on the other hand for productive capital investments, i.e. entire companies or production sites, or detachable parts thereof. Technical provisions for occupational health and safety are relevant for facilities, machinery and production materials. The compliance with health and safety regulations is an essential precondition for their marketability. For such goods, machinery and production materials therefore only the European harmonisation of technical safety at work enables genuine European markets.¹⁶³ Consequently, the field

¹⁶¹ On the concept, see B. Rommelspacher, *Dominanzkultur*, Berlin, Orlanda-Frauenverlag, 1998.

¹⁶² This aspect has been overlooked by Somek (*supra*, note 128) who has impressively criticised European anti-discrimination politics for functioning as a surrogate, compatible with neo-liberalism, for genuine social policies.

¹⁶³ Streeck, *supra*, note 111, at p. 383; F. Scharpf, 'Politische Optionen im vollendeten Binnenmarkt', in M. Jachtenfuchs and B. Kohler-Koch (eds), *Europäische Integration*, Tübingen, Mohr, 2003, at p. 230.

of technical protection of labour has developed at the European level¹⁶⁴ and has been expanded continuously.¹⁶⁵

In the case of markets for productive capital investments, those provisions of labour law play a role that are concerned with corporate restructurings, such as changes in operations or the transfer of an enterprise. These provisions act as transaction costs of such restructurings. If the social protection of workers and, hence, the transaction costs among member states diverge too much, these differences replace economic aspects that should actually be decisive. This is the backdrop for the European provisions on the law of the transfers of undertakings, of collective redundancies and of the insolvency of employers.¹⁶⁶

The harmonisation of other technical and social occupational health and safety provisions

The area of the technical health and safety provisions that cannot be traced back to their functional relevance for particular markets of production materials, facilities and machinery, can still be interpreted as market-functional. They prevent competitive advantages based on low health and safety standards.¹⁶⁷ Unlike conditions under a contract of employment, standards of health and safety, which do not concern the cost but the protection of labour, can be established Europe-wide: this is because the production-related price of labour is not concerned, but rather the costs of the conditions for production and services. Furthermore, the extensive technical protection of labour at the European level can be seen as a case of a true spillover of European regulation, inasmuch as a functional distribution of competences would cause practical difficulties.

¹⁶⁴ After the Single European Act came into force, the following Directives are seminal: Council Dir 89/391, improvement in the safety and health of workers at work, [1989] OJ L 183, 1 and Council Dir 89/392, approximation of the laws relating to machinery, [1989] OJ L 183, 9.

¹⁶⁵ See the encyclopaedic descriptions by W. Kothe, in H. Oetker and U. Preis, *Europäisches Arbeits- und Sozialrecht*, Heidelberg, Forkel, 1994, B 6100–6400.

¹⁶⁶ Council Dir 2001/23, safeguarding of employees' rights in the event of transfers of undertakings, [2001] OJ L 82, 16; Council Dir 98/59, approximation of the laws relating to collective redundancies, [1998] OJ L 225; Council Dir 80/987, protection of employees in the event of the insolvency of their employer, [1980] OJ L 283, 16.

¹⁶⁷ Krimphove, *supra*, note 57, par. 517.

The social protection of labour mainly includes the Directives on working hours, maternity protection and the protection of minors.¹⁶⁸ The individual contractual working hours of employees is a first element for determining labour costs. In this respect, European regulation of regular operational work hours would at first glance be similarly implausible as European regulation of wages. A different case are however maximum working hours and the special working arrangements for mothers and young people. Excessive working hours threaten both the health of the affected employees and, in many cases, the safety of third parties. But great differences in the member states' regular working hours also lead to distortions of competition, even if the actually paid wage is decisive,¹⁶⁹ because wages are based on the legitimate demands and needs of full-time workers and to a certain extent independent from the regular working hours of full-time employment. A national culture of excessively long full-time working hours therefore constitutes an unfair competitive advantage, which is ultimately based on undervalued labour similar to the case of discrimination.¹⁷⁰

The labour law annex to European company law

The fourth area is workers' participation as a kind of collective labour law annex to European company law. Without European regulation of participation of workers, legislation regarding original European corporate statutes, notably in the shape of the European Company (SE) and the European Cooperative Society (SCE), would not have been politically possible.¹⁷¹ However, it is symptomatic that the

¹⁶⁸ Parliament and Council Dir 2003/88, organisation of working time, [2003] OJ L 299, 9; Council Dir 92/85, maternity protection, [1992] OJ L 348, 1; Council Dir 94/33, protection of young people at work, [1994] OJ L 216, 12.

¹⁶⁹ This renders intelligible the inclusion of the provisions of Art. 120 into the TEEC (Art. 142 TEC, Art. 158 TFEU), also suggested by the Ohlin report, according to which member states were interested in maintaining parity as regards the regulations concerning paid spare time.

¹⁷⁰ However, the market-functional relation of general and specific maximum working hours is less compelling than in the previous cases. In this respect, it is characteristic that the Directives on working hours (originally as Council Dir 93/104, [1993] OJ L 307, 18), maternity protection and the protection of minors have all been adopted in the uniquely dynamic phase following the passing of the Community Charter of Fundamental Social Rights and in the context of the Maastricht Treaty (see above).

¹⁷¹ Council Reg 2157/2001, Statute for a European Company (SE), [2001] OJ L 294, 1 and Council Dir 2001/86, SE-involvement of Employees, [2001] OJ L 294, 22; Council

European legislature could not agree on real substantive requirements. Here again the different traditions of member state labour constitutions, especially in the field of industrial co-determination, showed their effect. Against this backdrop, the quite resourceful idea of 'negotiated co-determination' emerged.¹⁷² Negotiated co-determination is characterised by the fact that the law itself contains no substantive co-determination rules; rather, it is limited to negotiation procedures and minimum contents and provides standard rules for the constitution of workers' bargaining power and prohibits negative repercussions following conversions and mergers.

These are the four categories in which market-functional substantive labour law can be divided, which in turn has to be provided in the European association of labour constitutions by the EU level. As presented, it is this conception and not the notion of a 'social union' with an integrated labour constitution 'in the making' that renders intelligible the existence and the contents of almost all EU labour law legislation. The positive affirmation of this idea, which was already fundamental for the reference in Art. 117 TEEC to the market-functional legal harmonisation pursuant to Art. 100 TEEC, is therefore of essential use in the reconstruction of the functions of the EU level in the European association of labour constitutions.

Transnationalisation of labour-constitutional rights

The normative effects of the rights of the Charter should not be overestimated.¹⁷³ For the societal sphere of dependent labour, those labour-constitutional rights remain authoritative that have been established at the national level. But these rights are just conceptualised for the national context. They constitute a system of

Reg 1435/2003, Statute for a European Cooperative Society (SCE), [2003] OJ L 207, 1 and Council Dir 2003/72, SCE-involvement of Employees, [2003] OJ L 207, 25.

¹⁷² T. Blanke, 'Dynamik und Konturen des europäischen Sozialmodells', (2006) *Neue Zeitschrift für Arbeitsrecht*, at p. 1306.

¹⁷³ See above, 'the core problem of missing congruence'. The European trade unions seem to agree upon that insight and have recently begun to clamour for a social protocol in addition to the treaty (see B. Bercusson, 'Scope of Action at the European Level', paper presented at a Symposium of the German Federal Ministry of Labour and Social Affairs, Berlin, 26 June 2008). The aim is to establish the priority of social rights over the fundamental freedoms. But even the medium-term perspectives of this endeavour seem to be, to put it mildly, uncertain.

national industrial relations and are not designed as a framework for cross-border industrial relations.

European market integration made cross-border business orientation the central element of its agenda. If, in accordance with the social compromise for integration and taking social forces into account, European law attempts not to be openly biased, it has to compensate for the Europeanisation of the room for manoeuvre of enterprises.¹⁷⁴ As this compensation can actually not lie in a uniform system of European industrial relations, the only remaining alternative is to introduce a transnational dimension in member state labour constitutions. The transnationalisation primarily aims at the fundamental rights of member state labour constitutions, i.e. the individual freedom of exercise of profession, collective participation rights and collective bargaining rights including the right to collective action. As far as the transnationalisation is not provided for in member states labour constitutions, this function has to be covered by the Union level. In the following, the relevant European rights connected to this kind of transnationalisation as well as the associated competences needed for their articulation are explicated.

Transnationalisation freedom of exercise of profession

While the need for a transnationalisation of collective rights can easily be understood as a counterweight to the European reach of business opportunities, the systematic inclusion of the transnationalisation of the freedom of exercise of profession requires an additional explanation, because historically, it started as the free movement of workers (Art. 48 EEC) based on the intention to also increase the efficiency of the allocation of labour. Nevertheless, the transnationalisation of the individual freedom of profession at the same time serves to perceive European workers as a unitary, i.e. not an internally segmented, group. Since, after what has been outlined so far, this cannot be achieved by granting substantive European rights, all member state labour constitutions have to represent this unity individually in their national legal orders. Consequently, member state law has to extend its own freedom of exercise of

¹⁷⁴ With the same emphasis F. W. Wedderburn, 'European Community Law and Workers' Rights after 1992: Fact or Fake?', in id., (ed.), *Labour Law and Freedom*, London, Lawrence and Wishart, 1995, at p. 249.

profession to potentially all European workers according to European provisions.

Normally, the freedom of exercise of profession, as a right to exercise an occupation in dependent labour, is granted only for own nationals within particular national borders.¹⁷⁵ Foreign nationals are given entry at the state's discretion. Within the Union, however, the freedom of exercise of profession has been transnationalised together with the free movement of workers. As Union citizens, all member state nationals are entitled to work as employees all over the Union. In conjunction with the comprehensive prohibition of discrimination inscribed in the freedom of movement (Art. 39.2 TEC), workers can at the same time enjoy all those rights that the respective member state guarantees domestically for individual labour relations.

For this transnationalisation of the freedom of exercise of profession already guaranteed under primary law, there also exist legislative competences at the EU level (Art. 40 TEC, Art. 46 TFEU). On this basis, the Regulation on the Free Movement of Workers¹⁷⁶ was adopted; it entailed most important provisions for the given context, especially Arts 7 and 8, which required the equal treatment of domestic and foreign nationals with regard to working and employment conditions as well as individual trade union rights.

Transnational participation rights

The current constitutional law of the Treaties includes no provision that could provide a similar function for participation rights as the free movement of workers did for the freedom of exercise of profession. In this respect, the transnationalisation of co-determination rights has not undergone real constitutionalisation.¹⁷⁷ Therefore, the attention immediately turns to the European competence concerning legislative regulation, since due to its primacy also over national constitutional law even secondary European law could achieve equivalent results. As already explained, the competences of the Union are narrow. One competence, which

¹⁷⁵ See Art. 12.1 German Basic Law.

¹⁷⁶ Reg 1612/68, *supra*, note 31.

¹⁷⁷ Due to the dominating competence provisions, Art. 27 of the Charter cannot develop much effect. Furthermore, the right to timely information and consultation, promised in the Charter, is not particularly strong (Art. 28 of the Charter however is different. Its potential is explicated below).

can be exercised within the relatively dynamic regular legislative process, exists only for the general information and consultation of workers (Arts 137.2 and 137.1e TEC), which of course includes the regulation of rights to transnational hearing. Much more relevant for the balance of social power is the existing legislative competence for (transnational) business and operational co-determination, yet its exercise requires unanimity in the Council (Arts 137.2 and 137.1f TEC).

Accordingly, the results of previous legislation have remained modest. Besides the already mentioned provisions for the participation of workers in original European companies, directives were adopted on the introduction of a European Works Council¹⁷⁸ and on cross-border mergers¹⁷⁹. As in the law of the original European corporate statutes, the legislature could not find a different solution as the one of 'negotiated co-determination', in which the bargaining power of the employees is constituted by a default norm, which becomes effective once negotiations remain without result. In the case of cross-border mergers, this default norm is constituted by the most potent concerned member state co-determination law¹⁸⁰, in the case of the European Works Councils by the law of the headquarters' host country, which in turn is not allowed to fall below a substantive threshold set by the EU level.¹⁸¹

In both Directives, the default rules correspond to the form of the transnationalisation of labour-constitutional rights which has been developed above: it is not the EU level but member states that provide the relevant substantive law for the transnational collective labour relations at establishment and company level. The EU level provides only for the respective legal obligations of the member states. Regarding the European Works Councils, however, there remains the problem of the contents of the default norms. Here, member state law does not extend domestically effective legal positions to the transnational context; rather, it creates specific standards, which in turn comply with minimum standards

¹⁷⁸ Council Dir 94/45, European Works Councils, [1994] OJ L 254, 64.

¹⁷⁹ Parliament and Council Dir 2005/56, cross-border mergers, [2005] OJ L 310, 1 (Art. 16).

¹⁸⁰ Dir 2005/56, *supra*, note 179, Art. 16.

¹⁸¹ Dir 94/45, *supra*, note 178, Art. 7.

prescribed by the EU level.¹⁸² Although this European standard does not actually represent the lowest common denominator, it settles for a comparably low level.¹⁸³

Therefore, the bargaining position of workers has to be strengthened by another mechanism: in fact, by opening the possibility that the agreements concerning the European Works Councils can become the subject of transnational collective action. The transnationalisation of collective bargaining rights within the European association of labour constitutions, subsequently to be discussed here, is therefore of paramount importance.

Transnational collective bargaining rights

The Treaties themselves offer no basis for the transnationalisation of collective bargaining rights. The right of the social partners to establish contractual relations and to fulfil them autonomously (Arts 139.1 and 139.2 TEC) is however recognised in the constitution, and some legal attention has therefore focused on the question of whether these relationships could constitute European collective agreements.¹⁸⁴ The question of a European right to autonomous collective bargaining under Art. 139 TEC is in itself, however, of no major practical relevance as long as the issue of the right to collective action remains unresolved.¹⁸⁵ In the long run, no European employers association will conclude European collective agreements voluntarily.¹⁸⁶ The freedom of collective agreement and the right to

¹⁸² Dir 94/45, *supra*, note 178, Annex: subsidiary requirements referred to in Art. 7 of the Directive. The implementation in national laws could have exceeded the minimum standard. But this has only happened in some minor cases. For an overview see Europäischer Gewerkschaftsbund (ed.), *Die Umsetzung der EBR-Richtlinie in nationales Recht* (1999), Table 8-14.

¹⁸³ A. Höland, *Mitbestimmung in Europa*, Baden-Baden, Nomos, 2000, at p. 135.

¹⁸⁴ An innovative proposal suggests that the European social partners themselves decide about the normative effects of European collective agreements by agreeing on a framework for European collective bargaining (D. Schiek, 'Einleitung', in W. Däubler, *Tarifvertragsgesetz*, Baden-Baden, Nomos, 2006, par. 790ff; Krimphove, *supra*, note 57, par. 604). Closer to the wording of the Treaty and, hence, more convincing is the position that the legal effect of a European collective agreement is determined by national collective bargaining rights and is therefore different from member state to member state: O. Deinert, *Der europäische Kollektivvertrag*, Baden-Baden, Nomos, 1999.

¹⁸⁵ See *supra*, note 57.

¹⁸⁶ The autonomous agreements between the social partners established under Art. 139 TEC impressively confirm this. These are three 'framework agreements', concerning telework (2002), work-related stress (2004) and harassment and violence

collective action constitute a unity; the first without the latter is of no relevance for social power relations.¹⁸⁷ The bargaining power of workers and with this the possibility to achieve transnational collective agreements at all in controversial matters rest on the right to collective action.

A legislative competence of the Union for an EU-wide transnationalisation of free collective bargaining, including the right to association, collective bargaining rights¹⁸⁸ and the right to collective action, is explicitly excluded under current constitutional law. A European order of collective bargaining and collective action rights can therefore not emerge on the basis of European legislation. This means nothing less than that it is the member state labour constitutions which have to develop the standards providing a legal framework for intra-European transnational labour disputes and transnational collective agreements. Within the European association of labour constitutions, cross-border collective action concerning transnational collective agreements has in principle to be legally permissible, and European collective agreements must be recognised as such. This suggests putting transnational collective labour relations on an equal footing with domestic ones.¹⁸⁹ Transnational labour disputes should not be subject to more stringent requirements than national labour disputes, European collective agreements should have the same legal effect as domestic collective agreements.

at work (2007), and two 'frameworks of action' for the lifelong development of competencies and qualifications (2002) and on gender equality (2005). They do not even in at first glance appear law-like and the formal monitoring of their implementation also shows no signs that they are legal agreements.

¹⁸⁷ Bundesarbeitsgericht, Case 1 AZR 822/79, [1980] *Neue Juristische Wochenschrift* 1642.

¹⁸⁸ This is contested. For a preferable stance, see U. Preis and M. Gotthardt, in H. Oetker and U. Preis, *Europäisches Arbeits- und Sozialrecht*, Heidelberg, Forkel, 1994, B 1100, par. 43. For a different opinion, see Langenfeld and Benecke, *supra*, note 75, Art. 137 par. 97; Rebhahn, *supra*, note 75, Art. 137 par. 19; and E. Högl, in H. von der Groeben and J. Schwarze (eds), *Kommentar zum EU-/EG-Vertrag*, Baden-Baden, Nomos, 2003, Art. 137 TEC par. 43. Apart from the factual interdependence of the three subjects, the major problem for the opposing view is that minimum provisions – which are solely allowed by Art. 137.2b, as is rightly emphasised by Langenfeld and Benecke, *supra*, note 75, Art. 137 TEC par. 7 – are hardly conceivable for the legal effects of collective bargaining agreements.

¹⁸⁹ First developed for collective bargaining rights by Deinert, *supra*, note 184.

The constitutional link of the transnationalisation of member state bargaining can be found in Art. 28 of the Charter.¹⁹⁰ It guarantees the right to negotiate collective agreements 'at the appropriate levels'. With regard to the function of collective labour relations, it cannot be said that the transnational level is not an appropriate one. The right of industrial action is, in turn, granted even without such reference to appropriate levels. Taken separately, Art. 28 of the Charter requires the provision of a legal framework for European labour disputes and collective agreements. As long as the European level cannot step in due to its lack of competences, the transnationalisation of collective bargaining rights has to be an achievement of member state labour constitutions.¹⁹¹ member state law that would exclude or disproportionately limit cross-border labour disputes and collective agreements (Art. 52 of the Charter) therefore constitutes a breach of Art. 28 of the Charter.¹⁹²

It is still to be clarified in how far civil disputes in the area of transnational industrial struggle or collective agreements open up a field of application for Community law in a way that Art. 28 of the Charter gains legal relevance. The solution might be analogous to the jurisprudence of the Court on Union citizenship. The general rule might read as follows: in so far as the European constitutional law contains fundamental rights that *cannot* have an equivalent at the national level, a breach of these positions opens up the scope of application for Community law. This applies to Union citizenship as well as to the guarantee of a Union-wide right to collective bargaining.

Conclusion

The process of European integration is based on a social compromise for integration whose renewal is fundamental to the acceptance as well as to the future development of European integration. According

¹⁹⁰ Rixen, *supra*, note 62, Art. 28 par. 14; Fuchs, in M. Fuchs and F. Marhold, *Europäisches Arbeitsrecht*, Wien, Springer, 2006, at pp. 152 and 158.

¹⁹¹ The competence of member state labour constitutions for the articulation of the right to transnational collective bargaining is confirmed by the statements of the presidency of the Charter Convention, according to which the arrangement and limitations of transborder collective action have to be determined by member state law. CHARTE 4473/00, CONVENT 49, *supra*, note 67, at p. 27.

¹⁹² Case C-85/96, *Martínez Sala* [1998] ECR I-2691, and Case C-184/99, *Grzelczyk* [2001] ECR I-6193.

to the reconstruction of this compromise against the backdrop of present-day conditions the EU labour constitution consists of three elements: constitutional figures to support the autonomy of member state labour constitutions, legislative competences for the harmonisation of labour regulation in the case of labour cost induced competitive distortions, and the transnationalisation of fundamental, labour-constitutional rights of workers.

The precise determination of the shape of the EU labour constitution, as constitutional institutionalisation of the social compromise for integration, realises the systemic function of modern labour law in a transnational context. Labour law aims to prevent the antisocial and unfair competition for low labour costs as far as possible, in order not to interfere with fair and productive competition in all other fields concerning ideas, technology and organisation. Applying the same function, however, the shape of labour law changes depending on whether it is concerned with the competition of companies in the same national economy or in different economies, i.e. whether domestic or supranational labour law is at issue. In the first case, domestic labour law provides unitary general or sectoral minimum working conditions. The second case concerns the prevention of a race to the bottom concerning domestic minimum working conditions through supranational labour law. The absolute level of wages and working conditions remains a matter of societal power relations, whose legal framework also in the supranational Union are primarily constituted at the national level and which are not allowed to be shifted in a biased manner by the constitutional law of the Union.

The European association of labour constitutions establishes through the interplay of its member state and Union level a European social space of dependent labour, in which it reflects the economic fragmentation of the European market. However, it prevents this fragmentation from overriding the social contradictions inscribed in this space. Future conflicts about the shape of the European labour constitution will be about overcoming the misleading model of an EU labour constitution modelled after national labour constitutions. This model has had an effect in the dispute about social rights and guiding norms at the European level for a long time. Instead, those who advocate a strengthening of the social dimension of European integration will have to focus even more resolutely on those parts of

the EU labour constitution which can actually serve to reconstruct a viable social compromise. This task is intellectually and practically demanding enough.

Chapter 10

The failure of the macroeconomic dialogue on wages (and how to fix it)

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Introduction

The institutional set-up of European Monetary Union (EMU) is unique. Monetary policy is centralised at the supranational level, but many other policies with macroeconomic impact remain at the national level. This decentralised decision-making produces externalities, which are not correctly internalised in the decision-making procedures. The problem is not new and has received some attention with respect to fiscal policy.² It is much less regarded in the field of wage bargaining, presumably because markets are supposed to work efficiently. But experience reported in this paper shows that labour markets remain local markets and wage bargainers behave as

¹ I thank my colleagues at CER, notably Francesca Pancotto and Filippo Pericoli for research assistance and Ulrich Fritsche for useful comments. All mistakes are mine.

² S. Collignon, 'Is Europe Going Far Enough? Reflections on the EU's Economic Governance', (2004) 11(5) *Journal of European Public Policy*, pp. 909-925; id., 'Fiscal Policy and Democracy', paper presented at the Monetary Workshop, Österreichische Nationalbank, Vienna, 2004, published as ÖNB Discussion paper No. 4, November 2004; id., 'The European Republic. Reflections on the Political Economy of a Future Constitution', The Federal Trust for Education and Research, London, 2003.

if they are unaware of the fundamental regime change that took place with the introduction of the euro. In 1999 the German EU presidency set up the Macroeconomic Dialogue (MED), also called the Cologne Process, which was an attempt to focus policy maker's minds on the issue of wage bargaining externalities. But, I argue, it has failed, because it has remained an exclusive, secretive and confidential elite process. In order to prevent the risk of unsustainable tensions in the Monetary Union, wage bargaining must become part of the European public sphere.

Judged against the initial promise, the first decade of EMU has been a success: price stability has been maintained, the aggregate budget deficit reduced, and even if economic growth has been lower than in the previous decade, over 18 million new jobs have been created with unemployment falling from 10 per cent to 7.1 per cent. However, these favourable developments stand on weak foundations. In June and July 2008, inflation rose to four per cent. Subsequently, the world-wide financial crisis has pushed EMU into its first recession and inflation was down to 1.6 per cent in December. But the effects of the recession have hit member state economies unequally because of different positions of competitiveness and relative unit labour costs. High public debt and current account deficits, which are re-enforced by low competitiveness, restrain the margins for discretionary macroeconomic policies. Wage increases in the euro area have been moderate overall, but national divergences in unit labour costs (ULC) remain an important and underestimated factor for the long-term success of Europe's single currency.

The ECB is rightly concerned with *aggregate* wage and price developments in the euro area. It has frequently warned that temporary price shocks must not spill over into higher wages. The peak organisations of European social partners have agreed with the ECB on this point, but they have also insisted that the central bank must respond to voluntary wage restraint with growth-accommodating monetary policies.³ Yet, wages are not negotiated by

³ European Trade Union Confederation (ETUC), 'Europe Needs a Better Monetary Policy Regime', Resolution adopted by the ETUC Executive Committee in their meeting held in Brussels on 06-07 June 2006. Available at <<http://www.etuc.org/a/2460>>.

peak organisations, but in firms or industries at the national level and actual wage bargains pay attention not to European guidelines but to local economic conditions. Some countries – primarily Germany – exercise competitive wage restraint, others increase salaries to compensate for national inflation. As a consequence, unit labour cost levels diverge, and competition is distorted in the single market.⁴ The European Central Bank (ECB) cannot prevent these developments, as it has a mandate to maintain price stability for the euro area as a whole. High-cost countries are, therefore, able to free-ride on the wage restraint of others, because monetary policy cannot sanction them. But enduring divergences in ULC are unsustainable. In a non-cooperative environment, adjustment will ultimately take place through loss of market share, de-localisations and higher regional unemployment, although it will take a long time until these effects will have corrected existing distortions.⁵ In a cooperative framework, these welfare costs could be reduced by making agreements that keep national wages in line with the ECB's inflation target and taking into account initial disparities. In order to correct distortions in the euro area, these agreements ought to be symmetrical between member states: countries with excessive wage restraint must raise nominal wages, while high wage cost countries must bring them down.

The evidence for such nominal adjustment will be closer examined. Section one will cover the 'vertical' interaction between aggregate wage costs with monetary policy. Section two deals with the 'horizontal' developments in relative unit labour costs with respect to different member states. Section three seeks to find evidence for a long run tendency of unit labour cost convergence to the European inflation target. Finally, a discussion of policy issues is presented. A loose framework for coordinating wage bargaining and monetary policy exists at the European level in the form of the MED. It is based on the principle that macroeconomic policy makers (finance ministers and ECB), and those responsible for wage formation (employers and trade unions) should have a proper understanding of each others

⁴ The European Commission expressed concern about unsustainable divergences in competitiveness and current account balances, see European Commission, 'Competitiveness Developments within the Euro Area', Quarterly Report on the Euro Area (2009) 8 (1).

⁵ O. Blanchard, 'Adjustment Within the Euro. The Difficult Case of Portugal', 11 November 2006. Available at <<http://econ-www.mit.edu/files/740>>.

positions and constraints, so that the interaction between wage developments, fiscal and monetary policies are conducive to non-inflationary growth.⁶ But has it worked? In section four, I will discuss the problems of the European wage bargaining system and draw some conclusions for the necessary reform of the MED.

The interaction between aggregate unit labour costs and monetary policy

The golden rule of wage bargaining

The EMU is founded on the principle that good money reflects stable prices. The ECB has redefined price stability in 2002 as a rate of inflation measured by the Harmonised Index of Consumer Prices (HICP) 'below but close to two per cent over the medium term'.⁷ The HICP combines data from national consumer price indices. Above-average price increases in one country must therefore be mirrored by below-average inflation elsewhere.

Price stability implies stable unit labour costs. One of the most widely accepted models for explaining inflation is the expectation-augmented Philips-curve model, whereby stable inflation corresponds to some equilibrium in the employment level.⁸ It can be represented by a system of equations,⁹ where the price level is determined by a markup over unit labour costs (i.e. productivity-adjusted wage costs) and supply and demand shocks. The NAIRU model makes the price and wage setting equations explicit and explains inflation by inconsistent claims to income shares for wages

⁶ European Commission, 2008. Macroeconomic Dialogue (MED), downloaded 1 September 2008. Available at <http://ec.europa.eu/economy_finance/eco_research/eco_research8355_en.htm>.

⁷ ECB, 'The Definition of price stability' 2008, available at <<http://www.ecb.int/mopo/strategy/pricestab/html/index.en.html>>.

⁸ R. J. Gordon, 'Price Inertia and Policy Ineffectiveness in the United States, 1890-1980', (1982) 90 *Journal of Political Economy*, pp. 1087-1117; id., 'Understanding Inflation in the 1980s', (1985) 85 *Brookings Papers on Economic Activity*, pp. 263-99; id., 'The Role of Wages in the Inflation Process', (1988) 78 *American Economic Review*, pp. 276-83; D. J. Stockton and J. E. Glassman, 'An Evaluation of the Performance of Alternative Models of Inflation', (1987) 69 *The Review of Economics and Statistics*, pp. 108-17; K. H. Ghali, 'Wage Growth and the Inflation Process: A Multivariate Cointegration Analysis', (1999) 31(3) *Journal of Money, Credit and Banking*, pp. 417-431.

⁹ For reasons of space, I do not reproduce the equations here. Ghali, *supra*, note 8 gives a good synthesis.

and profits.¹⁰ Note, however, that the wage share is identical to real unit labour costs, from where nominal price and wage setting targets can be derived.¹¹ Assuming that the markup is stationary and demand and supply shocks have zero means, the price level will in the long run reflect developments in unit labour costs.¹² In most models nominal wages are set as a function of expected inflation plus labour productivity, adjusted by a variable for labour market tightness, and monetary authorities manage inflation expectations. The central bank's success in keeping prices stable then depends largely on its reputation and credibility with wage setters. An independent and conservative central bank will not accommodate price inflation, and wage bargainers take this into account, so that unit labour costs and prices conform to the inflation target. In this section, I will look at the underlying tendencies behind aggregate unit labour cost developments in the euro area.

With the advent of the EMU, a number of authors¹³ have focussed on the interaction between wage bargaining and monetary policy.¹⁴

¹⁰ R. Layard, S. Nickell and R. Jackmann, *The Unemployment Crisis*, Oxford, Oxford University Press, 1994.

¹¹ $ULC = wL/y$, where w is the wage rate, L the hours worked and y is output. Because productivity is y/L , nominal ULC are equal to nominal wages divided by productivity. Real unit labour costs are nominal wages deflated by the price level $RULC = wL/Py$ which is the same as the share of wages in GDP.

¹² For empirical evidence, see Ghali, *supra*, note 8.

¹³ O. Sievert, 'Geld das man nicht selber herstellen kann. Ein ordnungspolitisches Plädoyer für die Europäische Währungsunion', in P. Bofinger, S. Collignon and E. - M. Lipp (eds) *Währungsunion oder Währungschaos; Was kommt nach der D-Mark?*, Wiesbaden, Gabler Verlag, 1993, at pp. 13-24; P. A. Hall and R. J. Franzese Jr., 'Mixed Signals: Central Bank Independence, Coordinated Wage Bargaining, and European Monetary Union', (1998) 52(3) *International Organization*, pp. 505-535; P. A. Hall and R. J. Franzese, 'Mixed Signals: Central Bank Independence, Coordinated Wage Bargaining, and European Monetary Union', (1998) 52 *International Organization*, pp. 505-535; D. Soskice and T. Iversen, 'Multiple Wage Bargaining Systems in the Single European Currency Area', (2001) 28 *Empirica*, pp. 435-456; P. Mooslechner and M. Schürz, 'The Interaction of Wage Bargaining Institutions and an Independent Central Bank - A Methodological Reflection on Current Theories', (2001) 28 *Empirica*, pp. 487-506; A. Cukierman and F. Lippi, 'Labour Markets and Monetary Union: A Strategic Analysis', (2001) 111(473) *The Economic Journal*, pp. 541-565; S. Collignon, 'Unemployment, Wage Developments and the European Policy Mix in Europe' (1999) *Empirica*, pp. 259-269; id., *Monetary Stability in Europe*, London, Routledge, 2002.

There is now some sort of 'overlapping consensus'¹⁵ that in models with perfectly competitive labour markets, low inflation is achieved by stable money supply. In oligopolistic markets, where firms have market power, an independent, conservative central bank is needed in order to proactively resist pressures from wage and price setters. The tension of inconsistent wage claims by workers and firms is then resolved by changes in unemployment. If monetary authorities would accommodate higher wages claims, the adjustment variable would be inflation.

Calmfors et al.¹⁶ have argued that inconsistent claims depend on labour market structures. Inconsistencies are less likely in highly decentralised or highly centralised labour markets, so that an inverted U-shaped curve relates inflation and unemployment to an index for centralised wage bargaining.¹⁷ Subsequently, the argument was extended to other institutional arrangements. Coordinated sectoral wage bargaining can lead to the same economic outcome as centralised bargaining.¹⁸ Hall and Franzese¹⁹ showed that coordinated wage bargaining will produce Pareto-superior forms of equilibrium behaviour, provided that the central bank signals credibly to wage bargainers that it will maintain price stability and

¹⁴ Mooslechner and Schürz explain that these theories do not form a unified paradigm, see *supra*, note 13.

¹⁵ Overlapping consensus is a term coined by J. Rawls, 'The Idea of an Overlapping Consensus', (1987) 7(1) *Oxford Journal of Legal Studies*, pp. 1-25. It refers to how supporters of different comprehensive doctrines can agree on a specific form of political organization. I use it here to emphasize that different economic schools have come to a similar conclusion.

¹⁶ L. Calmfors, J. Driffill, S. Honkapohja and F. Giavazzi, 'Bargaining Structure, Corporatism and Macroeconomic Performance', (1988) 3(6) *Economic Policy*, pp. 13-61.

¹⁷ R. B. Freeman, however, argues that the inverse U relation was a transitory historic phenomenon and has now disappeared, see 'Labor Market Institutions Around The World', *NBER Working Paper 13242*, 2007. Available at <<http://www.nber.org/papers/w13242>>.

¹⁸ D. Soskice, 'Wage Determination: the Changing Role of Institutions in Advanced Industrialized Countries', (1990) 6(4) *Oxford Review of Economic Policy*, pp. 36-61; C. N. Teulings and J. Hartog, *Corporatism Or Competition? Labour Contracts, Institutions and Wage Structures in International Comparison*, Cambridge, Cambridge University Press, 1998.

¹⁹ P. A. Hall and R. J. Franzese Jr., 'Mixed Signals: Central Bank Independence, Coordinated Wage Bargaining, and European Monetary Union', (1998) 52(3) *International Organization*, pp. 505-535.

that wage bargainers integrate this message into their settlements. These models would explain good performances in economies with highly decentralised and highly centralised wage bargaining. But they announce potential trouble in Euroland, because national wage setting is far from the competitive ideal, and the degree of coordination for the euro area as a whole is lower than in most member states. However, I will show below that the standard indicators for labour market conditions are not very significant in explaining diverging unit labour costs in the euro area.

Unit labour costs depend on nominal wages, productivity and variations of economic growth. The ECB has frequently warned against nominal wage settlements leading to inflation.²⁰ Even more frequently social partners and politicians demand monetary authorities to do more for growth. Both demands are linked to productivity. If the ECB's inflation target is 2 per cent over the medium term, nominal wages must not increase by more than 2 per cent plus the rate of productivity growth. This is the 'golden rule' of wage bargaining in Europe that allows the ECB to support growth. The rule was adopted by the MED as a formal policy guideline for social partners.²¹ Yet, the golden rule is not without problems. Productivity varies with economic growth and between different sectors or countries. It is generally higher in manufacturing than in services or in the public sector. It can be expected to grow faster in countries with low per capita income as they are catching up with more advanced countries. If regional productivity in less developed regions is catching up with leading ones, money wages in Europe's poorer regions can rise rapidly without unit labour costs rising and becoming inflationary. This logic has supported the European social model in the past, when productivity was growing rapidly, but it is now undermined by stagnating productivity in several member states, notably Italy and Spain.

²⁰ See for example, J. C. Trichet, 'Hearing at the Economic and Monetary Affairs Committee of the European Parliament', introductory statement by Jean-Claude Trichet, President of the ECB, Brussels, 10 September 2008. Available at <<http://www.ecb.int/press/key/date/2008/html/index.en.html>>.

²¹ European Commission, 2005. 'Communication To The Spring European Council: Working together for growth and jobs', available at <http://ec.europa.eu/employment_social/key_en.html>.

So, which measure of productivity is to be used for the golden rule? Aggregate or sectoral or regional productivity? If sectoral rates are used, low productivity sectors would see their nominal wages stagnate relative to the high performing sectors. The golden rule would increase nominal wage dispersion and inequalities across sectors and regions, posing problems of economic and social cohesion. If aggregate productivity is the reference for wage setting, low productivity sectors would lose competitiveness and ultimately disappear. This may be a form of Schumpeterian 'creative destruction', but if the differences are too large, the social costs would be very high.

With flexible labour markets these distortions would be temporary and labour mobility would ensure that workers are employed where their marginal productivity is highest. The demand for labour depends on unit labour costs, for they determine the relative competitiveness of firms. The supply of labour depends on the purchasing power of nominal wages, because people work for what money can buy. If the supply side of the labour market is sufficiently flexible, workers will move to the highest wage on offer and a single wage (per skill group) will prevail in the economy. Thus, nominal wage convergence is a sign of labour market flexibility on the supply side, but a similar result could be obtained by centralised wage bargaining. On the demand side, the convergence of unit labour cost is a sign of competitive goods markets. If firms operate in a competitive environment, they can only offer a nominal wage that takes into account their relative productivity levels. If labour and goods markets are both competitive, low-productivity firms will disappear, and productivity will converge. However, this convergence process can be painful, particularly if low productivity firms are regionally clustered. Nominal wage dispersion can then keep less productive firms alive and contribute to unit labour cost convergence without productivity adjustment.

In the European Union labour mobility and social cohesion and solidarity are generally higher *within* nations than *between* them.²²

²² H. Krieger and E. Fernandez, 'Too Much or Too Little Long-Distance Mobility in Europe? EU Policies to Promote and Restrict Mobility', European Foundation for the

Nominal wages have therefore a higher degree of homogeneity at the national level. Given the different levels of economic development, European wage bargaining is dominated by national productivity and inflation rates, and significant wage differentials persist. Economic cohesion in the EU requires therefore the convergence of productivity, and nominal wages can only converge as a consequence of this process. National policies are the main driver in this catch-up development, although they will benefit from the support of European cohesion policies. But because mobility is imperfect, deviations from the golden rule often reflect some degree of sectoral and skill differentiation. On the other hand, if wages are not sufficiently differentiated by skills or regions, the mismatch between labour supply and demand may increase and push up the unemployment rates in specific regions and skill groups.²³

Table 10.1: Nominal wage gap

avg. growth p.a.1999-07	Productivity	Golden Rule	actual wages	Gap
Germany	1.57%	3.57%	1.89%	-1.68%
Austria	1.45%	3.45%	2.04%	-1.41%
Finland	1.98%	3.98%	3.13%	-0.85%
Belgium	1.26%	3.26%	2.64%	-0.62%
Euro area (15 countries)	1.08%	3.08%	2.58%	-0.50%
France	1.01%	3.01%	2.75%	-0.27%
Malta	1.30%	3.30%	3.21%	-0.09%
Netherlands	1.49%	3.49%	3.69%	0.20%
Italy	0.45%	2.45%	2.83%	0.38%
Luxembourg	1.36%	3.36%	3.80%	0.44%
Spain	0.44%	2.44%	2.97%	0.53%
Greece	3.28%	5.28%	6.06%	0.78%
Cyprus	1.11%	3.11%	3.90%	0.79%
Portugal	0.91%	2.91%	3.73%	0.82%
Ireland	2.53%	4.53%	5.72%	1.19%
Slovakia	4.15%	6.15%	7.62%	1.48%
Slovenia	3.31%	5.31%	7.77%	2.46%

Source: The annual macro-economic database of the European Commission (AMECO), 2007

Improvement of Living and Working Conditions, 2006. Available at <<http://www.eurofound.europa.eu/docs/areas/populationandsociety/mobility4paper2006.pdf>>.

²³ P. Du Caju, E. Gautier, D. Momferatou and M. Ward-Warmedinger, 'Institutional Features of Wage Bargaining in 22 EU Countries, the US and Japan', mimeo, 2008.

It follows that the golden rule is a general benchmark rather than a strict formula for setting wages. In reality few countries adhere to it. Table 10.1 shows annual data over the 1999-2007 period. Six euro area countries out of 16 have remained below the rule, while 10 have exceeded it. Germany, Austria and Finland have shown wage restraint significantly below the golden rule. The Southern countries Portugal, Greece, Spain and Italy all have exceeded it. But *aggregate* wage increases in the euro area have remained half a percentage point behind the Rule and this has helped the ECB's policy to maintain price stability.

Determining unit labour costs

To understand unit labour cost dynamics in Europe, one must look at their components. Figure 10.1 presents the evolution of quarterly data for wages, productivity and unit labour cost growth in the aggregate euro area over the last decade.

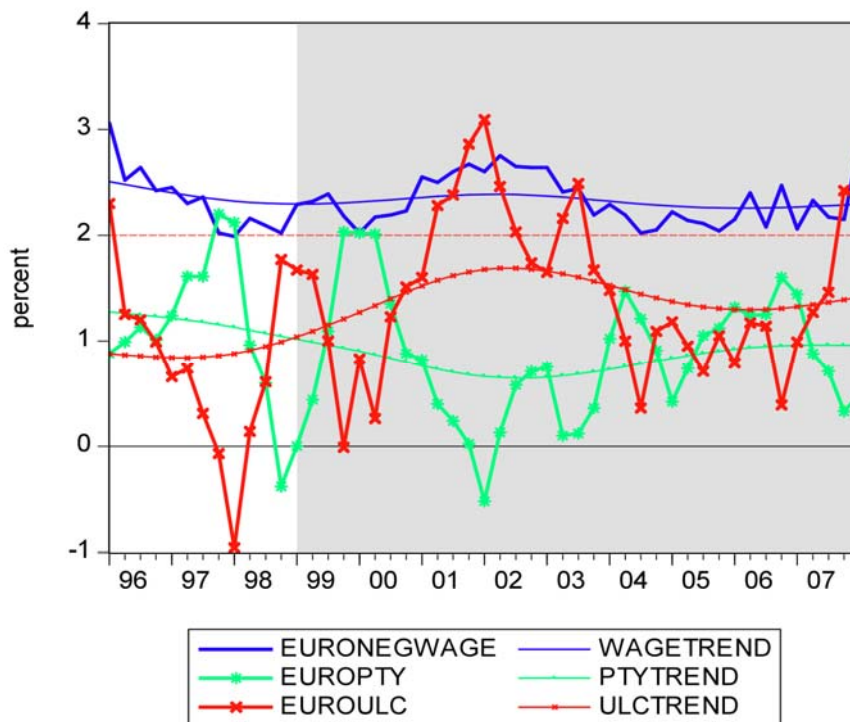


Figure 10.1: Wages, productivity and ULC in Euroland
Source: ECB

The first observation is that since the late 1990s negotiated nominal wages have remained remarkably stable. They moved in a range of 2-

2.9 per cent with a mean of 2.3 per cent and show the lowest standard deviation of all variables.²⁴ Second, productivity growth has been more volatile. It rose during the early euro-boom and fell after the dot-com bubble crisis. It then became negative in the first quarter of 2002.

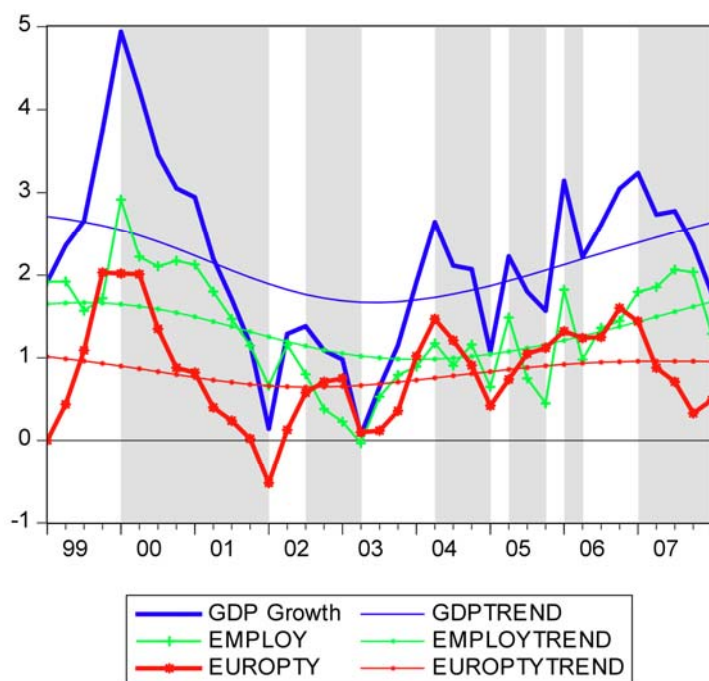
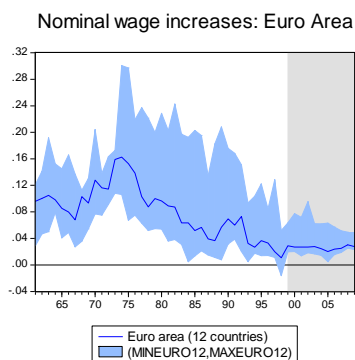


Figure 10.2: Economic growth and productivity

The standard deviation was twice as high as for nominal wages. Third, as a consequence, unit labour costs have varied more than nominal wages. They have been the closely matching mirror image of

²⁴ Long run annual data from the European Commission’s AMECO database reveal that nominal wage stability started with European monetary union. The chart below shows the range between minimum and maximum wage increases in the Euro-12 group and the aggregate growth rate in between.



productivity. But on average, ULC have increased only by 1.5 per cent per annum over the first decade of EMU. Thus, nominal wage restraint has contributed to the overall price stability of the euro, while changes in unit labour costs are largely driven by variations in labour productivity.

If productivity affects ULC, the slowdown in productivity trends has narrowed the scope for nominal wage increase and reduced the margins for monetary policy, because structural changes in the labour market have reduced the long-run non-inflationary growth rate. According to a widely held belief, 'rigid' job-protecting labour laws in Europe used to make it difficult for firms to 'hire and fire' staff. They resisted reducing employment when growth slowed down. Since the mid-1990s, labour market reforms have made the labour market more flexible and the long-term relationship between economic growth and productivity has been severed.

Figure 10.3 shows the correlation between long-term trends for employment, productivity and GDP growth. The top line represents the evolution of the long-term elasticity for employment, the lower series shows the same for productivity.²⁵ Both employment and productivity trends are positively correlated with potential output (the two curves are upward moving). In the mid-1990s (1996Q1) labour market reforms shifted the employability of workers structurally up and productivity down. After EMU started in 1999, a new stable trade-off developed. During the period of economic weakness (1999-2003), employment responded less to GDP trend growth, than in the second phase when economic growth improved (the curve was flatter in the downturn than in the upturn). The fact that the slope is much flatter for productivity than for employment between 1999 and 2003 is a sign for labour hoarding. This would correspond to the 'rigid labour market' story. But soon after growth started accelerating again, the productivity curve became horizontal. This low elasticity of productivity therefore imposes a 'speed limit' for economic growth around the 2.4 per cent mark.

²⁵ The variables are expressed as logarithmic value and this allows us to interpret the slope of the curves as the long run elasticities between economic growth and the two other variables.

remained below the inflation target of two per cent. It will be shown below that the benign developments of recent years are the unintended consequence of compensating national wage strategies. There is no policy mechanism that guarantees adherence to the golden rule. What will be observed in the next section is that aggregate realisations of the golden rule are achieved by regional divergences and 'rotating slumps',²⁸ whereby unit labour costs in booming economies overshoot the average and will get corrected subsequently by drawn out slumps.

This analysis has important policy consequences. Although monetary policy is not neutral with respect to economical growth and employment, the range within which it can affect real variables is very limited: cutting interest rates to stimulate growth and reduce unemployment is not a viable long term strategy for Europe, cutting taxes neither. Instead the focus must be on improving labour productivity by raising the capital-labour ratio and total factor productivity in order to improve growth, employment and wages in the long run. This is a more complex analysis than the 'dialogue de sourds', where the ECB exhorts social partners to avoid 'second round effects', while trade union complain that wage moderation has not sufficiently been rewarded by expansionary monetary policies.²⁹

The dynamics of relative unit labour costs

Regional divergences

Figure 10.1 and footnote 24 show evidence for remarkable nominal wage restraint in Euroland, but the phenomenon has been widespread across OECD countries. Some authors have called it the 'Great Moderation'.³⁰ One explanation for this stability is the effect of

²⁸ O. Blanchard, *A Macroeconomic Survey of Europe*, mimeo, 2006.

²⁹ A. Watt, 'Can Reform of the Macroeconomic Dialogue Improve Macroeconomic Policy-Making in Europe?', in E. Hein, T. Niechoj, T. Schulten and A. Truger (eds) *Macroeconomic Policy Coordination in Europe and the Role of the Trade Unions*, Brussels, ETUI and WSI, 2005.

³⁰ M. McConnell and G. Perez-Quiros, 'Output Fluctuations in the United States: What Has Changed since the Early 1980s?', (2000) 90 *American Economic Review*, pp. 1464-76; O. Blanchard and J. Simon, 'The Long and Large Decline in U.S. Output Volatility', (2001) 1 *Brookings Papers on Economic Activity*, pp. 135-64.

globalisation and Europeanisation on wages,³¹ which has driven down the wages of unskilled relative to skilled workers. The opening of markets has simultaneously increased the rate of substitution between goods produced in different countries. This makes it difficult to raise real wages for unskilled workers in the tradable goods sectors, because imports compete with local production. As a consequence, profit margins have improved and the aggregate wage share has fallen in most industrialised countries. Figure 10.4 provides some evidence.³²

Over the last decade, the wage share has fallen significantly in Germany, Austria and Belgium; it has remained stable in most of the Southern countries with the exception of Spain. If European workers and trade unions seek to redress this distributive imbalance by pushing wages up, something that Hahn and Solow³³ have called the 'justice motive', higher labour costs will translate into more unemployment because imports from low wage countries replace local products. These labour cost increases do therefore not cause higher inflation; instead, the growing unemployment will reduce the weight of sectors exposed to international competition and this explains the fall in the aggregate wage share.³⁴ Workers, therefore, have a choice of trading higher real wages in for job security. Wage restraint in Europe would then indicate a preference for employment security.³⁵

³¹ C. Bean, 'Globalisation and Inflation: Bank of England', (2006) *Quarterly Bulletin* Q4, pp. 468-475. Available at <www.bankofengland.co.uk/publications/speeches/2006/speech287.pdf>; C. Borio and A. Filardo, 'Globalisation and Inflation: New Cross-Country Evidence on the Global Determinants of Domestic Inflation', BIS Working Papers 227, 2007, May.

³² The shaded lines show the end of Bretton Woods in 1971, the creation of EMS in 79, and the ERM crisis in 1991/2.

³³ F. Hahn and R. Solow, *A Critical Essay on Modern Macroeconomic Theory*, Oxford, Blackwell, 1995.

³⁴ A. De Serres, S. Scarpetta and C. De La Maisonnette, 'Falling Wage Shares in Europe and the United States: How Important is Aggregation Bias?', (2001) 28 *Empirica*, pp. 375-400.

³⁵ To avoid misunderstandings: the trade-off is between real wages and job *security* and not between real wages and lower unemployment. I may accept to see my real wage reduced, while others may still lose their jobs.

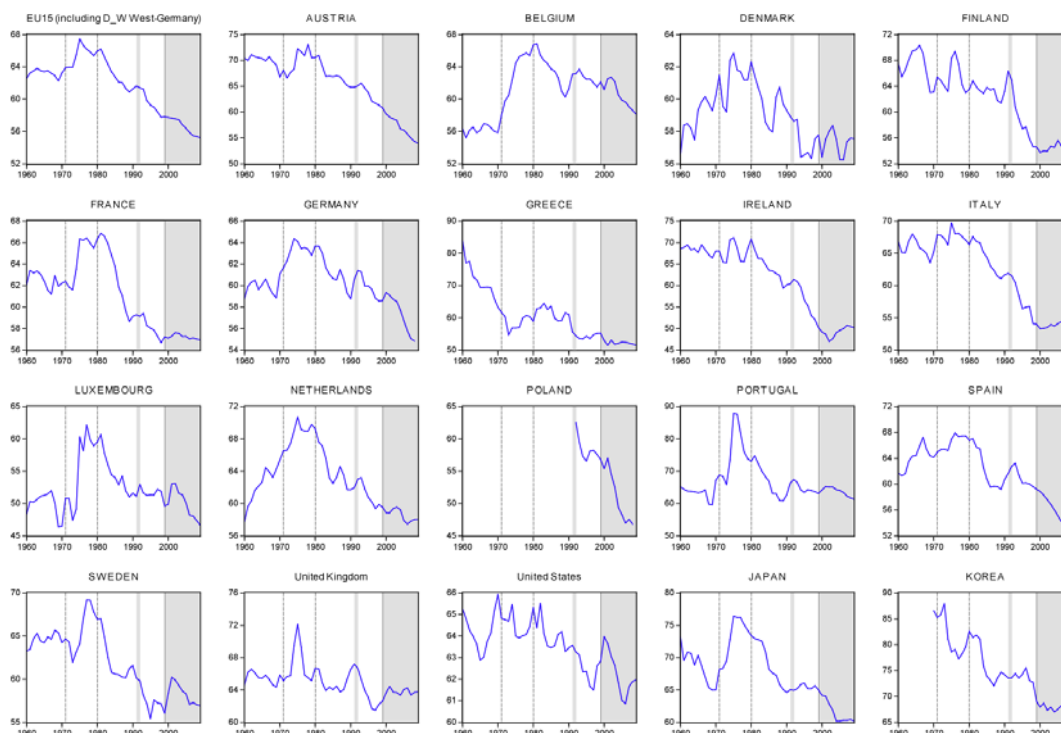


Figure 10.4: Adjusted wage share
Source: AMECO

However, not all workers are subject to the pressures of globalisation and Europeanisation. In the non-tradable goods sector, firms are less exposed to international competition. They have market-power in price setting and this facilitates the accommodation of higher wage claims. But because of the relative homogeneity of nominal wages, sectoral wage increases spill over into national unit labour costs and will increase the euro area's wage heterogeneity.

Figure 10.5 shows the evolution of unit labour cost *levels* expressed in a common currency (ECU and euro) since 1980. Calculating level differences is controversial. The European Commission uses an index, which has the same value of 100 for all member states in the base year. However, such index makes it impossible to assess distortions in relative cost levels. This is better judged by real unit labour costs, i.e. by relative wage shares. A country with a below-average wage share is likely to yield higher profits and be more competitive. For this reason, I have adjusted the ULC-levels to the wage share in 2000.

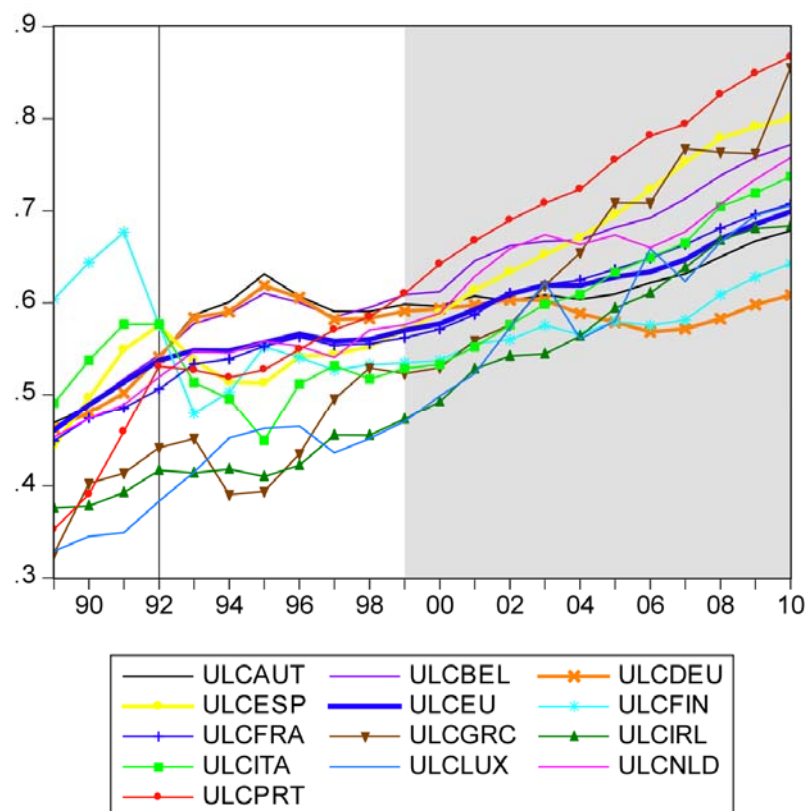


Figure 10.5: Unit labour cost levels (2000 = adjusted wage share)

Source: Ameco

ULC are calculated as the ratio of total remuneration of employees to real GDP using the GDP deflator with 2000 as the base year.³⁶ Thus, in the year 2000 nominal unit labour costs and real unit labour costs (i.e. the wage share) are the same. In other words, the unit labour cost *levels* in 2000 reflect the relative position of profit margins in the member states, one year after the Monetary Union started. But, because total remuneration does not take into account the share of self-employed work remuneration, the ratio of total remuneration per employee divided by real GDP does not reflect the adjusted wage share indicated by Figure 10.4. However, the adjusted wage share is the best indicator for profit margins in the economy (see footnote 34). If one wants to estimate the diversion of ULC-levels by the differences in profit margins, one must take into account the structural variations in self-employed labour in the member state economies. I have therefore re-scaled the 2000 data to account for the

³⁶ These time series were constructed with annual data from AMECO 2008 data bank.

difference of the real unit labour costs and the adjusted wage share.³⁷ The result is shown in Figure 10.5. Note that prior to 1999, ULC-levels are subject to exchange rate variations.

Before the start of the Monetary Union, there was significant shifts in relative unit labour costs caused by exchange rate realignments during the ERM crisis in 1992-3. While devaluations in Italy, Spain, Portugal and Greece brought labour cost levels below the Euro-average, Germany, Austria and Belgium became seriously overvalued as a mirror image. Thus, nominal exchange rate flexibility did not only eliminate distortions, but it actually created new ones. However, by the late 1990s, these distortions were at least partially corrected. By the time EMU started, Portugal had already the lowest profit margins in the euro area, and it has unabatedly persisted with high unit labour cost increases until today. Spain, Greece and Italy have also had rapid increases in ULC, moving from below-average to above-average labour cost levels. Today, Spain, Portugal and Greece are the most expensive labour locations in Europe (Luxemburg with its high banking concentration is considered as a special case). The opposite is true for Germany. It first kept ULC stable in nominal terms, while they were rising in the euro area; unit labour costs then actually *fell* in absolute terms after the Hartz-reforms started to bite. Today Germany is the cheapest labour cost location in the euro area. Finland devalued during the severe adjustment crisis after the Soviet Union, previously a prime trade partner, collapsed in the early 1990s. Contrary to Southern countries, Finland has maintained this initial competitive advantage. Austria has followed the German wage trajectory until Germany started to go against the stream of all the other euro member states.

The overall picture is one of significant diversity in unit labour cost levels and a cursory look at Figure 10.5 indicates that the divergences have increased since the mid-2000 decade. A precise measure of these divergences is so-called σ -convergence, which measures the dispersion of unit labour cost levels across the euro area.³⁸ Figure 10.6

³⁷ The time series was multiplied by the scalar of the adjusted wage share divided by the unit labour cost in 2000.

³⁸ R. J. Barro and X. Sala-i-Martin, *Economic Growth*, 2nd ed., Cambridge, MIT Press, 2004.

shows the cross sectional variance of the log of ULC *levels* within the group of 12 euro members. During the flexible exchange rate period after the breakdown of Bretton Woods, the dispersion of unit labour costs has varied rapidly and frequently; it has slowed down after the creation of the European monetary system in 1979, but then increased again when the EMS entered its 'hard' phase with fewer exchange rate adjustments in the late 1980s. Distortions were corrected after the ERM crisis in 1992/3 and ULC dispersion was stabilised during the first few years of Monetary Union. However, after 2004 the variance started to increase again, indicating rising tensions in relative competitiveness in the euro area. As will be shown below, it may not be a coincidence that this rising divergence occurred when German ULC levels started to *fall*.

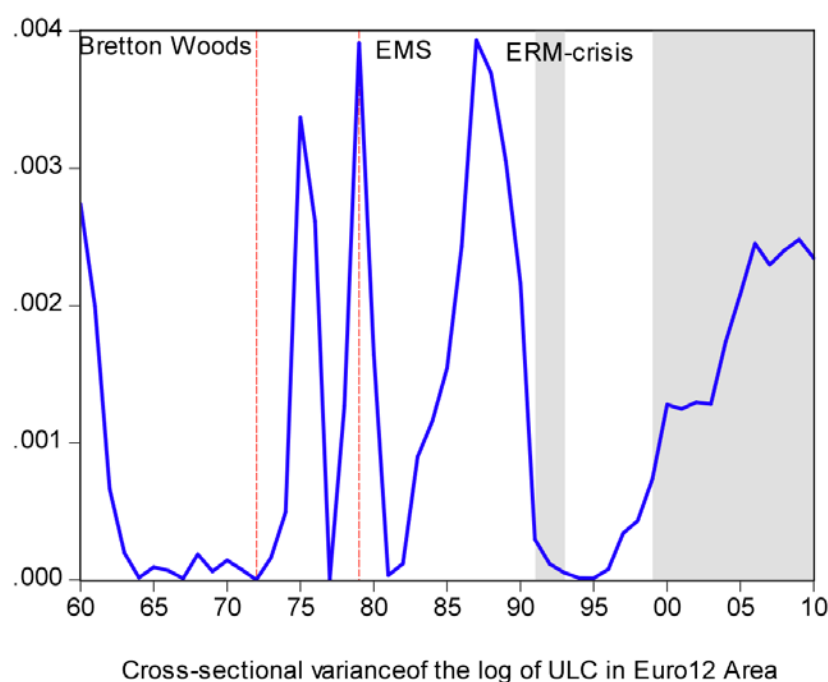


Figure 10.6: Dispersion of ULC in the euro area

Figure 10.7 shows the HP-filtered times trends for ULC-inflation. Because the HP-filter is sensitive to the final time series data, the Commission's forecasts for 2009 and 2010 have been included.³⁹ The shaded bloc shows the trend data on the actual realisations of the first decade of EMU. ULC inflation for the area as a whole has remained below the ECB target, although it has started to approach the two per

³⁹ Data from AMECO, 2008

cent mark at the end of the decade. Only Germany, Austria and Finland (until recently) have kept the increases of ULC below the euro-average; in Germany they were even negative. Greece, Italy, Ireland, Spain and Portugal all had above average wage inflation.

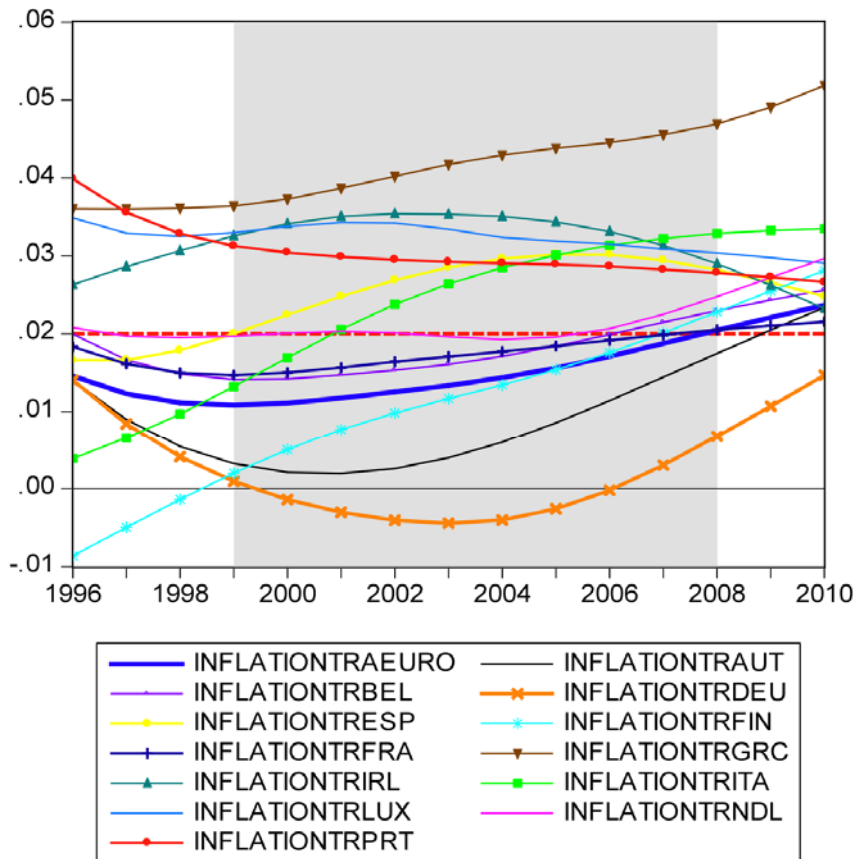


Figure 10.7: Unit labour cost inflation trends. HP-filtered data.
Source: AMECO

But while wage inflation trends have been accelerating in Greece and Italy, they were inverted in Ireland, Spain and Portugal. The structurally higher wage increases in Greece, Spain and Portugal may be due to the Balassa-Samuelson effect,⁴⁰ but Portugal is an example that catch up-countries can also converge downwards to lower wage inflation. Note, however, that Portugal still has to bring ULC-inflation further down, presumably by accelerating productivity, in order to reduce its uncompetitive cost levels. The other member states (France

⁴⁰ The Balassa-Samuelson effect assumes that productivity increases in the tradable sector, but not in the closed sector. When wages follow aggregate productivity in the economy, the average inflation is higher than in the tradable sector, without the latter losing competitiveness. See also below.

and Benelux) have converged to a trend that is close to the Euroland average and the ECB target. One may conclude that the South of Euroland (Greece, Italy, Spain, Portugal and Ireland) has had a tendency to push aggregate unit labour costs up above the ECB inflation target, while the north (Germany, Austria and Finland) have kept them down. France, as usual, is the *Weltkind in der Mitten*.⁴¹ If this was a persisting structural feature, it would be worrisome: north and south would drift apart, with the south becoming increasingly less competitive. If unchecked, such development could ultimately lead to the breakup of EMU.

ULC in tradable and non-tradable sectors

How can one explain the increasing dispersion of unit labour costs? Clearly, there are obstacles to a rapid and perfect convergence of unit labour demand to the competitive equilibrium. Given that the differences are *national*, the lack of flexibility must be grounded in the insufficient adjustment of national wage settlements to the aggregate euro-equilibrium. In fact, wages are determined by nationally-defined systems of collective bargaining without significant cross-border cooperation.⁴² Firms recruit workers in national labour markets. Unions are organised nationally by law, and they defend their members' interests with respect to employment and the purchasing power of wages in local contexts. Nominal wages are, therefore, more homogenous within countries. But national wage levels reflect averages over different sectors with different productivities and different nominal wage contracts. One of the most important sectoral distinctions is between tradable and non-tradable goods. It is usually assumed that productivity grows faster in the tradable sector due to economies of scale and technological competition. Trade unions have little wage setting power in the open

⁴¹ These groupings concord broadly with the convergence clusters for CPI inflation found by Buseti et al., which covered a shorter period, 1998-2004 and put France in our northern group, while Italy, the Netherlands and Luxemburg are in a medium position. See F. Buseti, L. Forni, A. Harvey and F. Venditti, 'Inflation Convergence and Divergence Within The European Monetary Union', ECB Working Paper Series No. 574, January 2006.

⁴² D. Soskice and T. Iversen, 'Multiple Wage Bargaining Systems in the Single European Currency Area', (2001) 28 *Empirica*, pp. 435-456; T. Schulten, 'A European Solidaristic Wage Policy?', (2002) 8 (2) *European Journal of Industrial Relations*, pp. 173-196.

sector of the European economy, but they keep such power to some degree in the non-tradable sector. They can, therefore, increase nominal wages more than productivity in the closed sector and unit labour costs in the non-tradable sector rise faster. This rise is often associated with the Balassa-Samuelson effect. Strictly, the Balassa-Samuelson effect assumes that nominal wages are equal in both sectors and pegged to the tradable sector, so that in fast growing open economies unit labour cost inflation will be high without general loss of competitiveness. However, these assumptions reflect a special case. As shown, nominal wages are not necessarily the same across sectors, nor will they always follow productivity in the tradable sector. If nominal wages are diversified across sectors, national wage bargainers can choose between two strategies according to their different national or political preferences or the institutional features of the national wage negotiating process. Assuming that trade unions seek to maximise the purchasing power of their membership, these two strategies are:

(1) If unions in the tradable sector dominate the negotiating process, say through pattern bargaining, they will seek to maximise employment by undercutting unit labour costs set by world competition. This has been Germany's economic strategy over the last 10 years, if not longer. Wage negotiations in the metal sector have often set the pattern for all others;

(2) Alternatively, if the non-tradable sector dominates collective bargaining, especially public services, unions will seek to maximise income by pushing wages in the protected sector above the European level. This has occurred in Spain, Portugal and Italy.

The first strategy leads to a fall of national unit labour costs and inflation relative to the euro-average; the second strategy leads to above average national price and wage inflation. Especially, if nominal wage increases are indexed on domestic inflation, rather than the ECB inflation target, the two strategies will cause accelerated divergence. But at the European level, the two strategies can

compensate each other, so that aggregate unit labour costs would remain stable. This seems to have been the case in the euro area.⁴³ Some evidence for the role of the tradable towards non-tradable sector is presented in Table 10.2. Unit labour costs have generally increased less - or even fallen - in the tradable sectors of manufacturing and commerce, transport, communication, while they have risen faster in the non-tradable sectors of construction and services. Furthermore, the ULC-spread between these two sectors has increased notably in the south, but also in France. In Germany and Finland ULC, the increases in the two sectors were more homogenous. Thus one can conclude that southern wage bargaining is more geared at the non-tradable sector where market power is distorting competitive equilibria; northern wages are reflecting the need to compete in the tradable sector and this has contributed to wage restraint.

As I have argued above, labour mobility and considerations of social cohesion should prevent large and persistent differentials in nominal wages. If the tradable sector dominates wage bargaining and fixes monetary wages at the competitive world level, workers would move to the non-tradable sector where they could earn higher wages. Total employment would rise up to the level where wages and inflation accelerate (the NAIRU-level) at which point the central bank would raise interest rates and unemployment returns to its natural rate. If the non-tradable sector takes the leadership in wage setting, the central bank would respond immediately to higher wages by tightening money and preventing further employment growth. Either way, wages in the tradable and non-tradable sector would converge.

⁴³ W. Carlin and D. Soskice argue that a real depreciation achieved by wage restraint would cause a slump in a large country, because low domestic consumption will outweigh the demand effects resulting from higher net exports (*Macroeconomics: Imperfections, Institutions, and Policies*, Oxford, Oxford University Press, 2006). In this case it would be rational for wage bargaining in large countries (Germany) to focus on the non-tradable sector and on the tradable sector in small countries. In reality we observe the opposite. Two arguments could explain this paradox: First, we must not confuse the tradable sector with the export sector. The tradable sector in countries like Germany or Finland for the matter may be significantly larger than in Southern Europe. Second wage bargaining is institutionally driven and unrelated to country size. For example public sector negotiations may dominate national wage setting, because unions are better organized and the private sector is weak and dominated by small companies like in Portugal and Italy.

Table 10.2: Sectoral unit labour costs, per cent annual change 1999-2005

	Agriculture	MANUFACT URING	Commerce, Transport, Communication	Construction	Other private services	of which: real estate services	Public Services	Total Economy
Germany	-2.53	-0.98	-0.71	1.12	2.10	-2.66	0.81	0.11
Finland	-2.25	0.18	-0.92	-0.04	1.79	1.37	0.34	-0.02
France	3.20	-0.66	1.73	4.14	2.62	2.18	3.35	2.09
Ireland	8.46	-1.87	2.70	9.59	2.52	11.77	8.69	4.39
Spain	2.05	1.95	2.39	4.65	2.78	6.84	3.05	2.78
Portugal	1.64	0.90	2.41	5.07	1.24	1.34	4.64	2.91
Italy	1.25	2.88	1.15	3.06	3.30	2.85	3.21	2.56
Greece	8.09	3.04	1.06	6.13	2.85	10.36	4.13	2.77
Euro Area	-0.74	-0.29	0.32	0.82	1.77	0.33	1.16	0.56
USA	0.71	0.04	-1.14	4.17	2.66	2.84	3.53	1.80
mean	1.99	0.52	0.90	3.87	2.36	3.72	3.29	1.99

Source: European Commission, KLEMS

But these mechanisms do not work to the same extent in EMU because labour mobility is lower and less responsive to regional developments.⁴⁴ A member state dominated by the tradable sector can reduce unemployment and increase export market shares by undercutting average European unit labour costs. But the subsequent adjustment process takes longer than in traditional nation States. First of all, the wage cut has deflationary consequences for domestic (and non-tradable) consumption and therefore unemployment and the competitive price advantage remain persistent. Second, few workers would migrate to the non-tradable (often public) sector in another country, so that labour supply is less responsive. Similarly, in a country where the non-tradable sector leads wage bargaining, above-average wage increases in one country do not attract a significant influx of labour. Hence, all sectoral wages will rise in this country. These cost increases can not be sanctioned by the ECB as long as aggregate ULC-increases remain compatible with the inflation target, which is to say as long as above-average wage increases in one country are compensated by lower increases in another member state.

⁴⁴ This has been the much discussed argument why Europe is not an optimal currency area. However, lack of mobility may even be desirable in order to avoid hollowing out peripheral regions. The problem is not labour mobility, but insufficient flexibility in the adjustment of unit labour costs.

In addition, European-wide trade unions, which could ensure social and wage cohesion across borders, do not exist and national trade unions do not consider the wage dynamics in other countries where they have no members. Thus, there is no mechanism, either through market pressures or through political processes, which would correct small unit labour cost divergences.

These two structural features make the traditional signalling game between the independent Central Bank and wage bargainers dysfunctional.⁴⁵ More homogenous wage bargaining would allow the Central bank to influence the process. If wage bargainers in all Member States had the same objective of creating jobs, they would agree to restrain wage claims and the ECB would have to relax monetary policy if it is to maintain price stability. If all agreed to increase wages, the ECB would respond to accelerating inflation by tightening. The interaction would then follow the traditional logic of a 'signalling game'. The main problem of wage bargaining in EMU is the co-existence of non-coordinated and contradictory objectives in the wage bargaining process. If trade unions disagree how to increase purchasing power – some seeking higher wages, some higher employment – the signalling game breaks down and regional distortions accumulate. There exists a strategic substitutability⁴⁶ between tradable and non-tradable sectors that will lead to a short term, but unsustainable, Nash equilibrium in wage bargaining, that will cause ever greater discrepancies in ULC.

Table 10.3: Pay-off matrix

		North	
		Up	Down
South	Up	0,0	7,7
	Down	-1, -1	10,5

⁴⁵ Hall and Franzese Jr., *supra*, note 19; W. Carlin and D. Soskice, 'German Economic Performance: Disentangling the Role of Supply-Side Reforms, Macroeconomic Policy and Coordinated Economy Institutions, (2009) 7 *Socio-Economic Review*, pp. 67-99.

⁴⁶ R. Cooper and A. John have developed the notion of strategic substitutabilities, which describes incentive structures for agents who can benefit from doing the opposite of what everyone else does. In our case here, however, the diverging behaviour is institutionally and not strategically determined ('Coordinating Coordination Failures in Keynesian Models', (1988) 103 *Quarterly Journal of Economics*, pp. 441-63).

The underlying logic can be modelled in a two-country game. Assume south plays a non-tradable strategy and seeks higher wages more than higher employment. North plays tradable and seeks higher employment more than higher wages. In principle, four strategies are possible;⁴⁷ (1) If both players were to push wages up, the ECB would raise interest rates with the consequence that neither higher employment nor significant wage increases were possible, although south would obtain a small temporary benefit; (2) If both countries lowered wages, interest rates would come down, so that employment would increase in both countries, although the utility of this fact would be valued higher in the north than in the south, because the non-tradable sector in the south does not gain higher income; (3) If north raised wages and south lowered them, the ECB would not react, but both would suffer from preference frustration; and (4) If north lowered wages and south raised them, the ECB would also not react, but both would be satisfied. Table 10.3 indicates the payoff matrix. Increasing wages in the south and lowering them in the north is the pure strategy Nash equilibrium.

Thus, uncoordinated wage setting in Europe leads to sustained divergence of unit labour cost levels in the short run. In the long run this is not sustainable. From the point of view of economic theory, one would expect that ULC distortions would sooner or later be corrected by pressures arising from (un)employment. The question is, how long does the process take? How quickly will unit labour cost levels revert to the European average? If labour markets are rigid, meaning that nominal wages do not respond significantly to relative cost differentials between member states, small deviations will gradually accumulate until the social costs will be considerable. At some point, the political consequences could become highly disruptive. If wage bargainers would understand and act on the need for reversing discrepancies, they would lower the social adjustment costs. Next, evidence for the adjustment speed will be presented, and for this purpose, an European error correction mechanism is estimated.

⁴⁷ Note that both players have different preferences, hence different payoffs.

Convergence of European labour costs? Estimating the Error Correction Model

The following section contains some technical detail, which is necessary to remove doubt about the empirical evidence. The econometrically less well trained reader may jump straight to the discussion of table 10.5. Our underlying model is inspired by Dullien and Fritsche.⁴⁸ In a single currency area with competitive markets regional unit labour costs cannot diverge for ever. Small deviations from the average accumulate to large unit labour cost gaps. The loss of competitiveness reduces employment and lowers wage growth. The following hypothesis is formulated; the further national cost levels drift away from the rest of the euro area, the stronger will be the pressures to revert to the European average. This pressure increases over time as the ULC-gap is growing and will ultimately overshadow short term wage dynamics.⁴⁹ The logic behind our hypothesis resembles the familiar model of beta-convergence.⁵⁰ It can be formally tested by an Error Correction Model (ECM). It implies that there is a long-run equilibrium relationship between ULC-levels and a correction mechanism that responds to deviations from this equilibrium. How strongly wage inflation responds to cost level discrepancy is estimated by the long run speed of adjustment coefficient. It should be negative and statistically significant at conventional levels. The estimated ECM looks like this:

$$d \ln ulc_{i,t} = c + \alpha_1 (d \ln ulc_{-i})_{t-1} + \beta (\ln ulc_i - \ln ulc_{-i})_{t-1}$$

Where ulc_i stands for unit labour costs in country i , and $-i$ stands for the euro area without country i .

⁴⁸ S. Dullien and U. Fritsche, 'Anhaltende Divergenz bei Inflations- und Lohnentwicklung in der Eurozone: Gefahr für die Währungsunion?', (2007) 74(4) *Vierteljahrshefte zur Wirtschaftsforschung*, pp. 56-76; S. Dullien and U. Fritsche, 'Does the Dispersion of Unit Labor Cost in the EMU Imply Long-Run Convergence', (2008) 5(3) *International Economics and Economic Policy*, pp. 269-295.

⁴⁹ In fact, inspecting unemployment rates for the Euro-years shows that unemployment rose in Portugal from below average to the mean while ULC inflation fell. In Italy and Spain, where ULC inflation increased, unemployment fell; in Ireland it fell slightly, relative to Euroland, but remained well below 50 per cent of the Euroland. By contrast, in Germany unemployment rose from below Euro-average to nearly two per cent above (source: AMECO).

⁵⁰ Barro and Sala-i-Martin, *supra*, note 38.

I use annual data from the AMECO database of the European Commission and calculate ULC-levels as the ratio of total labour compensation per employee divided by GDP at 2000 prices. Before 1999 they are expressed in ECU; after the EMU started, they became euro. Using ECU-data implies that earlier changes in unit labour cost levels reflect changes in exchange rates. After the start of EMU, there are of course no more changes in exchange rates, but only in nominal wages and productivity. I start with the annual data for 12 euro area member states from 1980 to 2008; then the data set for 1999-2008 is resampled, in order to see possible changes in the adjustment dynamic after the introduction of the euro. Before estimating the model, unit root tests were applied to the data. ULC levels can be accepted as being integrated as I(1).

The Engle-Granger Cointegration methodology is used to estimate the ECM. The cointegration vector for ULC levels indicates the long-run equilibrium relation between a country's unit labour costs and those of all other euro member states. This vector was estimated without a constant, with constant and with constant plus deterministic time trend. A cointegration vector with a constant implies that the absolute level difference in our data may be shifted by a constant multiple. For example, the adjustment of the wage share in 2000 by self-employed workers may cause such a shift. More worrisome is a positive deterministic time trend. A positive trend indicates that ULCs for a given country are drifting steadily above the ULC-level of the other member states, a negative time trend implies that they are falling below. In other words the gap is growing steadily larger, but the error correction keeps responding in the same linear fashion. Obviously, such development cannot last for ever, but if the time trend is statistically significant, it has dominated the last three decades.

Given the short period and the limited number of observation in our example, the cointegration tests were not highly significant. For the long run period it is possible to detect a cointegration relationship for Belgium and Spain and if one includes a deterministic trend also for Greece, Netherlands and Portugal (see Table 10.4). The time trends are positive for all countries, except Germany, Austria and Finland, three countries which have already been identified as the hard core of the Northern bloc. This means, as time goes on, ULC-gaps are growing. This is bad news. For Germany, Finland, Ireland, Italy and

Spain, cointegration evidence is found at least for the shorter period since the start of EMU. These results indicate that it is difficult to confirm statistically a significant long-run equilibrium relationship.

Table 10.4: Cointegration test

Cointegration test - Statistics resulting from the DF test on long run residuals without constant and without trend

McKinnon critical values at the level of statistical significance of:

5%	-2.8632	-3.0796	-3.5549	-4.014	-4.1222	-4.8286
10%	-2.5158	-2.6411	-3.1941	-3.4978	-3.7483	-4.1759

The cointegrating relationship contains:

	Equ. 1: No constant		Equ. 2: A constant		Equ. 3: constant and trend	
	1980-2008	1999-2008	1980-2008	1999-2008	1980-2008	1999-2008
AUT	-2.025188	-1.656634	-1.734773	-2.449071	-3.207404	-2.638887
BEL	-3.12964**	-0.999778	-3.316339*	-3.316795	-3.731292	-3.185284
DEU	-1.434065	-0.689538	-1.695704	-5.655141**	-2.018938	-14.81808**
ESP	-1.456456	-0.679968	-3.682951**	-3.713421*	-3.674179	-6.990701**
FIN	-2.000947	-5.433344**	-2.568998	-6.547894**	-3.000323	-7.659413**
FRA	-2.117825	-0.709874	-1.802662	-2.28328	-3.170092	-2.389625
GRC	-1.8602	-0.646093	-1.91972	-2.002528	-4.628107*	-2.459443
IRL	-0.803431	-0.598567	-0.911817	-4.30878**	-2.493	-4.463799*
ITA	-1.903743	-1.531382	-2.30198	-3.571448*	-2.357211	-10.0951**
LUX	-0.534717	-1.170108	-2.104281	-3.185072	-3.460521	-3.530485
NLD	-1.700032	-1.357728	-1.386828	-1.221615	-4.038469*	-0.892113
PRT	-0.392008	-2.132052	-3.002305	-2.677862	-4.094146*	-6.023325*

However, this does not necessarily prevent us from estimating the error correction model. The Dickey-Fuller test is known to have low power, i.e. there is a high probability of accepting the hypothesis of no cointegration even if there actually is cointegration. An additional approach for assessing cointegration consists in looking at the significance (if t -values $> |2|$) of the error correction coefficient in the ECM model. If the coefficient is $0 < \beta < 1$, negative and statistically significant, i.e. its t -value is < -2 , then it is justifiable to conclude that the two series are cointegrated, even if the DF-tests on residuals fails to reject the hypothesis of no cointegration.⁵¹ If the adjustment

⁵¹ J. Kremers, N. Ericsson and J. Dolado, 'The Power of Cointegration Tests', Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No 431, June 1992. Available at <http://www.federalreserve.gov/pubs/ifdp/1992/431/ifdp431.pdf>.

coefficient is significant in the ECM, it means that a time trend increases the gap but the reaction to the growing gap remains the same. For the shorter EMU period (1999-2008), a long run cointegration relation does not exist for Austria and possibly not for the Netherlands.

Table 10.5: ECM adjustment coefficients 1980-2008

		Equation 1		Equation2		Equation3	
		res0	dlog(EU_cou	res1	dlog(EU_co	res2	dlog(EU_country)
Austria	Coefficient	-0.226479	0.730781	-0.142471	0.965476	-0.381623	0.960917
	t-value	-1.680871	3.439221	-1.034915	6.590855	-2.490222	6.008484
	Prob.	0.1052	0.0021	0.3106	0	0.0198	0
Belgium	Coefficient	-0.285431	0.420654	-0.295032	0.449304	-0.359978	0.320894
	t-value	-3.083113	1.798253	-3.13881	1.983252	-2.629391	1.264963
	Prob.	0.0049	0.0842	0.0043	0.0584	0.0144	0.2175
Germany	Coefficient	-0.087625	0.297376	-0.13783	0.207387	-0.209894	0.207381
	t-value	-0.912139	1.003586	-1.401432	0.687498	-2.353016	0.75163
	Prob.	0.3704	0.3252	0.1734	0.4981	0.0268	0.4593
Spain	Coefficient	-0.057784	0.563829	-0.145616	0.870426	-0.245947	0.916819
	t-value	-0.78775	1.667068	-1.180865	2.4397	-1.470657	2.730186
	Prob.	0.4382	0.108	0.2488	0.0221	0.1539	0.0114
Finland	Coefficient	-0.262856	1.855087	-0.341968	1.47402	-0.337671	1.705019
	t-value	-1.731845	3.512239	-2.388336	3.958676	-2.116769	4.168622
	Prob.	0.0956	0.0017	0.0248	0.0006	0.0444	0.0003
France	Coefficient	-0.070648	0.635187	-0.076454	0.617265	-0.355397	0.531603
	t-value	-0.713497	4.753557	-0.784043	4.49152	-2.196081	4.936037
	Prob.	0.4821	0.0001	0.4404	0.0001	0.0376	0
Greece	Coefficient	-0.112612	0.965454	-0.111487	0.985676	-0.563081	0.809146
	t-value	-1.397093	1.288062	-1.358961	1.313689	-3.173353	1.470666
	Prob.	0.1747	0.2095	0.1863	0.2009	0.004	0.1539
Ireland	Coefficient	-0.031148	0.78831	-0.027633	0.79517	-0.313595	0.769247
	t-value	-0.365639	1.96895	-0.316634	1.975296	-2.663718	2.74067
	Prob.	0.7177	0.0601	0.7542	0.0594	0.0133	0.0112
Italy	Coefficient	-0.110627	0.818089	-0.223228	0.793365	-0.242838	0.801642
	t-value	-0.641436	1.386243	-1.469629	2.27301	-1.673556	2.473228
	Prob.	0.5271	0.1779	0.1541	0.0319	0.1067	0.0205
Luxembol	Coefficient	-0.093208	0.158708	-0.177135	0.429856	-0.530358	0.111325
	t-value	-0.875842	0.286068	-1.56748	0.771975	-2.700599	0.252066
	Prob.	0.3895	0.7772	0.1296	0.4474	0.0122	0.8031
Netherlan	Coefficient	-0.195727	0.792523	-0.166432	0.671635	-0.479826	0.480094
	t-value	-2.340881	3.240336	-1.943837	2.658031	-3.002241	1.797294
	Prob.	0.0275	0.0034	0.0633	0.0135	0.006	0.0844
Portugal	Coefficient	-0.01602	1.317971	-0.120474	1.457327	-0.268265	1.315244
	t-value	-0.331014	2.280614	-1.272216	2.733696	-2.154901	2.670866
	Prob.	0.7434	0.0314	0.215	0.0113	0.041	0.0131

Table 10.5 estimates the ECM for the three cointegration models (1. no constant, 2. with constant, 3. with constant and time trend) over the 1980-2008 period. Coefficients for the ECM with the first two

cointegration equations are only significant in Belgium, the Netherlands and Finland. This changes if one adds a time trend to the equilibrium relation. Now the adjustment coefficients are significant in all countries except Italy and Spain. All coefficients have the right sign. The speed of adjustment is highest in Greece, Luxemburg and the Netherlands and slowest in Germany. In Greece it takes 15 months to narrow the gap by 50 per cent, in Germany 40 months. Notice also that the short-run dynamics by which national ULC respond to changes in other member states ($d \log EU_country$) are generally larger than the long term adjustment coefficients. The error correction mechanism will therefore only make a difference when the gap between ULC-levels has become large.

Did the EMU change the wage regime?

Our long run estimates include 20 years of exchange rate adjustment (1980-1998) in addition to 10 years wage setting in the euro-regime (1999-2008). Has the abolition of the exchange rate altered the adjustment behaviour? We re-estimated the ECM for the euro decade, but the estimates were not reliable. Although the statistical significance was high, all adjustment coefficients were larger than -1, which does not make sense. We therefore check the estimates by performing Chow break tests, which are shown in Table 10.6.

Table 10.6: Chow test

Does a structural break in 1999 exist at 5% of statistical significance?						
	Eq.1		Eq.2		Eq.3	
	Prob. F(3,22)		Prob. F(3,22)		Prob. F(3,22)	
Austria	0.090	NO	0.013	YES	0.160	NO
Belgium	0.195	NO	0.216	NO	0.639	NO
Germany	0.000	YES	0.000	YES	0.001	YES
Spain	0.677	NO	0.531	NO	0.875	NO
Finland	0.664	NO	0.852	NO	0.978	NO
France	0.912	NO	0.832	NO	0.993	NO
Greece	0.860	NO	0.876	NO	0.880	NO
Ireland	0.470	NO	0.547	NO	0.693	NO
Italy	0.977	NO	0.831	NO	0.843	NO
Luxembourg	0.065	NO	0.075	NO	0.385	NO
Netherlands	0.222	NO	0.107	NO	0.259	NO
Portugal	0.784	NO	0.481	NO	0.809	NO

We can unambiguously reject the null hypothesis of a structural break in all countries, with the exception of Germany. In other words, despite the widening deterministic gap in ULC-levels, wage negotiations take place as if the possibility of exchange rate adjustments were still available. This fact points to serious shortcomings in the wage negotiating arrangements in the Monetary Union.

The one country, where we have evidence for a structural break, is Germany. Unfortunately, this change has gone in the wrong direction: after EMU started, German social partners have become less sensitive to the ULC-gap with other euro area member states. Although the government cannot interfere with wage negotiations in Germany (the principle of 'Tarifautonomie'), institutional changes seem to have affected the German error correction mechanism. Figure 10.8 shows the recursive estimates of the speed of adjustment. We find that for all member states the adjustment coefficients have remained stable, but in Germany it has moved up in 2004, at a time when the Schröder government started to implement fundamental labour market reforms (Hartz IV). The change in the coefficient means, Germany is less inclined to correct the growing undervaluation of its labour costs than in previous years. But given that there is a deterministic trend for German ULC to fall below the rest of the euro area, less adjustment will accelerate labour cost distortions.

Clearly, this pattern is unsustainable. There are limits to how long you can 'beggar-your-neighbourhood'. But the problem is not just that Germany is pursuing aggressive mercantilist wage policies at the expense of its European partners.⁵² The greater issue is that, given the large weight of Germany in the euro area, this policy is needed to stabilise aggregate unit labour costs for the euro area as a whole, as the ECB cannot target national wage settlements since its policy is oriented towards European price stability.⁵³ By keeping its costs systematically below other member states, Germany is preventing the

⁵² If the south would copy Germany's wage restraint, the ECB would have to lower interest rates in order to avoid deflation.

⁵³ F. Traxler, 'Bargaining, State Regulation and the Trajectories of Industrial Relations', (2003) 9 (2) *European Journal of Industrial Relations*, pp 141-161, at p. 155.

ECB from reacting to excessive wage inflation (i.e. above two per cent) in the south. The excessive wage pressures in the south are conditional on the un-cooperative wage restraint in Germany. The 'signalling game', whereby the central bank raises interest rates to communicate to wage bargainers that they are undermining price stability, breaks down.

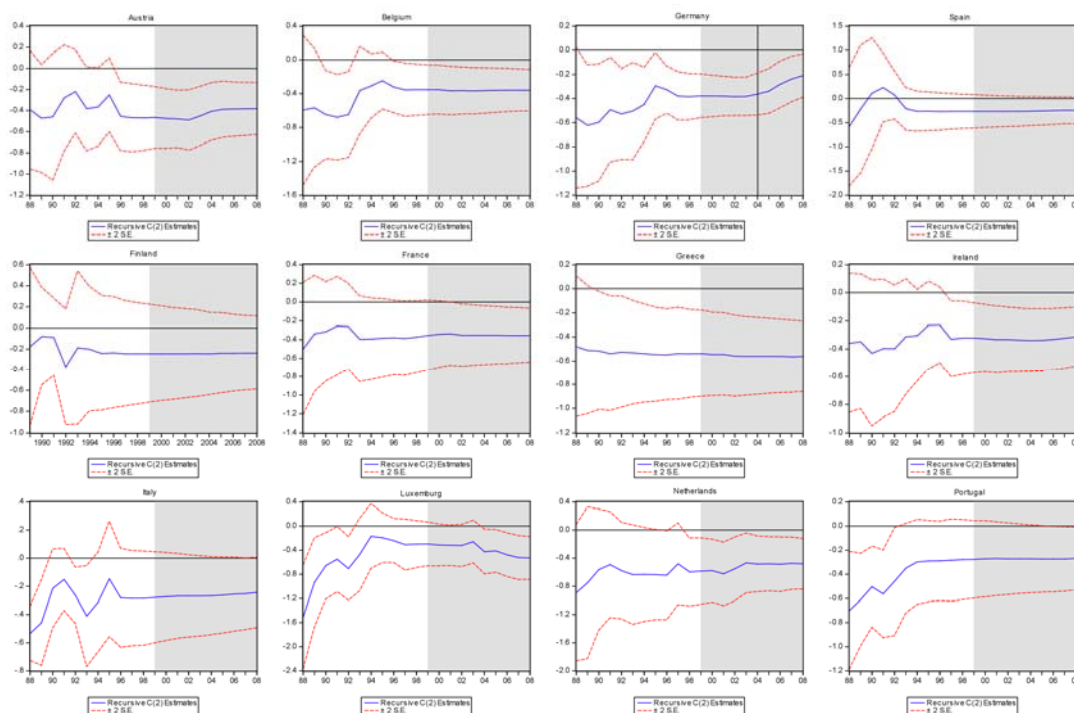


Figure 10. 8: Recursive estimates of adjustment speed

Reforming Euroland's wage bargaining procedures Labour market flexibility

Our analysis has shown serious shortcomings in the interaction between a unified monetary policy and national wage bargaining in Europe. I will now argue that the problem is *not* a lack of labour market flexibility in the traditional sense, but that national wage negotiators make decisions in the context of incomplete information, where cloistered national wage negotiators ignore euro-wide externalities.

Flexibility in the labour market has been a reoccurring subject in the assessment of EMU. It is the linchpin of the optimum currency area

literature. The ECB⁵⁴ has written: 'Efficiently functioning labour markets are of particular importance for countries participating in the Economic and Monetary Union (EMU), because these countries are unable to use country-specific monetary and exchange rate policies to address asymmetric economic shocks.' However, it is not entirely clear, what the expression 'efficiently functioning labour markets' means. Convergence to a single nominal wage rate for a given skill group would cause havoc because of national differences in productivity. Unit labour cost convergence would imply perfectly competitive goods markets where workers get paid according to their productivity. Presumably, this is what the ECB is concerned with, but as our analysis has shown, that can be achieved by removing the wage leadership of the non-tradable sector.

Europe is rightly or wrongly famous for its institutionally based labour market rigidity, which may prevent the realisation of efficient labour market equilibrium. The theory of institutionally induced market rigidity could explain why convergence to aggregate European ULC is so slow. Let us look at the facts.

Numerous indicators seek to measure the degree of labour market inflexibility.⁵⁵ Table 10.7 shows the correlation between the speed of adjustment estimated in Table 10.5 (equation 3) and a number of indicators, which are traditionally assumed to represent (national) labour market (in)flexibilities. To these traditional variables I have added some proxies for 'open societies'.⁵⁶ Table 10.7 also indicates the p-value for accepting the null hypothesis that the correlation coefficient is equal to zero. A negative sign signals that an increase in the value of the indicator will be correlated with an increase in the value of the adjustment coefficient (which has a negative sign).

⁵⁴ ECB, 'Labour Market Mismatches In Euro Area Countries', March 2002, available at <<http://www.ecb.int/press/pr/date/2002/html/pr020311.en.html>>.

⁵⁵ For recent surveys, see Freeman, *supra*, note 17; Du Caju et al., *supra*, note 23; OECD, 'Employment Outlook', 1997, Paris, available at <http://www.oecd.org/document/37/0,2340,en_2649_201185_31685733_119699_1_1_1,00.html>.

⁵⁶ Sources for these indicators are: OECD Employment Outlook, 2004 for labour market indicators; European Commission, Ameco 2007 for macroeconomic data; Eurobarometer 246, February 2006 for language skills.

Table 10.7: Correlation of adjustment and labour market indicators

Covariance Analysis: Ordinary		
Sample: 1 12		
Included observations: 9		
Adjustment coefficient correlated with:	Correlation coeff	Probability
SOCIALSECURITY2005	-0.025633	0.9478
CENTRALIZATION	-0.039633	0.9194
COORDINATION	-0.069328	0.8593
DWAGESHARE	0.09544	0.807
TU DENSITY	-0.142243	0.7151
CHANGE UNEMPLOYMENT	-0.171632	0.6588
WAGE SHARE 07	-0.255135	0.5076
EPL1	0.288203	0.452
WAGES HARE 96	-0.323476	0.3958
TAX BURDEN 2005	-0.353496	0.3507
EPL2	0.433952	0.2432
SUM DISMISSAL	0.43962	0.2364
UNEMPLOYMENT 199:	0.546147	0.1282
CBC	-0.558859	0.1178
POPULATION 2008	0.580259	0.1014
<i>GDPpc 2007</i>	-0.626165	0.0712
_3 LANGUAGES	-0.629915	0.069
UNEMPLOYMENT 2008	0.705423	0.0338
NO LANGUAGE	0.711151	0.0317
_1 LANGUAGE	-0.711151	0.0317
ENGLISH	-0.735396	0.0239
_2 LANGUAGES	-0.764418	0.0164

Despite the statistical weakness of the data, the result is surprising. Not even one of the typical labour market indicators are significantly correlated with the error correction coefficients estimated in Table 10.5. This is true for OECD labour market indices such as wage centralisation and coordination, facility of dismissal, employment protection legislation (EPL) or Trade Union density. Collective bargaining coverage (CBC) seems to weakly improve the adjustment speed. Macroeconomic variables at the national level such as social security contributions, the tax burden, GDP per capita, wage shares

and their changes (the justice motive) are insignificant. Evidence for an impact from unemployment is very weak.

However, to our surprise, the only significant factors relevant for the speed of adjustment are the proxies for an open society. The sign for the population variable is positive, signalling that the larger a country is, the less it is concerned with adjusting its wages to the developments in other countries. The importance of international broad-mindedness is even more strongly documented by indicators for the percentage of people speaking no, one, two or three foreign languages or English: a high percentage of exclusively native speakers reduces the speed of wage convergence; speaking many languages, or at least English, improves it. These variables are a reflection of the mechanisms underlying the role of the non-tradable sector that we have observed above. Dominance of the non-tradable sector in wage bargaining implies focussing on narrow national economic conditions, rather than the broader European requirements. It is the expression of a bias in favour of the familiar immediate environment; it is a form of economic chauvinism, which is matched by the narrow-mindedness of closed economies where people only communicate with themselves in their own language.⁵⁷ This result points in an interesting direction: rather than focusing on institutional reforms in European labour markets, better results may be obtained by improving the communicative processes in European wage bargaining. What matters may not be the institutional hardware, but its software.⁵⁸

Reforming the MED

This brings us to the MED. The Cologne European Council in 1999 set up the MED as the third pillar of a broader European Employment Pact. It intended 'to improve the conditions for a cooperative macro-economic policy mix geared to growth and employment while

⁵⁷ I owe the definition of chauvinism as 'a bias in favour of the familiar' to I. Ravenscroft, *Philosophy of Mind. A Beginner's Guide*, Oxford, Oxford University Press, 2005, at p. 58.

⁵⁸ Freeman, *supra*, note 17, also found that economic performance in labour markets is affected by information, communication and trust.

maintaining price stability'.⁵⁹ Based on economic ideas laid out by Collignon and Koll,⁶⁰ the MED sought to introduce wage and income policies into the tool-box of macroeconomic policy. It has been called the 'high point of the euro-Keynesian political approaches' in the neoliberal economic order.⁶¹ However, the political motivation was less ideological; it was derived from the realisation that a single currency area required a unified approach for efficient stabilisation policies.⁶² The idea was to get social partners to agree and coordinate their wage settlements with monetary and fiscal policy in order to ensure a policy mix in support of high growth and employment creation. But due to resistance by the UK government, the notion of wage policies was banned from public documents and ECB, careful to preserve its independence, only agreed to 'cooperate' without committing to ex ante coordination.

Table 10.8: Participants of the MED and their level of activity in EMU and the EU (without EU-COM)⁶³

	Monetary policy	Fiscal policy	Wage setting
EMU or EU level (<i>policy dialogue</i>)	ECB	ECOFIN or Eurogroup	European peak organisations (UNICE, ETUC, CEEO)
National level (<i>technical level</i>)	National central banks	National legislators (enacting national budget laws)	National Social Partners (decentralised wage bargaining)

⁵⁹ W. Koll, 'Macroeconomic Dialogue Development and Intentions', in E. Hein, T. Niechoj, T. Schulten and A. Truger (eds) *Macroeconomic Policy Coordination in Europe and the Role of the Trade unions*, Brussels, ETUI and WSI, 2005, pp. 175-212.

⁶⁰ Both authors were responsible as civil servants in the German Finance Ministry for setting up the MED during the German EU-presidency in 1999, see S. Collignon, 'Unemployment, Wage Developments and the European Policy Mix in Europe' (1999) *Empirica*, pp. 259-269; Koll, *supra*, note 59.

⁶¹ T. Schulten, 'A European Solidaristic Wage Policy?' (2002) 8(2) *European Journal of Industrial Relations*, pp. 173-96.

⁶² See S. Collignon, *Monetary Stability in Europe*, London, Routledge, 2002; id. (ed.), *European Monetary Policy*, London, Cassel Academic, 1997; id., *Europe's Monetary Future*, London, Pinter Publishers, 1994; S. Collignon and D. Schwarzer, *Private Sector Involvement in the Euro. The Power of Ideas*, London, Routledge, 2002.

⁶³ Adapted from Koll, *supra*, note 59.

The weak political will translated into an institution that imposed few constraints and favoured confidential exchanges of policy information. As the German presidency put it, 'in a macroeconomic dialogue, based on mutual trust, information and opinions should be exchanged in an appropriate manner concerning the question of how to design macroeconomic policy in order to increase and make full use of the potential for growth and employment'.⁶⁴ Technically this is achieved in a two-level process: first, national monetary and fiscal authorities meet with national social partners, and then peak organisations of social partners meet with the ECB and ECOFIN.

The Dialogue represents a soft form of policy coordination, which resembles the Open Method of Coordination with few constraints. The driving political agent is the Economic Policy Committee of the Council, not the Commission. As a consequence, partial interest rather than the European 'common concern' dominates the deliberation. It re-enforces chauvinistic policy outcomes in the sense described above.⁶⁵ The outcome is a general 'understanding', rather than binding commitments. But what guarantees the implementation of political 'understandings' between participants in the MED? Andrew Watt⁶⁶ has correctly observed: 'The concrete impact of the MED on its participating institutions and on policy making remains unclear. In particular, there is currently no way for the MED to send 'signals' to the outside world, which would have a stabilising impact on expectations and on the economic developments themselves.' It may therefore not come as a surprise that the normative guidelines formulated for wage bargainers such as the golden rule, are not respected in member states. They lack the binding force that is established when agreements are based on fully informed deliberation on collective choices.

Wage agreements in the euro area must take into account European-wide economic and monetary conditions, including the relative competitive positions of national production locations and policy reactions by the ECB. But this is not possible, given the strong role of

⁶⁴ Bulletin 1999, Press and Information Office of the German Federal Government, Issue 49, Bonn, August 16, 1999.

⁶⁵ See *supra*, note 57.

⁶⁶ *Supra*, note 29, at p. 252.

national wage bargaining institutions. The way to improve on Europe's macroeconomic policies is therefore to broaden the communicative processes of wage negotiations and integrate European reasons and arguments into the deliberation of national wage settlements. How can this be done?

One approach is to make use of the single market and Europeanise collective bargaining. An increasing number of firms are nowadays operating in the single European market. They have concrete knowledge of local production conditions and they have to deal with competitive pressures in the European and world markets. Increasingly, the information flow in such trans-national European companies is supported by European works councils. They offer an institutional framework which can potentially underpin cross-border bargaining. Although all the EWCs were constituted as information and consultation bodies with no formal negotiating role, there have been cases where framework agreements have had an impact on collective bargaining.⁶⁷ Firm-specific European wage agreements with differentiated cross-border contracts would be able to take into account local as well as European conditions of productivity, standards of living, working conditions etc. This would broaden the constituency for wage negotiations beyond national borders. Management would become accountable to a European constituency. If these agreements could take on a role as lead negotiations for national wage bargaining, it would shift the focus away from non-tradable sectors to the European wage/price dynamic. This would help to accelerate adjustment of potential shocks and distortions. The value of such an arrangement does not consist in negotiating a unified wage contract, say for European carmakers, but in establishing the sector for tradable goods as a benchmark for others.⁶⁸ It would require, however, that other sectors, such as public service, would accept this wage setting leadership.

Secondly, there is a role for macroeconomic policy. The analysis has shown evidence for wage restraint in the euro area, and it cannot be

⁶⁷ J. Arrowsmith and P. Marginson, 'The European Cross-border Dimension to Collective Bargaining in Multinational Companies' (2006) 12(3) *European Journal of Industrial Relations*, pp. 245-266.

⁶⁸ Du Caju et al., *supra*, note 23, have pointed out that "pattern bargaining" can be an important source of wage coordination.

excluded that the existence of the MED has contributed to it at least to some degree. However, the evidence showed few member states having followed the Broad Economic Policy Guidelines,⁶⁹ which were inspired by the Dialogue: national wages have not increased in accordance with the formula of the golden rule. The reason, here argued, is that wage setters take into account national unit labour costs rather than European inflation targets, and that they are accountable to national audiences and not to a European constituency. Partly, this is intrinsic to the nature of negotiating national wage contracts, although it is paramount to abolish national indexing mechanisms. But it is also true that the confidential nature of the MED prevents actual wage bargainers to refer to European norms as negotiating constraints, because these norms are only known to a small group of insiders. In order to Europeanise the wage bargaining process, it would be necessary to open the MED up and have a broad general debate about appropriate wage policies.

This leads us to propose a simple reform of the MED. Both levels of the Dialogue should be conducted publicly and be submitted to permanent public scrutiny. At the national level it would open up deliberations for all wage negotiations rather than keeping the focus on particular sectors – especially the non-tradable sector. But it would also make the transfer to the European level transparent. However, deliberation at the second level also needs to be conducted in a public sphere. It needs a forum where debate on reasonable macroeconomic policies can take place, so that the chauvinistic ‘bias in favour of the familiar’ can be overcome. By definition national governments or parliaments cannot represent European interest. The only public sphere that exists for such purposes is the European Parliament.⁷⁰ Hence, the MED should be transferred from the European Council to the European Parliament. Given that the Committee on Economic and Monetary Affairs auditions the President of the ECB five times a year, it would be appropriate that it invites and listens to European social partners prior to these auditions and then makes recommendations, which integrate monetary, fiscal and wage policies in the interest of the objectives of Euroland and the European Union.

⁶⁹ European Commission, *supra*, note 21.

⁷⁰ S. Collignon and C. Paul, *Pour la République européenne*, Paris, Odile Jacob, 2008.

This would also support the ECB, as its authority depends on the public consensus it can build for its policies.

Conclusion

The analysis has revealed a lack of convergence in national unit labour costs that could potentially threaten the sustainability of the euro. The urgency of this problem is masked by the fact that ULC developments in the north keep aggregate cost and price levels down, so that monetary policy cannot intervene. Institutional reforms in national labour markets are unlikely to solve this problem on their own. A more promising route for overcoming divergence is improving the communicative framework within which national wage negotiations take place. Moving the confidential Macroeconomic Dialogue from Ecofin to the European Parliament may be a first step in this direction.

Chapter 11

The painful Europeanisation of taxes Democratic implications

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A brief lesson from the past

Taxation has always been a social and legal phenomenon closely intertwined with democracy. In human history there are countless cases in which economic integration of states or territories failed because of a taxation system not consistent with the fundamental issues of democracy. Taking on another point of view, it could be said that in the past the first example of the issues discussed in this chapter is probably the case of the Roman Kingdom, which evolved into a Republic to fall as an Empire. Obviously Romans were not the first ones in the so called Western world to levy taxes, but they were the first ones to develop, particularly in the latest stage of their history, a somehow modern and scientific way to assess and collect fees, taxes, tariffs and tributes.

They developed their taxes while attempting to integrate into one complex body (the Empire) states, territories and kingdoms that were conquered by the legions and were different under many aspects, such as for law, traditions, welfare (if any), economic tissue. It could be said, under a very peculiar point of view, that also Romans attempted to harmonise (tax) law in the latest stage of their rule when

the Emperor Caracalla¹ attributed Roman citizenship to all the inhabitants of the Empire and therefore abolished the distinction between Cives and other individuals dwelling in the civilised world.

Even for Romans, centuries before the Magna Charta libertatum and of the always quoted maxim 'no taxation without representation', tax was a way to collect economic resources accepted only with the consent of the taxpayers: that is, the Roman (male) citizens. In this respect, the Roman word for tax (tributum) refers to one of the basic social organisation of the early Rome during the Republican era: the tribe. Some historians of Roman law are, however, in a different position: in their view, the word tributum derives from the Latin verb 'tribuere' that is 'to give', and therefore tributum is 'something that must be given'.²

Obviously taxes were not born with the Republic and democratic institutions. There is evidence in Roman literature³ and history that taxes were levied as well during the Kingdom of Rome (from the foundation and until the rise of the Republic) on individuals on a lump sum basis (a sort of poll tax) and the concept of tax was by Livy (Titus Livius) connected for the first time to the voting rights. However, the fact that the poll Tax (tributum in capita) was not levied on rich people casts more than a doubt on the authenticity of the record, particularly when taxes are levied by the later republic in a way more consistent with the ability to pay.

In other words, Livy tries to use the argument of taxes to emphasise the tyranny of the Kingdom (were affluent people didn't pay) in contrast to the democracy inspiring the Republic⁴ where all citizens

¹ 'Constitutio Antoniniana de Civitate' (a. D. 212).

² See also C.F. Balleine, 'The Tributum Capitis' (1906) 20 *The Classical Review*, at p. 51. The second interpretation mentioned above seems to represent the mainstream position at the moment. The linguistic research is far beyond the capacity of the writer, however it is interesting to note that the ancient word in Old English for tax is 'gafol', while the Gaelic word was 'cáin'. Possibly the word tax derives therefore from *tithe* (the tenth part of) which was actually a *tax*; in any case the etymology of the word does not influence the current research.

³ See for instance Livius, 'Ab Urbe condita libri' 1, 43, 10.

⁴ In the early development of Rome, the need for revenues originating from taxes was not so urgent as nowadays. Administrators of Rome (Kings and later the various higher Magistrates) used the economic resources obtained by the expansion of the city to the disadvantage of the neighbors in Italy and then in Europe, Middle East

contributed to the welfare (and most certainly to the warfare) according to an (alleged) ability to pay, or at least in the respect of the principle of equality (rich people were not exempted from taxation).

In any case, a census is necessary for any kind of not arbitrary taxation consistent with the rule of law, and the first census recorded in that respect in the history of Rome was the one by King Servius Tullius.⁵ On that occasion all citizens were counted and divided into Tribes in order to organise the army of the city state. The more a citizen was rich, the better he could be armed (being the cost of the equipment at his complete charge) and the more he could contribute to the defense of Rome (later in the centuries this sort of 'ability to defend' the country became the 'ability to pay'): the *tributum ex censu* (tax on wealth) was then applied without any consideration to military duties, assessed and collected tribe by the Tribe.⁶ It was the King who decided the amount of it and when to apply it.

During the era of the Republic, Rome experienced a period of military expansion financially supported by the defeated populations, and therefore found, with only few exceptions, no need to levy taxes on (the wealth of the) citizens. Most of the revenue was raised either by custom duties (*portoria*) or by royalties collected on the lease of public resources (lands, woods, mines, etc.) to individuals.

A clear exception in this respect is the *Lex Manlia*, which introduced the *Vigesima Libertatis* (literally 'twentieth part for freedom'): it was a five per cent⁷ (indirect) tax levied when a slave was set free by a Roman citizen. It is interesting to note that this tax was proposed by a consul and passed as law approved by the *Comitia Tributa*⁸ gathered

and Africa. The contributes, up to that period, were in kind (*operae*) or provided directly and spontaneously by some affluent clans, mainly for religious necessities as far as no welfare characterised the Kingdom.

⁵ VI Century b.C.

⁶ Every Roman citizen also belonged to a tribe in the city. The concept of tribe during late Kingdom and Republic has not to be intended as making reference to ethnic or racial characteristics, but rather to geographical areas of the city the inhabitants lived in.

⁷ The taxable base was the market value of the slave as decided by a committee appointed for that purpose.

⁸ Direct participation of (male) citizens was always possible in the assemblies such as 'Comitia Curiata' or 'Tributa or Centuriata', however the larger the city became, the

outside of Rome.⁹ At that time there were no problem of democracy or representation, as far as every man counted and voted for himself in the assembly, and decisions based on majority were accepted.

To a certain extent, taxation as legal phenomenon was born in a democracy and under the rule of law. In any case, taxation was an exceptional event in the life of the *Res Publica*, and the criticism of Livius towards the *Lex Manlia* is also a clear example of that. Just like income tax in United Kingdom centuries after,¹⁰ taxation was used only in cases of clear and present danger, such as the never ending Roman wars, and the need for a modern army equipped for warfare. In this respect, it is not easy to distinguish between taxes and compulsory loans (that had to be reimbursed later on by the Republic, using the goods looted to the defeated populations).

In the last stage of the Republic and during the dawn of the Empire, tributes were not collected any longer, because there was no need for that. The burden and the cost of the welfare and of the warfare of the Roman machine were supported entirely by the defeated nearby nations and soon to become provinces of the always enlarging Empire. Specific taxes (actually, lump-sum payments) were levied every year or occasionally, depending on the duration of the war, on the resistance opposed to Rome, on the peace condition and according to other elements of the case. A remarkable exception in this sense is the *Lex Titia*¹¹ passed during the first Triumvirate, which introduced a sort of 10 per cent tax on wealth in Rome and was levied on the provinces ruled by Romans. The tax was first justified by the war against external enemies, and later by the Civil war necessities.

more difficult was the participation. Moreover, according to the historic reconstructions, citizens living in the outskirts of Rome were systematically overrepresented in the 'Comitia Tributa'. That is why republican Rome can be considered as a democratic society only in a very limited sense of the word. See O.F. Robinson, *The Sources of Roman Law. Problems and Methods for Ancient Historians*, London, Routledge, 1997, at p. 3.

⁹ Livius, 'Ab Urbe condita libri' 7, 16, 7 and 8. The law was passed in 357 b.C.

¹⁰ Income tax was introduced in the United Kingdom (but not in Ireland) by William Pitt the Younger in 1799 as a means of paying for the war against Napoleon. It was repealed by Lord Addington in 1802 during a brief peace period and then introduced again the next year, when war erupted again in the continent.

¹¹ 43 b.C.

Even if there is no reason to get into details here,¹² it is worth mentioning that in the dying Republic it was the Senate which passed and decided the amount of the contribute, later on, as was pinpointed, any reference to the republican rule of law and separation of power was lost. Once more, taxes were introduced only via representative bodies, and being the Senate the latest one of these still functioning, although only an elite of the population was allowed there, it took the political responsibility for that.

The Roman emperors greatly relied on (conquered) provinces to raise the money they needed as the Republic previously did, but they generally felt somehow compelled to find a reason under law for that. And so, the ten per cent tax on wealth was justified in some cases by ancient law before the arrival of the Romans, by the protection of the emperor, or by various other reasons.

To a certain extent, taxes were the sinews of peace even centuries ago: the sinews of the Pax Romana. The provinces conquered (preys, praedia) by Roman people and later controlled by the Emperor were therefore subject to the praedia tributaria just like, at least apparently, ancient Romans had to pay the tribute. The amount, the duration and the taxable bases were, however, demanded to the discretion of the Empire, just like the collection procedures were attributed to private business.¹³ In this respect, the lesson we can learn from the Romans, as a first attempt to understand the relation between democracy, taxation and economic integration across Europe has come to an end.

Taxes were born on the continent as a sort of fee to be paid by all free men to the Res Publica. In this respect, no taxes were levied without consensus of the taxpayers as far as the publicity (that is, the public purpose) that grounded the justification of the tax could not exist without it. There could not exist taxes outside a democratic environment and rule of law. Later on, as Livy seemed to emphasise, the tax (either direct or indirect) was refused as such by Romans, with the only exception of customs, arguably because it was

¹² For further references see for instance N. Lewis and M. Reinhold (eds), *Roman Civilization, I, The Republic and the Augustan Age*, New York, Columbia University Press, 1990, at p. 237.

¹³ The 'publicani', perhaps the most known example of them is the apostle and evangelist Matthew.

considered as a sort of payment in consideration for the usage of roads and ports.

The Principate (the early Empire) on the other side clearly manifests an approach to taxation that was remarkably different from the one that inspired the behavior of the emperors in other aspect of law. The evolution of Roman law clearly culminated in the *Corpus Iuris Civilis* by Justinian as the last attempt to harmonise and restate a multiseular experience: but it is no surprising that such an (nowadays) important aspect of public law was not clearly restated (particularly for what regards the consensus of the taxpayer).

The reasons were probably various: first of all, there was no tax law, but only taxation. In other words, taxes were levied without any guarantee for taxpayers in the provinces, and moreover, taxation was never intended as an instrument of integration of the different provinces into a larger entity, but rather an instrument to raise funds with a clearly discriminatory intent. Every province was taxed differently according to different traditions and consistently with the history of its annexation to the Empire. To this extent, economic integration was driven by the legions rather by the taxes, but no doubt that the provinces had no right to be heard by the emperor or to provide a sort of consensus via representative bodies within the Empire.

Integration, harmonisation and the roots of the EU approach to taxation

The attempt to compare the Roman experience to the progressive EU integration could appear at first glance as a little more than a divertissement without any specific utility both under a theoretical and a practical point of view. On the contrary, I think that Roman law (and Roman approach to taxation) has still something to teach modern lawyers, and probably can be helpful to provide an answer to the question set out in this chapter.

The Treaty of Rome and the subsequent treaties amending it, up to the latest Constitution¹⁴ (and the condensed version of it)¹⁵ had

¹⁴ The never approved text of the European Constitution signed in Rome 29 October 2004, [2004] OJ C/310/01.

towards taxes and taxation a pragmatic approach justified by the main purposes the Treaty was adopted to implement. The Community and the Union had to become a geographical area where fundamental freedoms of movement of goods, persons, services and capital were respected, and in this sense, any limitation to these movements had to be progressively removed. In a common market common rules are needed only where the market needs them, and where the single member states, taken individually, could not do better.

This clearly functional approach to taxation had as a consequence the full integration of customs law, as *condicio sine qua non* for Europe to be considered as a one as seen from outside, and the harmonisation of turnover or indirect taxes considered as the most dangerous kind of taxes for a truly integrated market. To this extent it is undoubtedly true the fact that direct taxes have always been considered as the domain reserved of sovereign states since XVIII century and therefore nations have always been quite reluctant to surrender their powers to the new born communities, but it is also true, on the other side, that direct taxation was not a priority for the common market, as far as its impact on goods and services delivered was, quite paradoxically, not as direct as the one delivered by indirect taxes.

While an excessive direct taxation could eventually push a business to move from one country to another in a mid-long term, an indirect tax could prevent the same business to sell its products or services in another member state, immediately frustrating the core purpose of the Treaty. Indirect tax harmonisation was therefore considered a priority by the Community, consistently with the scope of the Treaty. For this reason the first directives implemented on VAT date back to 1967,¹⁶ when a general consensus on an harmonised turnover tax partially inspired by the one applied in France was reached.

The unanimity needed in the Council to pass such directives (and more generally any directive on direct taxation) was considered at the same time both a clear recognition of the importance of taxation for

¹⁵ The reference is to the Treaty of Lisbon signed in Portugal 13 December 2007, [2007] OJ C/306/01.

¹⁶ The first VAT Directive, 67/227/EEC, was adopted by the Council 11 April 1967, [1967] OJ L/71.

the member states, as mentioned above, and also a sort of second-best solution in the attempt to ground the decision making process from a democratic point of view.

It is well known that the European Parliament has little or no influence in the adoption of directives in the field of taxation, although it is the only representative body in the European constitutional framework: that is why many authors questioned, under a theoretical point of view, the compatibility of EC (and later EU) power to tax with the national constitution (if any) and the generally recognised principle of 'no taxation without representation'. In this sense, the consensus of the government needing the support of the Parliament to operate could be considered as a sort of indirect representation of the member states in the decision of the Union. In any case, the compatibility of the EU decision making process and the reserve of law in taxation was only theoretically important as far as the directives on direct taxes adopted in the past never imposed other duties on the taxpayers and had, as final outcome, the increase of the tax burden, perhaps with only one (indirect) exception.

The democratic consensus of taxes is an *acquis* of the Western world and it is aimed at defining the possession of each individual against the need of the Leviathan state. In this respect a deprivation of a property or of a possession is legitimate only insofar it takes place consistently with the will of the taxed person, expressed indirectly by the representative body. Under this perspective, therefore it could be argued that not every tax provision must be passed via Parliament or representative bodies, but only those that impose new economic burdens on the citizens or on the people living in a state, in a region or in a specific territory.

Because of the unanimity required, in the history of the Community and of the Union, only a few provisions affecting direct taxation were ever adopted. This had also a legal reason in the wording of the Treaty. Art. 293 clearly states that direct taxation, and particularly the issue of removal of double taxation, was demanded to bilateral initiatives of the member states, fostered if necessary by the

intervention of the Community.¹⁷ From the letter of the article it was argued (interpreting it a contrario) that the Community had no competence in direct taxation and the limited interventions were possible only insofar they were absolutely necessary for the implementation of the market, respecting the rule of the subsidiarity and all in all as a sort of *extrema ratio*.

If we move from the theory to the practice of the EU direct taxation, we discover, however, that the most relevant directives affected dividends payment,¹⁸ interests, royalties¹⁹ and merger and acquisition operations (the so called 'passive income' an some corporate operations). Despite the different nature of income involved, all the directives had one clear objective: to minimise the international double taxation and the administrative burdens the taxpayer had to incur when moving outside the border of her home country. This feature is particularly clear not only in the *consideranda* (preliminary remarks) of the various directives,²⁰ but also in the text, where generally the European legislator clearly says that the European rules are applicable only insofar they concur to reduce in international double taxation better than national or international rules are able to²¹ and in this respect can be derogated both by national provisions or by international treaties.

¹⁷ In this respect 'member states shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals: [...] the abolition of double taxation within the Community'.

¹⁸ European Economic Communities (EEC) Council Directive No 435/1990 of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states [1990] OJ L/225/6, later amended.

¹⁹ European Community (EC) Council Directive No 49/2003 of 3 June 2003 on a common system of taxation applicable to interests and royalties payments made between associated companies of different member states [2003] OJ L/157/49, later amended.

²⁰ In the 2003/49/EC directive for instance is clearly stated that 'national tax laws coupled, where applicable, with bilateral or multilateral agreements may not always ensure that double taxation is eliminated, and their application often entails burdensome administrative formalities and cash-flow problems for the companies concerned'. See also M. Greggi, 'Taxation of Royalties in an EU Framework', (2007) 46 *Tax Notes International*, at p. 1151.

²¹ A clear example of this approach, clearly inspired by the subsidiarity principle can be found in the 1990/435/EEC directive, [1990] OJ L/363/129, par. 7.2 that reads as follows: 'This Directive shall not affect the application of domestic or agreement-based provisions designed to eliminate or lessen economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipients of dividends'.

It is not the first case in legal literature where a source of law of upper level²² potentially abdicates to its primacy in favor of a lower one, nonetheless this can be considered a clear symptom of the European cautious approach to tax issues. Under this perspective, it could be argued, that at least in direct taxation the democratic deficit of the European institutions (the Commission and the Council) is a serious theoretical issue but not so relevant in tax law. The Community carefully exercised its power in this field of law aiming only at the implementation of new rights and freedoms for the taxpayers with a prejudice (if any) to the state only. Even if the existence of an European tax law is a (complex) reality of the everyday practice of any European lawyer or academic, the key feature of the discipline is that (in direct taxation) EU law is aimed only at reducing the taxing power of the states, thus at decreasing the burden of taxes upon the taxpayer. In this respect, the need for a democratic consensus is obviously not as urgent as it would be where European law should involve also new ways and means of collecting economic resources in addition to the ones implemented by the states. This second hypothesis is clearly theoretical until now, and will be discussed below²³ in a *de jure condendo* perspective.

There are, however, some remarkable exceptions to the above mentioned European approach to taxation: one involving indirect taxes such as customs duties and VAT, and the other the 2003/48/EC directive, on the Taxation of savings. The reasons which justified the harmonisation of VAT and of the customs duties are well known and even recently summarised in academic literature.²⁴ In the case of custom duties, it was so obvious that the priority for the (soon to be) harmonised market was to neutralise any difference in customs law (most notably, differences in the amount of the tariffs) in order to prevent any 'customs duties shopping' by the importers of goods in

²² I am referring to the Italian legal system, where EU rules (treaties, regulations and directives) have a specific primacy over international treaties and national law. This primacy in Italy can be also directly applied by every judge, who can simply disregard the national provisions (or the Treaty as well) he think is conflicting with an European rule. The situation can be slightly different in other member states, but in any case the primacy of EU law over international treaties and national law is clearly affirmed by the ECJ.

²³ See par. 8.

²⁴ A. J. Menéndez, 'Taxing Europe: Two Cases for a European Power to Tax', (2004) 10 *Columbia Journal of European Law*, at p. 305.

the Common market: it had to be perceived as unitary from outside.²⁵ The same goes for VAT, but in this case the removal of internal²⁶ customs borders occurred only in 1993, when the barriers to the market were also physically taken away²⁷ and the VAT changed dramatically.²⁸

In both cases, however, EC law did not introduce any new tax in the member states, but limited its intervention to a progressive harmonisation of already existing²⁹ ones. Consumption of goods and services on the one hand, and the import of goods on the other, were already considered facts capable of displaying a specific ability to pay on the purchaser or on the importer. Anyway, this is not the main reason leading to the justification of these kinds of taxes in the light of a 'democratic clause'. The main reason is that all these provisions and all these progressive harmonising and regulating interventions were already enshrined in the Treaty of Rome, and then maintained in all the subsequent amendments and integrations, until the very recent Constitutional Treaty proposals.

In this respect no lack of democratic survey is recorded as far as the consensus of the Parliament (if not by the population, with a referendum) was manifested on the approval of the Treaty. Obviously it only contains the general principle inspiring VAT and Customs taxation, not including for instance rates, rules applicable for the calculation of the taxable base and so forth, but all these

²⁵ *Ibid.*, at p. 301.

²⁶ That is, between member states of the Common market. That is why, in VAT law the sale of goods between two businesses resident in two different member states are qualified as exportations or importations until 1993 and from that year as 'intra-EC sales'. The difference is not only a matter of words, but also of legal duties that must be respected during and after the contract (involving the invoicing procedure, the record of the sale and so forth).

²⁷ In Italy, for instance, most of the customs inspectors working at the borders were moved elsewhere, particularly at the airports and at the internal offices.

²⁸ See the 1991/680/EEC, [1991] OJ L/376, Directive applicable since 1 January 1993.

²⁹ No European countries had a VAT when the Treaty of Rome was signed, with the only exception of France (which had a tax that was quite similar in its application to the current VAT, without being identical in all the respect); however, every country had developed a specific way of taxing consumption, in some cases with a single stage tax (similar to the US Sales and Use Tax) or in other circumstances using a multiple stage tax. In this respect, it could be argued, EC didn't implement a new tax, but rather harmonised an already considered taxable base: consumption of goods and services.

details can be decided by other non-representative bodies even under national tax law in most of the European countries. In Italy, for instance, the reserve of law is considered as relative and allows the Government of other public bodies³⁰ (depending on the tax of the case) to decide rates, allowances and so on.

In this perspective, and still using as an example the Italian situation, the Fundamental charter of the country clearly rules that (Art. 11) limitations of sovereignty are allowed under the Constitution insofar they are necessary for Italy to join international organisations. It is well known that the founding fathers of the Italian republic introduced the mentioned article to allow the Italian accession to the UN, but it was used to join the EEC as well later on and also other international organisation demanding some quotas of sovereignty to be renounced by the state.³¹

The case of the 2003/48/EC³² is anyway completely different. The directive deals with the taxation of saving in the Union and beyond. It is the (late) answer to an issue recorded for the first time in the mid eighties:³³ the significant tax evasion on income yielded by savings that individuals kept on bank account in other member states (and even outside the EU). As a matter of fact the evasion is simple to be realised, yet difficult to be discovered. Assuming that the taxpayer is taxed on the income produced according to the tax return she presents; the evasion was realised simply avoiding to declare the amount of interests (or of any other capital income) obtained on the

³⁰ The most frequent case in the Italian experience (but the same arguably goes for every country) is the one involving tax rates. It is well known that in several cases the Parliament attributes to other bodies (namely, regions and municipalities) the power to establish the rate of the tax between a minimum and a maximum. In Italian academic literature this characteristic is accepted and judged constitutionally compatible with the reserve of law in taxation (and therefore the implied principle of no taxation without representation) as far as the latter is considered as a *relative* reserve (on the contrary, for instance, the reserve in Criminal law is qualified as absolute and no leeway for any integration by other public bodies is accorded in that respect).

³¹ An accurate quotation of Art. 11 of the Italian Constitution should report as well that Italy renounces to a part of its sovereignty only insofar the other states do the same while joining the international organisation and only if the aim of this organisation is to foster the international peace and justice between nations.

³² Council Directive on the taxation of savings income in the form of interest payments adopted on 3 June 2003, [2003] OJ L/157/38.

³³ Menéndez, *supra*, note 24, at p. 335.

savings abroad. Even if EC law had a number of directives dealing with the exchange of information between tax authorities³⁴ to tackle this kind of violations, it was in any case nearly impossible for the National revenue Services (or Agencies) to require information on a specific taxpayer because she had no idea in advance on the individuals to ask information on.

The mentioned 'Saving Directive' solved efficiently this problem, forcing the tax authority of the state where the bank account is open and active to communicate to the administration of the state where the beneficiary³⁵ of the account is resident his name and the income yielded in the form of interests. The automatic and massive exchange of information now makes that kind of evasion nearly impossible with a great advantage of the coffers of the Treasury. Needless to say, the implementation of the directive did not solve entirely the problem. Tax avoidance and evasion were (and are) still possible for two obvious reasons: the first one deals with the implementation of the schemes, whose complexity is such that can't be discussed in this context.³⁶ The second one deals with the involvement of third countries with special relations with the EU, and this aspect rather than constituting another technicality of the discussion plays a fundamental role in the current discussion.

When the directive was proposed for the first time by the Commission, many European countries were afraid that the adoption of the directive would have determined a flow of capital from (just

³⁴ For instance the directive 77/799/EEC of 19 December 1977, [1977] OJ L/336/15.

³⁵ The directive uses the concept of 'beneficial owner' in this respect.

³⁶ Moreover the nature of the tax planning scheme is not important for the scope of the present article. In any case, nearly all of the schemes currently implemented involve the use of a stepping stone company (or a trust) to be considered as the owner of the foreign bank account, and incorporated in a favorable country. In this case while the tax authority of the state where the bank account is opened has the duty to communicate it to the authority of the place where the individual is resident, it has not the duty to communicate it in case the bank account is at the disposal of a company or a trust. This condition arose a significant criticism in academic literature but was one of the conditions for the directive to be approved at the unanimity of the member states of the Union. While a look through approach is possible and some anti avoidance provisions are consistent with the directive, as a matter of fact the concrete effect of the European provisions is strongly limited by the application restricted *ratione subjecti* (that is, to individuals only).

for example) Luxembourg³⁷ or Austria³⁸ to the advantage of countries like Switzerland or the Republic of San Marino thus both frustrating the effect of the Directive and reducing significantly the business of the most affected European countries. A compromise had to be found, and actually it was reached involving specific third countries in the application of the European provisions.

Once more, it is not possible here to get into details, but the application of the Directive is easy in this respect, at least under a descriptive approach. In the case in which an EU resident citizen register a bank account (or another equivalent financial account)³⁹ in one of those countries, he has two options: (1) allow the tax administration of the state to communicate to her own tax administration the existence of the account, the interest yielded and any other useful information for assessing the due income on those profit; or (2) refuse to allow the tax administration of the bank account state to provide such information, but accept as exchange a withholding tax of a specific amount, that going to be higher and higher with the passing of time. These taxes are then transferred by the bank account state to the home state in order to (partially) prevent a full evasion on the income produced abroad.⁴⁰ Of course the consensus of Switzerland and of most of the other countries⁴¹ was not for free, asking then in exchange the application of some other European freedoms to business resident on their territory and to

³⁷ A brief description of the tax system in Luxembourg and the effect of the mentioned directive can be found in JP Winandry, 'Luxembourg report', 1, available at: <www.eatlp.org/uploads/public/2006_Luxembourg_Report.pdf>.

³⁸ Luxembourg is well known in the tax planning community for the flexibility of the financial services and for the particularly low level of taxation, while Austria is preferred for the bank secrecy.

³⁹ Art. 4 of the directive uses the concept of paying agent, which is of course broader than the concept of bank.

⁴⁰ Switzerland for instance paid to Italy a significant amount of money last year, being that amount the sum of all the withholding taxes applied on the interest yielded by money Italians have on their bank account in Switzerland and whose names are unknown to the Italian tax administration. In this respect, the Italian revenue service does not know the name of the Italians (or of most of them) having a bank account in Switzerland, but has an idea of the overall amount of money present there and belonging to Italians.

⁴¹ See Art. 17.2i of the directive: it is the case of Swiss Confederation, Liechtenstein, San Marino, Andorra, Monaco and the United states of America.

individual.⁴² In this respect, while Switzerland abandoned some of the advantages historically granted to people bringing money in to the world famous coffers of her banks is still granting bank secrecy and enjoying⁴³ some European rights and freedoms just like it were part of the Union.

In a purely European perspective, the directive constituted an unique event in the history of European tax law until now. It was, in other words, the first case of a directive unanimously passed by all the member states, involving direct taxes and clearly aimed at the optimisation of the tax burden amongst the taxpayers. It was not written, like all the others before and the Directive 2003/49/EC of the same year, to reduce the tax burden sustained by the companies investing cross-border, but its sole scope was to put the tax administration of each member state in a better position in a fight against (possible) tax evasion and to know more about every taxpayer having interest income flowing from another country belonging to the Union.

In a very broad sense it was the first case in which, theoretically speaking, the principle 'no taxation without representation' should have to be respected⁴⁴ because of the intrinsic value enshrined in it; that is, the more money the state requires from its citizens (taxpayer),

⁴² For example, in the agreement between the Union and Switzerland 26 October 2004, [2004] OJ L/385/51, the Confederation was allowed to step in the Schengen area.

⁴³ Actually, Swiss businesses and companies are enjoying them. Under a purely legal point of view, it's worth while mentioning that the agreement on the application of the Savings Directive in respect of the Swiss Confederation was negotiated directly by the Union, with the effect on all the member states. It also constituted a blueprint for all the other bilateral agreements involving the EU and the third states such as San Marino etc. In this way, the Union supported some member states (for instance, the already mentioned Luxembourg, but also Austria and Belgium), which were afraid to loose some of their clients in favor of the companies and financial services of these non-EU states. Yet some criticism is maintained as far as private investors, once lost the advantages of accounts in some European states and in the nearby countries (either because of the agreement such as Switzerland or because of the EU accession, such as Malta and Cyprus) are moving their financial reserves in tax heavens such as Singapore, thus demonstrating that the preoccupation of the mentioned member states was not ill founded.

⁴⁴ The Directive does not lead to a higher taxation but to a higher level of informations at the disposal of every tax authority on selected taxpayers. This higher level of information can possibly lead to a higher level of taxation when withholding taxes are levied.

the more it can do that consistently with the principle of democratic consensus. With the implementation of this provision the European citizens (again, in a very broad sense)⁴⁵ have two options: surrender part of their rights as foreign bank customers, in favor of the revenue service of their home country; or they must be ready to accept a higher level of taxation (perspectively up to 35 per cent of the interests paid).

In the traditional cost – benefit analysis is itself evident that the sacrifice of the many is clearly justified by the overall advantage that the mechanism set up shall provide in term of a minor tax evasion and therefore lesser need to find financial resources elsewhere (if everybody pay, they pay less) but in these cases the need for a complete privacy was just a little more than a fig leaf concealing an interest to evade the tax due. In any case, if in a practical point of view the directive is reasonable, welcome and positively accepted by most of the member states and by all the revenue services, under a theoretical perspective it could be considered as the first violation of the principle ‘no taxation without representation’ taken in the narrow sense (that I think more appropriate), which tends to read in the reserve of law a guarantee to be respected in favor of the taxpayer that does not involve any tax provision, but only those making the position of taxpayer more burdensome both under a financial⁴⁶ or administrative aspects.⁴⁷ Whether this sort of violations are consistent with the spirit of the Treaty and with the aim pursued by the founding fathers is a question for the academic to answer to.

Once more, the purely legal approach to this sort of problems is particularly inadequate and, to some extent, unsatisfactory. Most of the supreme courts answered the question giving the title to this chapter in a very clear sense: Violation of the reserve of law principle can not be questioned in front of the Court as far as the principle ‘no taxation without representation’ can easily coexist with the current European decision making process applicable in the community as far as it was adopted until now and according to the provisions

⁴⁵ I do not share this view, but nonetheless it must be admitted that it is not ill founded in its entirety.

⁴⁶ That is, introducing new taxes or increasing the ones already existing.

⁴⁷ It could happen if the legislator should implement new burdensome administrative formalities to be respected by the taxpayers.

already mentioned.⁴⁸ That does not mean that the EU, in the view of the National Constitutional Court⁴⁹ has the power to tax or the power to implement tax provisions applicable also to Italian citizens thus violating Art. 23 of the Italian Constitution,⁵⁰ but its effective exercise until now is consistent with that provision.

The aftermath on national systems

The case of Italy and the theoretical approach to the relation between EU law and national law

The relation between EU law and national law, at least in the Italian perspective, clearly mirrors the (need for) connection between democracy and legitimate decision making. The first problem academics and courts had to solve in Italy after the accession to the Community was the consistency of the European decision making process with the sinews of the national Constitution: two legal orders were in possible conflict both according to their content and under the compatibility of the decision making process of the former with the Constitution of the latter. The possible solutions arrived from the national Constitutional Court and from the ECJ: both called to solve the practical and the potential conflicts. Unfortunately (and apparently) until 2008 they shared different theories to declare the primacy⁵¹ of EU law on national law.

⁴⁸ See the next paragraph for a detailed analysis of the reasoning followed by the Italian Constitutional Court, just to give an example.

⁴⁹ I make reference to the Italian situation once more, but I think that the same conclusion can be extended to most of the continental countries with a 'hard' constitution (hierarchically superior to the acts passed by the Parliament) and a constitutional (or supreme) court with powers analogous to the Italian one.

⁵⁰ Art. 23 enshrines in the Italian system the many time mentioned principle of 'no taxation without representation'. Yet the literature discusses whether it could be considered as a founding principle of the Italian democracy (just like the principle of equality, for instance) or just a fundamental rule of the legal system of the peninsula. The same literature discussed whether Art. 23 of the Constitution is infringed by all European binding provisions, such as directives and regulations, or by the latter only. In the case of directive a national act implementing the European rules is always necessary, therefore, at least under a purely formal perspective, the principle seems to be respected. In the case of VAT for, instance, the discipline was blueprinted by a number of directives, but the national implementation was demanded to national acts (once more, in Italy VAT was introduced with a Presidential decree, n. 633, 22 October 1972).

⁵¹ In the view on the Italian Constitutional Court the use of the word 'primacy' would not have been entirely accurate for the reasons clarified later on in this paragraph.

The ECJ adopted, since the decision of the first cases, the monistic theory.⁵² According to the ECJ point of view the Treaties instituted a legal system of their own, and the law created by the Community can be qualified as fully autonomous from the one of any member state. The latter accepted the limitation to their sovereignty entering into the Treaties under a reciprocity clause, and now it can not make national provisions unilaterally prevail over treaties, regulations and directives.⁵³ This solution was generally accepted by the academic literature supporting the monistic theory; the only point of uncertainty was related to the potential conflict between a national constitutional provision and a treaty article.

The ECJ was of the opinion that EC law had to prevail even on constitutional rules and general principles as far as each member state joining the Union accepted limitations to its sovereignty. This sort of self restraint obviously had to involve any source of national law from regulations to the Constitution founding the legal order within any country.⁵⁴ The final outcome of this interpretation is that national law can not in any way limit the application of EC law, and the efficacy of the latter can not be different from state to state. EC law must be applied without conditions or restrictions in the same moment and with the same efficacy all across the territory covered by the Union. Eventually, the monistic theory was summarised by the Court in another case in the mid seventies:⁵⁵

[...] in accordance with the principle of the precedence of community law, the relationship between provisions of the Treaty and directly applicable measures of the institutions on the one hand and the national law of the member states on the other is such that those provisions and measures not only by their entry into force render automatically inapplicable any

⁵² EU and national law belong to the same order with the first hierarchically supra-ordinated to the second, just like in a kelsenian *stufenbau* construction. in this respect, every national rule not consistent or in conflict with an EU one had to be repealed by courts or in any case had not to be applied to the case in the Court.

⁵³ ECJ manifested this approach since the cases C-26/62 *Van Gend en Loos v Administratie der Belastingen* [1963] ECR I-3, C-6/64 *Costa v E.N.E.L.* [1964] ECR I-1141 and C-11/70 *Internationale Handelsgesellschaft mbH v Einfuhr- und Vorratsstelle für Getreide und Futtermittel* [1970] ECR I-1125.

⁵⁴ Case C-48/71 *Commission v Italy* [1972] ECR I-529.

⁵⁵ Case C-106/77 *Amministrazione delle finanze dello Stato v Simmenthal* [1978] ECR I-629.

conflicting provision of current national law but - in so far as they are an integral part of, and take precedence in, the legal order applicable in the territory of each of the member states - also preclude the valid adoption of new national legislative measures to the extent to which they would be incompatible with community provisions.

The Italian Constitutional Court always maintained (at least until 2008) a completely different approach, inspired by the so called dualistic theory. In this perspective, national and European laws are considered as two sets of rules completely distinct from each other, although forced to coexist. The relationship between the former and the latter is not built on a rule of supremacy, but rather of different contexts and conditions for their application. Where EC law is applicable national one is not. The more EC law expands its field of application, the more national law withdraws.

The Constitutional Court clarified its position in a well know case,⁵⁶ which is important not only for Italy but also for all those countries which adopt the same legal theory, where first of all recognised that EC law steps into the national system thanks to Art. 11 of the Constitution, and commenting Art. 11 says that the article quoted '[...] means that, when certain conditions are met, it is possible to enter into International Treaties limiting the state sovereignty and execute them trough a ordinary Act of the Parliament [...]', but at the same time the way in which Treaties get into the national system is also an intrinsic limit to their efficacy, and to this extent

this doesn't generate any deviation to the rules applicable to the efficacy in the internal system of the International obligations the state entered into together with other states as far as Art. 11 of the Constitution does not bestow on the ordinary Act implementing the treaty of the case any different (superior) efficacy of the ordinary law [...].

The Court went back on the same issues in a number of cases. Out of these, two are still relevant and useful to understand better what was the position of the Constitutional Court at that time. In the second of

⁵⁶ Italian Constitutional Court, 7 March 1964, note 14.

these⁵⁷ the Court judged on the legal nature of the so called Derivative EEC law (that is, the rule of law stemming out from directives and regulations) according to Art. 189 of the Treaty and clarified that in the Italian perspective:

this power [that is, to adopt directives and regulations] is attributed to the organs of the Community for the fulfillment of their duties under the conditions specified by the Treaty; therefore each member state transferred part of its legislative powers to the Community, according to a specific apportionment criterion based on the areas of European interest covered by the Treaty.

It is also for this reason that some years before the Court was able to qualify as constitutionally compatible with Art. 23 (reserve of law, and no taxation without representation) the EEC Regulations as far as Art. 23 is applicable only to the rules and the acts of the national system, and not to the European one.

To a certain extent, the dualistic theory was the ground upon which European taxation could be justified even if missing the 'democracy test', or, in other words, even in absence of a clearly manifested democratic consensus. In any case, the Court was aware that the decision would have been quite questionable in the light of the fundamental freedoms safeguarded by the Constitution, and therefore added, with particular reference to Art. 23, that: '[...] the clear and specific provision of the Treaty [of Rome] provide an adequate warranty, therefore it is difficult to imagine (even theoretically speaking) that an European regulation could have an impact, on civil, social or politic rights inconsistent with the Italian Constitution [...]'. It could be argued, therefore, that the democratic consensus is not necessary for European directives and regulations as far as these are intrinsically consistent with the (national) law.

Obviously, this is not the end of the story, with the ECJ on one side affirming the unity of the national legal system, and the Constitutional Court still ruling that it was possible to have one system and two laws. It was not only a theoretical issue, as it could emerge from the last mentioned paragraph of the sentence n. 183. As

⁵⁷ Italian Constitutional Court, 27 December 1973, note 183.

a matter of fact, the adoption of one theory or the other had also an effect on the decision about the most influent Court in the legal system of the country. In the case of the monistic theory, obviously the ECJ has the power to test the compatibility of any provisions (including Constitutional rules) with the European law; on the contrary (dualistic theory) the Constitutional Court is ultimately in charge to decide the limit of the retreat of the national law in favor of the European one, and ultimately to set limits (basically of constitutional nature) to the European derivative law.

A balance between the two vision was later reached when the supremacy of the fundamental principles and human rights over European law was acknowledged by both the Court, which as a matter of fact demanded to a third body (the European Court of Human Rights)⁵⁸ to assess the nature and the identity of the fundamental rights and freedoms enshrined in every constitution that neither the Treaty of Rome nor the derivative European law could infringe. It is needless to say that the issue was absolutely theoretical and by now in never had a concrete application nor arguably will ever have.

In any case the decision by the ECJ, answering the Constitutional Court, is relevant in the development of this research as far as it insert in the dichotomy between Europe and nation state the role of the fundamental rights and the European Convention on Human rights and fundamental freedoms.⁵⁹ In this respect the field of the analysis in widened to another multilateral Treaty EU is bound to respect just like the states. Anyway, the states are members of the Council of Europe, but the Union is only self bound to respect the fundamental rights and the Convention.⁶⁰ In this respect, the test of democracy to be passed by any decision involving taxes could be reformulated to an 'human rights test' for any tax to be consistent with national and European law. In this perspective, the analysis ceases to be purely theoretical as far as there were in the past cases in which the tax sovereignty of European countries was tested according the ECHR, and in some of these taxes had to be reshaped

⁵⁸ ECtHR, from now on.

⁵⁹ ECHR, from now on.

⁶⁰ Art. 6.1 of the Treaty reads as follows: 'The Union is founded on the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law, principles which are common to the member states [...]'.

in a way consistent with the fundamental rights and freedoms. And even were these amendments were not needed, the Court in Strasbourg set out principles of general application that could be relevant as well for most of the European countries.

Continues: the role of the fundamental rights The European convention on human rights and taxation

In the text of the ECHR there are many provisions which are important for the application of taxes such as Art. 5 (right of freedom of any individual), Art. 6 (due process of law), and Art. 14 (non discrimination). Moreover, Art. 1 of the first protocol to the Convention ensures everybody the peaceful enjoyment of their possessions. Even if it was inserted in the Protocol to protect every individual from arbitrary deprivation, it's evident that some taxes could reach the same result and therefore the article could be used even in our context.⁶¹

For what concerns the principle of non discrimination, the one capable of having the most significant impact on National tax law, the Court of Strasbourg⁶² highlighted that it: '[...] complements the other substantive provisions of the Convention and the Protocols. It has no independent existence since it has effect solely in relation to the enjoyment of the rights and freedoms safeguarded by those provisions.' The outcome of this interpretation is therefore a significant reduction of the possibilities for Art. 14 to be applied in favor of the taxpayer, being it useful only when read in conjunction with another article of the Treaty.⁶³

⁶¹ And it was, just like in the ECtHR Case *Darby v Sweden* Series A no 187 (1991) 13 EHRR 774. That's probably why taxation is specifically excluded from the scope of the article in par. 2.

⁶² Case *Rasmussen v Denmark* Series A no 87 (1984), par. 29.

⁶³ Perhaps one of the most interesting reading in conjunction of Art. 14 is with Art. 1 of the First protocol. In a number of cases commented later in this research, the Court said that even if Art. 1 can't be directly applied to tax law because of the clear exclusion in par. 2, nonetheless the peaceful enjoyment of the possession must be guaranteed consistently with non-discrimination principle. Therefore, a tax unreasonably discriminatory can be considered as in violation of Art. 1 of the Protocol taken in conjunction with Art. 14 of the Convention, thus using the latter article as overriding provisions of the exceptions enumerated in Art. 1. The first protocol to the European Convention on Human rights was adopted in Paris 20 March 1952.

In any case, and not counting EU law,⁶⁴ the ECHR is the only Treaty effectively protecting taxpayers rights in an international context, despite the nature (truly democratic⁶⁵ or not) of the legal process of tax implementation in each country. It is not easy to find out general principles of international law to be considered as limits to the (taxing) power of a state beyond that Treaty. In this respect the Permanent Court of International Justice, in the case *Lotus*, underlined that '[...] Now the first and foremost restriction imposed by international law upon a state is that [...] it may not exercise its power in any form in the territory of another state[...]'.⁶⁶

The taxpayer position, in other words, has no international guarantees but international conventions on double taxation and (if applicable due to the residence or citizenship) EU law, obviously and unluckily democracy is not a fundamental or an 'a priori' condition for the exercise of taxing power.⁶⁷

Anyway, after the Second World War the countries belonging to the Council of Europe pointed out that the protection of some, well identified, Human Rights had not to be left to the single national system. A minimum level of guarantee had to be recognised by the democratic nations in any case. The first positivisation of this political issue was however taken by the UN: Art. 38 of the Statute of the International Court of Justice adopts the '[...] general principles of law recognised by civilised nations [...]' to solve conflicts between different countries. Far from being an absolute reform, it is to say that a similar provision was enshrined in the former statute of the Permanent court of International Justice (operating in the society of

⁶⁴ And also the bilateral conventions on double taxation that many countries enter into according to the O.E.C.D. Model Convention.

⁶⁵ Whilst the democratic nature of the state is a fundamental prerequisite (a sort of 'condicio sine qua non') for the accession of the country of the case to the Council of Europe, it is not necessary that the 'test of democracy' had to be passed even in a purely fiscal perspective.

⁶⁶ *S.S. Lotus*, Collection of judgments, Publications of the Permanent Court of international justice, n. 10, Series A-10, Leyden, 1927, 18. The case mentioned however did not involve a fiscal issue.

⁶⁷ However in this latter case some Italian authors noted that it is difficult then to draw a line between taxation and arbitrary deprivations of properties and possession. This reasoning finds an echo in the case *The National & Provincial Building Society, the Leeds permanent Building Society and the Yorkshire building society v The United Kingdom* (1998) 25 EHRR 127 at par. 79. In that paragraph the Court seems to acknowledge that double taxation is, as a matter of fact, an expropriation.

nations). It's worth to remember that these principles have both to be found enforceable 'in most part of the countries' and they must be seen as compulsory under the point of view of international law, in order to obtain a general international acknowledgment.

In this perspective, the question this chapter began with could be observed from a completely different perspective. The test of democracy taxation should (could) pass is not related only to the procedure to be adopted to implement new taxes (approval by Parliaments or other representative bodies) but also to the content of the taxing provision, to the identification of the taxable base, and so forth.

It could be argued that some taxes and some ways and means to implement them are not democratic if they are not consistent with human rights and the conventions protecting them (first of all the ECHR, at least in Europe). The concrete application of this sort of 'substantial condition' (while the former, traditional one could be considered therefore formal, but only for the sake of a easier explanation) depends obviously on the impact of the human rights and particularly of the European Convention on the legislation of every state which joined the Council of Europe.⁶⁸ It is an issue not very different from the one discussed in the former paragraph in respect to the EU law. To a certain extent, therefore, it is not so surprisingly that the 'human right issue' was raised in the past by some national constitutional courts as a limit to the supremacy of the European law in the monistic construction brought forward by the ECJ, and that the ECHR was implicitly referred to by the ECJ in an attempt to reduce the discretion of the national Courts in the application of the EU law.

The case of Germany is evident. Art. 23 of the *Grundgesetz* allows the transfer of sovereignty to the European institutions with the only limit of the respect and protection of the Fundamental Rights as enshrined in the Constitution. The Court referred clearly to the national principles as limit to the EU law, sending back to the 'core provisions' of the *Grundgesetz*. The Italian Constitutional Court in a

⁶⁸ In a provocative sense, the title of this chapter could be reshaped also in 'Can economic integration be but democratic? The case of taxes'.

similar way⁶⁹ recognised the primacy of the European sources of law in the comparisons with the national ones, respecting however the '[...] fundamental principles of our constitutional order and the inviolable rights of the human person [...]', thus limiting the influence of the EU law. It is therefore evident the importance of the ECHR in tax law, and particularly in the relation between taxes and democracy: the application of the principle of 'no taxation without representation' and the subsequent, possible, reserve of law in this respect. Actually, the Court faced this issue (namely: the possibility to implement tax provisions without involving a representative constitutional body): it happened in 1999 in the so called *Spacek*⁷⁰ case, from the name of the company involved and which raised the issue of the compatibility of Czech law with the ECHR.

In 1991 the individual enterprise Spacek SW carried on its business holding a single-entry book keeping, as far as it was allowed by the law of that time, and changed its accounting method to the double-entry only in the next year, due to the incorporation in Spacek s.r.o. In April, 1993, the Czech internal revenue service assessed the corporation for omitted payment of due taxes in the passage from an accounting system to the other. In the Czech Republic, just like in many Western countries, the enterprise taxable income is determined through the accounting balance sheet. However while in other tax systems the income is taxed according to special rules of law, in the Czech Republic it was the Ministry of Finances who decided the taxable bases and the ways to calculate it: as a consequence (and as a matter of fact) the amount of the tax due was left to the decision of the Ministry. The taxpayer in the case raised various issues of incompatibility of the Czech system with the ECHR, being the reserve of law not only a mean to safeguard the participation of the taxpayer to the decision involving their assets, but also an adequate legal instrument for the effective knowledge of the tax provisions by the taxpayers.⁷¹

The assessment of the amount of tax due (and much more of the fines in case of evasion) was relevant according to Art. 1 of the first protocols to the ECHR. The taxpayer argued that even if Art. 1 of the

⁶⁹ Italian Constitutional Court, 8 June 1984, n. 170.

⁷⁰ *Spacek s.r.o. v Czech Republic* Series A (2000) 30 EHRR 1010.

⁷¹ Apparently, it was not the same in the case of the Ministerial regulations that were allegedly difficult to be found or known in time.

protocol is limited in its application by par. two, nonetheless it requires a law to regulate taxation in every country, and therefore two solutions were possible for the case in discussion. According to the first one, Art. 1 of the protocol enshrines implicitly the principle 'no taxation without representation': being this true, the Czech legislation is in violation of the ECHR. According to the second one, even if the principle is not inserted in Art. 1, nonetheless its non application to taxes (according to par. two) is possible only insofar there is a law of a state that rules on taxation. Basically, Art. 1 is not applied in favor of the taxpayer against a national law, but can be applied in full extension against a national Ministerial Regulation, such as the one in the case in question. In this respect the sovereign fiscal interest receives a particular protection inside the Protocol (par. two of the provision voids of most of the effect of the article in tax area), but only if exercised through the instrument of a 'law'.⁷²

The ECtHR, however, reasoned in a different way. In the interpretation of the Court, the concept of 'law' (and consequently 'reserve of law' embedded to the axiom 'no taxation without representation') must not to be read in a formal sense (that is, inserted in a tidy system of sources), but in a substantial one, including not only the acts passed by the Parliament but also the rulings of the Courts, and some regulations of the Government. In a democratic state under the rule of law, representation in taxation is not necessary to the latter to be consistent with the fundamental rights of the individual, the Court seems to say.

The concept of normative act as understood in the Italian system is perhaps closer (although not coincident) to the meaning of 'law' as expressed in the first protocol in the reading of the Court. The ECtHR moved on finding in the presence of some qualitative requirements (specifically those of 'accessibility' and 'foreseeability') the conditions of conformity of the laws to the ECHR. In this respect, the publicity system of the laws enacted (which is far more complex for the parliamentary acts than the regulations of the ministries) therefore is underestimated to simple instrument of information. The enactment of the Regulation of the case can consequently be preceded by some advertise on papers different from the Official Gazette or the Federal

⁷² Arguably, Spacek's view, an act passed by the Czech Parliament.

register, deprived of that presumption of knowledge of the act that the publication on those papers is capable to create.

The rejection of the taxpayer's requests is relevant even in the different perspective of this research. First of all, it teaches that representation and democratic consensus are not necessary in the ECHR to have taxes consistent with the Fundamental Rights of the individual, and even if taxation as an overall phenomenon must still be consistent with other principles of the Convention, as mentioned above, no reserve of law (more to the point, reserve to the Parliament to decide on fiscal issues) is compulsory. Obviously, the importance of this principle is evident for all those who support the theory of the taxing power of supranational bodies, such as the European Union. The fact that no limits are to be found in the ECHR clearly removes a possible argument against an EU tax. Rather than be determinant in this respect, the ECtHR decision in *Spacek* can be easily used to indirectly support under a legal and political level this solution.

Levels of integration: states, regions and territories

The vertical effect of the EU law

As mentioned in the former paragraph and in par three, the relationship between the Constitutional Court and the ECJ was neither straightforward nor clear. This complexity was due to the peculiar effects EU law has on the national one, and the case of Italy is paradigmatic of many other countries on the continent. In this respect a recent case⁷³ decided by the Italian Constitutional Court is helpful to understand better the current trends of this relation and at the same time to assess the impact of the European provisions on taxing power of non-sovereign territorial entities such as regions, provinces municipalities and so on. The case discussed involves the consistency of some regional taxes with the Italian Constitution (principle of ability to pay, equality and reserve of law) and within the EC Treaty (Arts 87 and 49) with freedom of establishment and non-discrimination.

Sardinia, a special region in the Italian Constitutional system with autonomous taxing powers and therefore the possibility to introduce different taxes from the ones implemented on the continent, decided

⁷³ 15 April 2008, n. 102.

to pass⁷⁴ a number of new taxes later qualified by the press as 'luxury taxes'⁷⁵ as far as they were applicable only to certain goods or services of high value. The aim pursued by the Governor of the region, who proposed the Acts to the Regional Assembly, was all in all reasonable. He tried to tax the use of luxury ships, yachts, private airplanes and helicopters in Sardinia and use the resources obtained in this way to support the development of the internal areas of the region, that being outside the flows of the high wealth tourists are still underdeveloped. The flow of income yielded by such taxes was undoubtedly high as far as Sardinia is qualified by an elite tourism and an impressive use of luxury goods such as the ones mentioned above and other specified by the law.

However, while drafting the text, Mr. Soru, the Governor, probably tried to get a bridge too far. In the law it was specified that the tax was due only by those business providing transport services (using yachts, private helicopters and so on) insofar their residence was outside of the region. As matter of fact, a Sardinian company providing this kind of services⁷⁶ to affluent people was tax exempt, while an Italian (but continental) one or a European as well were not. The reasons for such a discrimination were founded by the Sardinian Assembly on the fact that companies resident in the region were not free riding the beauties of the land and were already paying taxes to the region, while the non-resident companies were making profits exploiting for free the international appeal of the region.⁷⁷ Obviously these taxes were adopted in the framework of the special statute enjoyed by Sardinia caused the harsh reaction of the Italian government, which appealed to the Constitutional Court for a

⁷⁴ According to the regional statute of Sardinia taxes are passed with acts approved by the Regional assembly, a sort of regional parliament.

⁷⁵ The taxes were introduced and later amended by two regional acts: 29 May 2007, n. 2; 11 May 2006, n. 4.

⁷⁶ The tax was not only applicable to the goods, but to the services themselves as far as it was calculated on the income produced by, for instance, the business providing shuttle services to and from Sardinia with luxurious devices (airplanes, etc).

⁷⁷ In other words, the Governor argued that part of the profits of these companies was due to the fact that affluent people rented airplanes as a taxi to go from their home or office in the world to Sardinia. And while Sardinia supported the costs of this service, considered as a higher pollution, for instance, not a cent of the profits of such companies (or not enough of them) was given to the coffers of the region.

number of reasons,⁷⁸ partially mentioned above, considering the new taxes as unconstitutional. At the same time however, and in front of the Court, it also raised issues of compatibility of such taxes with the EC Treaty: and namely with Arts 49 and 87.

Going beyond the details of the fact, it is evident that the decision of the Italian Government in the second perspective could have been considered as ill founded. The fact is that in a purely dualistic theory where the Constitutional Court find itself as a *superiorem non recognoscens* body of the judiciary it would be quite difficult (although not impossible) for her to raise a question to the ECJ according to Art. 234 of the Treaty. This is not the case for the Court in 2008. The judges decided that all in all the Constitutional Court can be considered as any other judge in the Italian legal system, thus fully entitled to raise questions of compatibility under Art. 234 of the Treaty of Rome, as amended.⁷⁹ While the case has still to be decided by the ECJ, the raise of the issue by the Italian Court is enough in this respect for the aim of this research.

First of all, it probably established the first stone of a bridge linking together the two theories mentioned above, and aimed at the ultimate overtaking of the dualistic one. The Italian legal system is progressively (even if slowly) moving towards a monistic theory as wished by the ECJ. On the other side, it is evident that the progressive economic integration within the common market is also relevant for regions and other non-national or non-sovereign legal bodies, such as the Italian regions. Even when these enjoys special statutes of autonomy, allowing them to levy taxes also to non-resident citizens,⁸⁰ they can do that only consistently with the Treaty

⁷⁸ First of all, the violation of the principle of equality was pinpointed by the Government in front of the Court.

⁷⁹ See par. 8.2.8.3 of the Sentence, which reads as follows (unofficial translation by the Author): 'This [Constitutional] Court, even if quite peculiar in its nature, being a constitutional organ appointed to guarantee the respect of the constitutional charter by the Parliament, is a judge to all the effects and, more to the point, it is the only and exclusive judge for constitutional issues (as far as no appeal is possible against any decisions, according to Art 137 (3) of the Constitution). The Court therefore in any judgment involving the constitutionality of the law is allowed to apply Art 234 (3) of the EC Treaty, thus raising issues of compatibility of national law with the EU one'.

⁸⁰ To a certain extent, it could be argued that even in a sub-national level the principle of 'no taxation without representation' is wounded once more, as far as the Sardinian Parliament, for instance, voted a tax potentially applicable to all the

of Rome, on the contrary, their acts can be challenged in front of the ECJ just like any other Act passed by the National Parliament.

The ECJ driven integration: some cases from the recent past and the effect on the member states

The unanimity required to approve directives in the field of direct taxation⁸¹ has always been the most significant obstacle to the economic integration in the case of taxes. It was difficult to reach it when the Community moved its first step, it is even more difficult now when 27 countries have to give their assent for new taxing rules to be applied. The particularism of every member state, the nature of the investments developed on the territory⁸² of the case and the subsequent cost/benefit analysis which follows every time a new proposal is introduced by the Commission makes the decision making mechanism (even without the relevant involvement of the Parliament) lengthy and possibly able to take decades before a single directive were adopted: this is the case of the 2003/49/EC Directive mentioned above, for instance.

Nation states have always been jealous of their tax sovereignty, especially when it involves direct taxes. For this reason, when the Treaty of Rome was signed in 1957, a progressive harmonisation was considered in indirect taxes such as VAT and customs duties, but not in personal income or corporate taxes. In these latter fields, the Treaty used self-restraint to foster the bilateral relations between nations, especially through the so called Double Taxation Conventions. In subsequent years, however, it became more and more evident that the DTCs, although fundamental, were not enough to guarantee the

italians managing a specific business in the region without their implicit consent as non-resident (thus non-voting) in Sardinia.

⁸¹ The words must be interpreted consistently with what mentioned above in par. 3. Although the possibility for the EU to levy a tax is debated by the academics nowadays, with most of the lawyers on the position that this is not possible, for a number of reasons analysed in the subsequent paragraphs, this does not mean that the implementation of directives in the field of taxation is not possible. In this respect, the Commission can propose, and the Council approve directives necessary to fully implement a common market, even involving direct taxes if this is necessary to ensure the goal while respecting the proportionality and subsidiarity principles. Actually this did happen in the past, as specified above in this chapter.

⁸² It was the case, mentioned above, of some relatively small states which blocked the adoption of the 2003/48/EC directive for years, being afraid that its implementation would have been too expensive for their financial market oriented economies.

full free movement of capitals and businesses across the Union and that the remaining differences between member states could constitute a limit to foreign investments in the common market as well.

The ECJ played (and still plays) a fundamental role in this respect. The basic idea of the ECJ case law is that, even if direct taxation is excluded from an intervention by the Council, nonetheless the fundamental freedoms⁸³ enshrined in the Treaty must be respected, such as the freedom of establishment, the free movement of capital, labour, etc.⁸⁴ Where a direct intervention is lacking, a progressive interpretation of the four freedoms and the principle of non-discrimination could be successful, although in a sort of second-best approach. In recent years, academics and practitioners have recorded an ever-increasing number of cases decided by the ECJ using the Treaty in the field of direct taxes. Despite the efforts of the ECJ, it is evident that a harmonisation of such a complex field as direct taxation can not be demanded to the activity of the judiciary and to the interpretation of specific cases based on peculiar circumstances. More to the point, it is fundamental for the business to know exactly and in advance the amount of taxes to be paid, and even more to the point, what state would legitimately exercise its taxing powers in the EU framework. Only by respecting this basic condition a subsequent economic integration is conceivable.⁸⁵

The case law of the Court and the inspiring jurisprudence of it has mainly been aimed at the achievement of this goal, particularly in the last years. It is generally true that the case law made integration is negative, being grounded on cases that demolish national rules and obstacles to the integration, and it is even truer in case of taxes. Here the *pars destruens* of the ECJ case law is evident in reasonably recent cases such as the *Cadbury Schweppes*,⁸⁶ where national anti avoidance

⁸³ And the principle of non-discrimination.

⁸⁴ In the EC Treaty: Art. 12 (prohibition of discrimination), Art. 23 (goods), Art. 39 (workers), Art. 43 (establishment), Art. 49 (services), Art. 56 (capitals and payments).

⁸⁵ This problem was particularly evident when flows of dividends, interests and royalties were considered, because of the more volatile nature of the underlying assets (while compared to business income or profit from real estate investments) and thus also the need for a level playing field across Europe was (and still is) more urgent.

⁸⁶ Case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-7995.

provisions, aimed at the recapture of otherwise lost income, were declared incompatible with EU law. After *Cadbury*, new (tax) rules are introduced by the Court in EU (tax) law, but they are not aimed at the taxation of people or companies resident in Europe or at broadening their tax base, but rather at restricting the taxing power on the member state, also directly affecting their sovereignty in tax law. In this respect the importance of the case is also emphasised by the fact that it deals with an issue which has always been of extreme importance in national academic writings, but that has been unveiled only recently in a European context: the notion of abuse of law and its assessment in a fiscal context.

The facts and the circumstances of the case are well known and not relevant in this research. It is significant anyway to focus attention on the fundamental freedoms allegedly infringed (Arts 43 and 48 of the Treaty: freedom of establishment) and on the anti-avoidance rule challenged in front of the Court: the British CFC regulations, considered as a choice of the sovereign state to tax specific companies in a peculiar way (thus a fully discretionary choice, particularly in UK Constitutional law). In this case, the Cadbury Group set up an Irish-controlled company to take advantage of the lower tax rates of that country, when compared to the UK ones. The tax saving was then reached through a leasing and financing operation from the latter to the former: the interests were tax deductible in the UK and, of course, taxed at a lower rate on the Irish subsidiary. In order to avoid this tax deferral, the UK, just like many other European countries, introduced CFC regulations, attributing to the resident parent company the profits (or part of them) realised by the non-resident subsidiary, without any necessity to wait for the distribution of dividends by the foreign subsidiary.

At first glance, provisions like these could impair the freedom of establishment because a resident company could be prevented from establishing a subsidiary abroad if this decision could then immediately and directly increase its taxable base. The UK CFC rules, considered alone, were reasonable because aimed at preventing the foreign allocation of profit where this decision is inspired mainly by tax considerations: the abuse in this case could consist of a business activity developed abroad (and not in the homeland) only for tax purposes. Surprisingly or not, the conclusions and the underlying reasoning were not so straightforward in the Union.

In the view of the Advocate General Legér (and then of the ECJ) tax planning across Europe is a legitimate way to spare taxes and the delocalisation of subsidiaries or branches of a company only for tax reasons cannot be challenged by the home state tax administration. It could be said, then, that a certain level of tax competition amongst member states is not only tolerated but reflects the need of a Common Market. In other words, tax motives are, in themselves, legal motives. The Advocate general clearly pointed out in his final remarks that when a parent company chooses another member state in which to establish a company only because in the latter the taxation is significantly lower, it isn't abusing the freedom of establishment enshrined in the Treaty. This conclusion was, all in all, already upheld in the *Centros*⁸⁷ case, even if the latter was not exactly a tax case.

For instance, in *Centros* the freedom of establishment was defended by the ECJ even if, in the specific circumstances, the seat of the company set up in the UK was merely artificial, as the main business was developed in Denmark. The same goes for a case in which the company was set up according to a member state commercial law and then was transferred to the UK or elsewhere. In these circumstances, the company tried to circumvent only commercial law provisions and no abuse is assessed even if the main seat abroad is fictitious or not effectively involved in any business at all. In tax cases, such as *Cadbury*, the distinction is not so straightforward, and the artificial nature of the subsidiary could constitute a reasonable limit to the fundamental freedoms of the Treaty. Of course *Centros* and *Cadbury* have a significant common ground. In both cases the Court ruled that the nationals of any member states can not use EU law to '[...] improperly circumvent [...] the national legislation or, in another point of the decision, that they are not allowed to [...] improperly or fraudulently [...] take advantage of the community law. When such conditions are not met, then no restriction to the freedom of establishment is allowed in an EU perspective, unless, and this is specifically a case relevant to tax law, other overriding reasons of public interest do not emerge. And even in this case the derogations and the limits to the fundamental freedoms must be

⁸⁷ Case C-212/97 *Centros Ltd. v Erhvervs-og Selskabsstyrelsen* [1999] ECR I-1459. In this case the UK was chosen because of the lesser conditions to be met in order to set up a limited company, in comparison to those in Denmark.

appropriate, proportional and consistent with the aim pursued. The sovereignty of the state has met therefore a new border settled by the ECJ, and particularly in one of the most important issues in taxation: the battle against tax avoidance (and evasion).

It is self-evident that the need of every member state for specific countermeasures to tax avoidance falls into one of the overriding reasons of public interest, but those provisions must be proportionate to the aims pursued and to the actual dangers. If this condition is not met, then it is the member state that abuses this possibility. That's why the Court plays a fundamental role in defining the notion and the condition of abuse: defining tax avoidance, it also contributes to the definition of abuse of right by the member state. In EU law this is particularly true: the abuse of the taxpayer is counterweighted by the abuse of the member state; both subjects are, to a certain extent, in an equal position in front of the Court.

Clearly in the specific view of this research it's interesting to note that the ECJ consider at the same level (and ultimately making the latter prevail) the sovereignty of the state in direct taxation, the interest of every country to defend as far as it could the taxable base on one side and the right of the taxpayer to set up even very aggressing tax planning schemes only insofar these don't reveal to be pure apparent constructions void of any business purpose other than pursue a tax reduction. The lesson taught by the ECJ is quite bitter in this respect. There is a sort of 'negative' tax law in EU, already in force and applicable, built up on the Fundamental Freedoms (namely, on market values) aimed at limiting the taxing power of the states. It's quite surprising (although legally founded) that limits to exercise of taxing power by representative bodies derive from others that are not. Obviously a *pars construens* of the European tax law is needed, but probably this is a duty to be taken by political scientists and not by lawyers, involving the mediation between conflicting interests of the states, cultures and traditions. Until now, only timid attempt by the Commission and by academics are advanced in this respect. The idea to introduce an EU tax is undoubtedly seducing, even if a different context⁸⁸ probably would be necessary in this respect.

⁸⁸ An European Constitution (either in a short or extended version) could be useful to emphasise those social rights that have already been pinpointed by academics and should constitute the background of an EU tax.

On limits and possibilities: the need for an EU tax in the eyes of the Commission

The need for a EU tax and the necessity to find new ways and means to find financial resource to the Union has been recently put forward by the Commission in a 'Report on the operation of the own resource system'.⁸⁹ The pages written by the Commission constitute probably the better example of the current situation in the Continent: plenty of theoretical possibilities (each one with advantages and drawbacks) on one side, lack of wide consensus by the member states on the other, and possibility of legal background in the Treaty, as will be discussed in the following paragraph.

The report start from a basic consideration: the current financial mechanism is inadequate both under a qualitative and quantitative aspects to match the needs of the larger Union. The qualitative lacks are to be found, in the view of the Commission, in the absence of a specific link between the financial necessities of the Union and the individual citizens,⁹⁰ as far as in the current system the cost of the Union is mainly supported by the member states (thus indirectly by the citizens only). The quantitative lacks (even if not directly specified, for obvious reasons) are to be found in the need of adequate resources for the always more demanding necessities of the Union, particularly in order to offer common resources to face common problems or needs: welfare necessities on one side, irregular immigration on the other, just to cite two different kind of issues affecting all of the states (the first one) and the borderline ones (the second one).

The aspect that struck the eye of the reader when analysing the mentioned report is the absence of any reference to an European tax, just like the word itself could hurt the sensibility of some states. It is probably for this reason that the conclusions of the report mention the necessity for a 'tax-based own resource', and not, straightforwardly, for a tax. The linguistic carefulness clearly pinpoints better than any other reference the cautiousness inspiring the behavior of the Commission. The compatibility of a 'tax-based own resource' with the Treaty is not discussed in depth by the

⁸⁹ COM (2004) 505 final, available at <http://europa.eu/legislation_summaries/budget/l34016_en.htm>.

⁹⁰ See p. 12 of the English version of the report (par. 6).

Commission, being more a technical body than a political one is focused at proposing a possible technical solution, leaving to other bodies, namely to the Council and the Parliament⁹¹ to establish the political conditions for the passage from this system to a future, more efficient one. In the eyes of the Commission, three solutions are feasible, involving: (1) the taxation of energy consumption; (2) the reference to the national VAT base; and finally (3) the possible implementation of a Common Consolidated Corporate Tax Base (CCCTB). There's no need here to analyse in depth the reasons which made the Commission focus the attention on these kind of taxes, but it is interesting to underline that two on three are related to consumption of goods (of a specific one in the tax on fuel, and on all of them in the second), while only the third is based on the income generated by specific taxpayers (the companies and some other legal entities).

The project of a CCCTB, although recommended by the Commissioner to Taxation and Customs Union Mr. László Kovács,⁹² did not encounter the expected feedback despite the extreme quality of the model and the lack of reliable alternatives on the harmonisation of the corporate tax base. The issues are not related to the lack of democracy in the definition of the features of the new system, but rather, as emerged, that some of the member states are afraid to lose a significant part of their competitive advantage towards the others and thus their capacity to attract foreign investments (such as it is happening in the new member states). In this perspective it seems that the most significant barriers to an EU tax in the perspective shall be raised not under a purely legal point of view, emphasising the lack of democracy in the process of the economic integration, but rather by a short-term cost/ benefit analysis by each state, afraid to lose ground in respect to the others. This is also true in respect of the two other provisions, namely the

⁹¹ And to the singular member states, for those who believes that an EU tax would lack of the proper legal justification in the current set of the Treaties: to a certain extent 'no taxation without recognition of the specific power in the Treaties'.

⁹² M. Tenore and F. J. Almeida, 'Conference Report: Common Consolidated Corporate Tax Base: the Possible Content of Community Law Provisions', (2008) 38 *Intertax*, at p. 400; C. H. I. J. Panayi, 'The Common Consolidated Corporate Tax Base - Issues for Member States Opting Out and Third Countries', (2008) 48 *European Taxation*, at p. 114; J. Freedman and G. Macdonald, 'The Tax Base for CCCTB: the Role of Principles' in M. Lang, P. Pistone, J. Schuch and C. Staringer (eds), *Common Consolidated Corporate Tax Base*, Wien, Linde Publishing House, 2008, at p. 219.

application of an EU tax on the VAT base (perspectively making VAT a fully EU tax) or on the consumption of fuel, not counting that some of the EU countries can not afford at the moment a significant reduction of the flow of income produced (this is also the case of Italy) and were the EU tax had to be intended as a new fee for the Union that would seriously reduce the support of the European citizens towards an always more expensive institution.⁹³

Continues: the legal background to the proposal and the feasible alternatives

As was mentioned in the former paragraph, the proposal by the Commission and by the Commissioner received a feedback by tax lawyers across Europe, while nearly all of them were in favor of a perspective EU tax, it was also noted in many cases that the state of the art of harmonisation across Europe and the letter of the Treaty do not allow it or discourage the implementation. This is probably an interpretation inspired by a black letter approach to the Treaty, but nonetheless it must be taken into account that the progressive slow down of the Constitutional step up of the Treaties, the adverse reactions of some countries (Ireland and Poland in the very last minute), and the widespread (although unreasonable) disaffection towards the EU institutions work against the adoption of a tax⁹⁴ in the current historical moment.

Anyway, the attempt to implement an EU tax should be made on the basis of Art. 269 of the Treaty reading 'Without prejudice to other revenue, the budget shall be financed wholly from own resources [...]'. Clearly the mentioned provision was introduced to determine a sort of apportionment of taxing powers between the member states and the Community.⁹⁵ In this perspective, it can't justify a taxing power, but only the subdivision of an (already applied) tax. The attempt to extend the meaning of the first part of the provision in order to encompass a possible EU tax could be done according the theory of the implied powers of the Union, but eventually would be too far reaching, as was mentioned by authors cited.

⁹³ The effect on the inflation on a national scale should be considered as well.

⁹⁴ In the Treaty there is not a definition of tax nor any reference to any possible form of it, see S. Heidenbauer and R. Piscopo, 'Report on the Conference: EU-Taxes', (2007) 35 *Intertax*, at p. 653.

⁹⁵ More to the point, it is clearly a provision used as a legal basis to allocate income from national taxes to the Community.

Other possible legal grounds to establish an EU tax on are Arts 175⁹⁶ and 308 of the Treaty, the first one regarding environmental taxes and the second one being a sort of last instance instrument that can be used only while pursuing a specific goal on in a specific context of the market. Theoretically speaking, Art. 308 is the only one that could now justify from a purely legal point of view the implementation of a new tax (or a different apportionment of an already existing tax), but yet the problem scientifically speaking shifts from a legal to a political perspective, and therefore outside the scope of this research.

Concluding remarks (escaping the Sieyès's curse)

One of the greatest lawyers of the French revolution, Emmanuel-Joseph Sieyès,⁹⁷ considered that radical reforms or political innovations were possible only along breaking lines (rupture) of the constitutional order. Of course his impressions derived from the peculiar situation France was facing on those days before the *états généraux* were summoned by the King. In any case, I think that the French lesson could somehow be useful nowadays to inspire the reasoning on the relation between democracy, economic integration and taxes. The three concepts are not randomly written, but ordered according to a priority which also derives from the personal convictions of the writer. Democracy stands first, economic integration follows and taxes are to be considered only a means amongst various ones⁹⁸ to provide resources for the first and the second.

Economic integration could not need directly taxes, or direct taxes by the Union. Other ways and means could be found in the European Central Bank (or better the European Investment Bank) and on the possibility to issue bonds or an European debt to be used for the purposes the Council (or better, the Parliament) will judge as worthy to be pursued, possibly according to a revised conditionality

⁹⁶ Particularly at par. 2. It was also noted that in this case no violation of the principle 'no taxation without representation' would occur as far as the environmental tax would have to be implemented by every national parliament.

⁹⁷ E. J. Sieyès, *Qu'est-ce que le tiers état?*, Paris, 1789, particularly at par. 6.

⁹⁸ It was already theoretically considered the possibility to introduce a 'seignorage' fee on the emission of the euro currency, then discarded by the reason that it would leave unsolved the problem of the countries belonging to the Union (most notably UK) and still preserving their national currency.

mechanism as that used by the IMF, deprived by the elements that lead in the past to so much criticism by some authors and academics.

The Union is still too young to be in a legitimate position to request specific taxes; to a certain extent, the sacrifice of the personal possession (protected by the ECHR) to the advantage of a supranational body will be politically conceivable only when citizens in the continent shall begin to think to themselves more in terms of Europeans rather than Spaniards, French, Italians and so forth. Speeding up this mechanism is theoretically possible, but the economic asymmetries⁹⁹ still present in the continent would be difficult to be politically overtaken and the introduction of an European tax can be all but a zero-sum game.

The Union as it is, particularly its blueprint in the treaty of Rome is the outcome of one of the most tremendous ruptures the world had ever experienced. The people who witnessed the forties and worn on their skin the scars of the war were so brave and far-sighted to build Europe from the ashes of the conflict. As a matter of fact, the more that generation extinguishes, the more the European harmonisation process slows down and the national particularism rises, and taxation is possibly the edge of that. It's on the current policy maker to decide whether to test the accuracy of Sieyès' prediction once more or set aside in the more convenient way the national egoism in favor of a larger home for everybody. Probably Europe will not stand another rupture, and most certainly the younger generations do not deserve it.

⁹⁹ To be interpreted as 'diversities', thus in a very broad meaning, see D. G. Mayes and M. Virén, *'Asymmetries in the Euro Area Economy'*, Bank of Finland Discussion Papers 8, 2004.

Chapter 12a

Can economic integration be democratic? The case of taxes

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Introduction

This chapter is a comment to Marco Greggí's chapter, which is full of interesting ideas and well worth reading with care and in detail. I began by trying to decide what questions it was asking. I conclude that there are three: (1) What would be a democratic tax system?; (2) How would this translate into an economic union?; and (3) How well does it apply in the EU?

It would probably be appropriate to try to break down the question according to the types of taxation: personal income, corporate income, expenditure, wealth (property) and capital gains and of course to include charges for public services as they all form parts of public finance. The pressures on the system relate far more to income tax and corporation tax than they do to expenditure taxes, although smaller countries with land borders may be substantially affected by cross-border shopping (once excise duties are included even sea crossings can become economic as is seen between Estonia and Finland for example). However, this disaggregation would lead to a very complex approach for a short comment. These remarks therefore

focus on a selection of the issues raised in the chapter under the three headings just described.

What would be a democratic tax system?

This is quite a difficult question to answer. The chapter rightly emphasizes the basic tenet of 'no taxation without representation'. However, we can ask what this would mean in practice. The simple interpretation is that the individuals to be taxed have the opportunity to vote for the people who are going to determine what taxation shall be. But is this enough? There are three sorts of questions one can ask about taxation. The first sort relates to what is to be taxed, what the rates might and how they should vary over different sectors, locations and groups in society. But on the whole, discussing one side of public finance and expenditure does not make much sense. Taxes are not raised for their own sake but to finance spending on public services and to provide an element of redistribution towards the less fortunate in society. One might wish to argue that what one wants representation for is decisions on equity. This second sort of question probably lies more at the heart of the debate than does taxation *per se*. People are probably more concerned about net benefits and costs than they are simply about the gross tax rate. The third issue surrounding taxation and democracy relates to the deadweight cost or efficiency of the system. It is one thing to have views about how taxes are raised and spent but it is another to have views about the burden imposed by the process. Some forms of taxation are cheaper to collect than others – one reason for having zero tax rates for low incomes has nothing to do with equity; it is simply that the collection cost for both parties is too high relative to the benefit/yield, especially if such groups are in any case likely to be net beneficiaries.

European integration certainly introduces some complications in regard to taxation from all points of view. Simply adding a layer of government is likely to increase the deadweight. Redistribution becomes more difficult to work out and the relationship between taxation and the decisions regarding it more indirect. At present, certainly the principle of no taxation without representation does not apply to anyone in the EU living outside their country of citizenship. Elsewhere, the principle does apply. In New Zealand, for example, any resident has full democratic rights irrespective of nationality and indeed irrespective of whether they are paying taxes. Of course one does not ask whether it would be appropriate to reverse the epithet

and suggest no representation without taxation, although that is precisely what used to be the case in many European countries. Those who are paying should have more of a say over how the money is spent – that principle is certainly applied in other parts of society, even though it would be viewed very unfavourably for enfranchisement as a whole.

As a generality, one might wish to conclude that tax systems per se are not particularly strongly associated with democracy. It is certainly difficult for any voter to express a view about the tax system per se. Taxation is usually bound up among many other policies. However, tax cuts in some form or another are frequently devised in order to win elections, even though the consequences of such cuts may be less clearly spelled out. In a sense of course one could apply direct democracy provided that it possible to match the electoral unit and the tax raising unit fairly directly, as is the case in the Swiss cantons. At this level, direct questions about taxation can and have been put. Indeed, balanced budget requirements have been added by referendum in a number of the US states. To a limited extent, it is also possible to exercise one's views about taxation by moving to other jurisdictions where the mix is more congenial. This of course is a major fear in the EU; that those paying the highest tax migrate to the low tax jurisdictions and those receiving most benefit move to the highest benefit locations. The inequality then becomes worse as the low tax regime can now raise revenue more readily and may be able to reduce tax revenues while the high tax regime is both losing taxpayers and gaining beneficiaries.

One of the issues in taxation that has a direct impact on the relationship with democracy is where government revenues instead are raised far more through user charges. In these cases, charges can be made to vary with income. Fines, for example, are income related in a number of countries, such as Finland. If the penalty for an offence is to have the same gravity of impact on people with different incomes, then the fines need to be different. Support for education is often means-tested. In these ways, issues of equity in terms of access to public resources are dealt with directly rather than indirectly through the tax system.

How can an economic union have a democratic tax system?

If we look at an economic union, the simplest way to approximate the democratic nature of a national tax system would be to have a single tax system. Provided of course there was an electoral match, then the national system would be reproduced at the federal level. A simple alternative is fiscal federalism. This admits that the ability to raise taxes varies from region to region as does the need for expenditure. In this way, prior discrepancies in the ability to operate the same system across the union are removed. While under a single tax system some degree of centralization is presupposed, under fiscal federalism there is simple netting at the regional level, and the payments that have to be made from the richer to the poorer areas to achieve any particular level of equity are minimized. However, for such a system to work effectively it probably needs to be accompanied by complete freedom of movement of people.

Democracy vs. fairness

To some extent, the issues being discussed here are confused, because highly democratic ways of dealing with taxation may not at the same time meet the conditions of fairness. One example is free-riding. With freedom of movement of persons it may become impossible for a country to impose the tax and benefit system that its citizens would like because migrants can make it uneconomic (this is not a symmetric problem as migration, which makes tax raising easier, is not going to inhibit the ability of society before immigration to have the tax and benefit system it wants after migration). As is mentioned in the chapter, take the case where a poor country or poor region is faced by a lot of wealthy visitors. A normal device, as practiced in Maldives for example, is to tax the visitors. Differential pricing is not normally possible, although it may be. Prices in resorts can be much higher than in the country as a whole. Differential prices can be demanded for public facilities. (Some countries play the system the other way round and actually subsidise travel for visitors.) In Maldives, hotels have to pay a tax on every visitor bed night. However, this is not a simple occupancy tax as residents and people with work visas are not charged it. The EU does not permit such discrimination.

The EU system, on the other hand, already offers the opportunity for tax equalization. A resident in one country earning income in another is supposed to pay tax in the country of residence rather than earning – covered by double-taxation agreements. However, there can be loopholes where residents can claim to be not permanent and are hence not domiciled and can reduce their tax liability. Some countries solve this by imposing withholding taxes so that whatever avoidance is possible abroad, the tax is not reclaimable unless it can be shown to be paid in the country of residence. Sometimes such equalization can be more direct. More New Zealanders live in Australia than Australians live in New Zealand. The New Zealand government therefore makes a transfer to the Australian government to cover the discrepancy (based on the net benefits payable in Australia and not those that the people would have received at home).¹

In the EU, there are examples of topping up provisions whereby people receiving benefits at a lower rate from their home state can top up to the levels of domestic residents. Deposit insurance is a case in point. In general, however, migrants do not face equality of treatment and lose some or all of their accumulated benefits and have to start again in a new location. A retired person may for example get free transport in his country of origin (having effectively paid for it in past taxes) but not be able to get it in his new country of residence. This is equal treatment when looked at from the country of residence but unequal when looked at from the point of view of the country of taxation. Thus, if you view taxation in part as being an insurance scheme, if that insurance is not transferable, then a union will be inequitable compared to a nation state and there may be no democratic route of recourse. There is some evidence that people do indeed move to try to take advantage of the anomalies, but until recently such movement in Europe has not been very widespread.

How does the EU match up?

An initial remark is simply that if it wished to, it could achieve similar levels of equity across the Union relatively cheaply if payments are to be only net. The MacDougal report of 1977, for example, suggested that only a net budget of 2.5 per cent of EU GDP was required and only five to seven per cent gross if current

¹ Dollar for dollar the New Zealand system is more generous but average incomes are higher in Australia, the difference being affected by the exchange rate.

expenditures were maintained. This of course related to the EU9, but similar figures were obtained by Mayes and Begg² for the EU12 (while the sums would not have worsened for the EU15, it is likely that they would be larger for the EU27 but steadily being improved by the structural and cohesion funds.)

There are some small issues stemming from spillovers, particularly in border regions, both from an environmental point of view, where one country can impose costs on another, and where a person can commute across borders. However, these are usually relatively small by comparison.

Harmonisation

The principal worry expressed about the EU and other economic unions is that there might be damaging tax competition in the sense that taxes are competed downwards to a level that damages the provision of public goods and services to the needy in the least competitive locations. It is however not immediately obvious that this is how tax competition works. In the case of corporate tax, for example, it is a common tactic to improve employment opportunities in disadvantaged regions to create tax free zones or at least allow substantial periods of tax relief to get firms started. Thus, the employment-creating aspect is deemed more important than the revenue distortion. Isolating just the tax aspect of competition is therefore insufficient in considering the impact of the system and the interaction with democracy.

Secondly, there are countries where tax competition is permitted and any rush to the bottom is very limited. Finland is a good example, where local income tax represents about 40 per cent of total income tax. Local authorities tend to compete in attracting industry by the provision of good facilities both for the firms and for their employees. Thus, the concern is rather more over the provision of infrastructure than it is the impoverishment of disadvantaged regions and groups in society.

² D. G. Mayes and I. Begg, 'A Strategy for Economic and Social Cohesion in Europe after 1992', Regional Policy and Transport Series No. 19, European Parliament, Luxembourg, 1991.

An area focused on in the Lisbon Strategy is competition over the tax wedge (the difference between the total tax on labour and income tax paid by the employee). Indeed, the Strategy encourages such competition as it argues that a high tax wedge is one of the factors reducing both EU competitiveness and employment. Tax competition can hence be a positive force for social objectives.

Clearly there are many aspects of tax policy where there can be distortions, which the EU might want to address. Why, for example, should corporate or personal income be privileged? Does it make any real difference whether I operate as a partnership or self-employed and pay income tax or turn myself into a company and pay company taxation? One might want to argue that the tax rates should be the same so that I can make a choice based on merit of how to organize my business.

In any case, why is tax competition such a bad thing? It is part of the ideas behind integration that people should be encouraged to integrate and hence to move. Movement of both businesses and of households will contribute to that. What is appropriate will depend on social as well as economic objectives.

The real problems related to democratic relationships however occur for taxes that relate to the European level in the current institutional structure. Currently EU taxes are hidden. They are either collected directly before reaching the individual, as in the case of import duties, or indirectly by government transfer. There is an amazing idea that support for the Union might be increased by having identifiable direct taxes, say on telephone calls³ or even that part of income tax should be identified in this way. Revealing the EU as being an identifiable cost strikes me as one of the quickest routes to making it unpopular. The current process of trying to identify projects financed through the EU, even if such a route financing made them more expensive, makes far more sense even if it is many respects dishonest. (If a country is a net contributor to the EU then it is very difficult to imply that others have contributed to the expenditure. Indeed, for a country that contributes 10 per cent more than it receives some will

³ I. Begg and N. Grimwade, *Paying for Europe*, Sheffield, Sheffield University Press, 1998.

want to argue that any EU project has been 110 per cent financed by the domestic taxpayer!).

Compromise

It seems inevitable therefore that solutions to the problem of having various levels of responsibility for taxation, and hence different wishes for both expenditure and taxation, will be an element of compromise between having a completely harmonized system over the EU and allowing unfettered competition among the states/regions.

The current system provides some limits, although these tend to be fewer than the restraints on expenditure, say, through state aids. However, much of the approach stems from trying to run a good monetary policy focused on reducing inflation and imposing a measure of fiscal prudence through the Stability and Growth Pact and the Broad Macro-Economic Policy Guidelines. One of the biggest steps forward in fiscal policy has been to get it focused on the longer term so that it can cope, *inter alia*, with the ageing of the population without impossible strains on debt. Further steps in improving fiscal policy may be possible but it looks far more likely that the debate in Europe will continue to be about prudent fiscal policy rather than taxation *per se*. The relation between taxation and democracy, although relating to a fundamental tenet of sovereignty, may be largely subsumed in the relation between fiscal policy and democracy.

The RECON models

The renationalisation of tax policy will do nothing to solve the fundamental problems faced by taxation across borders in the EU but federalism could address most of them. Certainly it could address the fundamental concern of no taxation without representation. It then reduces tax issues to the same level as within a diversified nation state. Federal countries such as Canada have been able to cope with considerable variety of wishes among their component states. However, a key feature of most federal systems is that the role of the centre is relatively strong. It is debatable whether this has to be the case in a federal system in Europe. Even with fiscal policy at the European level accounting for less than 10 per cent of GDP, *i.e.* less than a third of total spending/taxation, all the normal objectives of a

federal system could be met, particularly in terms of regional equity. The problem is clearly more difficult over the coming years since the expansion of the EU to include 10 transition economies but even so the absorptive limits would tend to keep the budgetary issues within bounds.

It is the cosmopolitan model that provides the most interest and complexity. Certainly, if considerable proportions of taxation can be decided at a relatively local level then a much more direct involvement in decision making over taxation would be possible. The higher the level/larger the area, the more issues will tend to be bound together and the smaller the chance of affecting taxation per se. However, even this may be pessimistic if we consider the importance of taxation in some election campaigns. Cuts in taxes or promises not to raise them can be very important aspects of the election platform. In smaller units it appears to be possible to hold referenda to mandate prudent policy, such as balanced budget or golden rules. Indeed, probably the only way to get serious democratic involvement in the tax system as a definable issue is through direct democracy. Perhaps, therefore, the Swiss model is one of the ways to look at how a cosmopolitan system might work. Some simple, direct rules can be placed on the system. A substantial part of the tax burden could be decided at the local level, while the bulk would be a national concern, still leaving a sizeable proportion to be determined at the EU-wide level. This implies a variety of democratic involvement and, while much less simple than the federal route, may indeed prove to be the most democratic, because it assigns decision making to levels appropriate for the particular forms of expenditure to be financed. Indeed, the cosmopolitan model makes much more sense by starting with different sorts of expenditures, and how localized their determination can optimally be, before considering how the decisions about their financing might be allocated. Thus, while the time honoured slogan may be no taxation without representation, the more critical and prior issue may be over who decides about which areas of expenditure.

Chapter 12b

Is the labour constitution normatively prior to the democratic constitution?

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Introduction

The comprehensive and sophisticated analysis of European labour law contained in Florian Rödl's chapter shares quite a number of intellectual concerns and normative premises with the papers to be found in the first part of this report. It contains a succinct but all-inclusive analysis of positive law by reference both to constitutional categories (with the tripartite distinction between fundamental rights, guiding principles and competences). Furthermore, it provides an alluring socio-economic assessment of the sources of the 'legitimacy' crisis of European labour law, and of European integration in general. Indeed, the author rightly affirms that the erosion of the legitimacy basis of Community law has found expression in the negative outcomes of the Constitutional Treaty referenda and in the social backlash experienced after the rather silly decisions -if the reader allows me to betray my admiration for the Goons- of the ECJ on *Laval*,

Viking Lines and *Rüffert* (the troika horribilis of the Court).¹ In his view, the legitimacy crisis of the Union finds its roots on the betrayal

¹ So horribilis that they seem to have provoked a lost of faith in Rödl. Cf. with his comments *just* before the trio of decisions, not obviously in line with his present argument: 'To avoid any deregulatory pressure, labour law scholars have urged that labour regulation be taken out of the application of market freedoms and that collective bargaining should be taken out of the scope of competition law. But this would appear to be a step too far. Market freedoms do not just represent the interests of foreign corporations, and competition law does not just represent the interests of corporate competitors or an overall interest in efficiency. The conflict of market freedoms and competition law with national labour regulation must also be interpreted as a kind of mediation of the competition of labour constitutions. The capacity of foreign corporations to compete with products and services on domestic markets also represents a result of the functioning of a labour constitution, and it comes into conflict with the domestic labour constitution via the four freedoms and via competition law. Taking labour regulation out of the application of market freedoms or out of competition law would resolve a conflict of labour constitutions unfairly by granting full advantage to only one of them. *This is why the line established by the European Court of Justice deserves approval in the light of our reasoning. It says, in the case of the market freedoms, that labour law might account for an impediment of a market freedom, but that it is valid if it stands the tests of Keck and of Cassis de Dijon.* These tests establish accommodations of the conflicting labour constitutions mediated by the legal conflict between individual market freedoms and national labour regulation. With regard to the *Cassis* test, the Court ruled that even the extension of mandatory national wage scales to foreign workers is upheld. Sure enough, the Court did not apply the conceptual idea of competing labour constitutions, not even for one side of the conflict, the national labour regulation of the host country. It did not put it in terms of the protection of the autonomy of a labour constitution, but instead chose to approach the case only in terms of social protection of workers. This led to the effect that, according to the Court, the level of protection of a foreign worker has to be compared with his level of protection at home. On the basis of reinterpreting the case in terms of conflicting labour constitutions, this seems questionable. The common good to be invoked would not be the social protection of workers but support for the domestic labour constitution against harmful competitive pressure; but even then a comparison of social standards misses the point. Moreover, for the institutions of a labour constitution which go beyond mere social protection – for example, the German model of codetermination – the Court's conceptual choice is inadequate. Thus, the reference point of justification must not be understood in terms of the protection of workers, but in terms of adequate support for the domestic labour constitution. *In conclusion, the Court's jurisprudence on the Fundamental Freedoms aims to provide a restrained form of autonomy for national labour regulation; European law will, to a certain extent, which is defined by the Keck test and a refined Cassis de Dijon test, allow national labour constitutions to be supported by means of domestic regulation',* in F. Rödl, 'Constitutional Integration of Labour Constitutions', in E. O. Eriksen, C. Joerges and F. Rödl (eds), *Law, Democracy and Solidarity in a Post-National Union*, London, Routledge, 2006, pp. 165-6.

of the 'social compromise for integration' underpinning the founding Treaties of the Communities. Such 'social compromise' can be succinctly expressed as follows:

The Member States labour constitution shall thus remain both legally autonomous from the Constitution of the Common Market and factually autonomous from its effects.²

The founding social compromise would have been broken by the confluence of what, in a rather liberal rephrasing of Rödl's more precise terminology, could be referred to as (1) a radical reconsideration of the implications of the four economic freedoms, the extent to which they assign preference to mobility of workers and mobility of capital³ over any other constitutional principles, including fundamental socio-economic rights and collective goods; (2) the very specific design of European monetary integration, which rules out the use of exchange rates as a means of buffering the national economy from more or less covert forms of social dumping without recreating any functional equivalent through (one guesses) some form of European *gouvernement économique*; (3) the suicide – assisted in some cases by fervent neo-liberal governments – of trade unions.⁴ In particular, and again seems to me that the author is essentially right, Rödl claims that the dramatic transformation of the role played by European law has to do both with the instrumentalisation of economic freedoms ('the actual state of mobility for the production factors labour and capital makes it impossible to abolish competition based on labour costs completely, a fact which represents a fundamental shift in the power relationships between capital and labour')⁵ and the mismatch between European constitutional labour law and the capacity of European institutions to flesh it out.⁶ This lack of 'congruence' leads Rödl to conclude that the formal European labour constitution is in reality a 'camouflage', a way of window-dressing what has at its core has become an anti-labour, pro-capital instrument.

² At p. 375.

³ Something which, by the way, is not done only and exclusively through the construction of free movement of workers and of capital, but in many occasions is the consequence of freedom of establishment and provision of services, as in the case of the posting of workers.

⁴ At p. 377.

⁵ At p. 377.

⁶ At p. 384 and from a historical perspective, at p. 393; indeed since Maastricht we would have experienced an 'asymmetric development: the expansion of rights and principles on the one hand, and the stagnation of competences on the other'.

On such a basis, Rödl concludes that, besides some false solutions (like the mirage of social governance, which he rightly points is based on the flawed and historically dangerous assumption that the societal conflicts articulated by labour law are the result of inadequate knowledge, of cognitive deficits or dissonances) or some marginal reforms which would be wise to implement (and which he essentially considers at the end of the chapter), the 'real' solution requires restating the social compromise for integration, which

means above all else that the norms of the Member States generated on a labour constitutional basis shall not be threatened by restrictions that did not exist before the beginning of the project of European integration. *What is needed therefore is an effective protection of the autonomy of Member States' labour constitutions.*⁷ (my italics)

In legal-dogmatic terms, Rödl is persuaded that this requires reconsidering the principle of primacy of Community law, which should not be extended to the relationship between Community law and the national labour constitution. Otherwise, the national labour constitution cannot but be impaired, because the 'societal functional logics' of European constitutional law and of national constitutional labour law are necessarily antagonistic. It is worth reading the paragraph with clear Luhmannian undertones in which this simple idea is expressed:

In these constellations, the mere enforcement of primacy equals the extension of societal functional logics that are subject to Union law and competences (competition and the single market) to the detriment of those functional logics that are to be instantiated by Member States according to their order of competences.⁸

And that is precisely why the rulings in *Laval* and *Viking Lines* are so problematic; even if they could be found to be reasonable in abstract terms, and even if they vow to the European labour constitution,

⁷ At p. 399

⁸ At p. 404

including the always revolutionary right to strike safely within the precinct of the European constitution, the judgments *do* indeed impinge upon the functional logics of national labour constitutional law. To quote again:

The ruling in Laval is a flagrant breach of the principle of protection of Member States labour constitutions against EU law, which is functionally bound by other objectives and foundations.⁹

Reiterating again my sympathy and empathy for the main thrust of the argument, I may say that it is not fully obvious whether the transition from diagnosis to prognosis is justified. In my view, the author is carried away by a rather particular, and in my view, wrong understanding of what the labour constitution is about; an understanding which, as I will argue, stands in paradoxical contrast with the underpinning normative assumptions of the article, to the extent that the idea of a pre-political constitution, be it economic or labour, has the smack of political conservatism if not reaction. This comes hand in hand with what to me seems a too generous assessment of the rulings of the European Court of Justice as expressive of the proper construction of European constitutional law, at least expressive of its underlying functional logics. These two assumptions push Rödl into what seems to be a nostalgic longing for what probably never was, namely, the autonomous national labour constitution, and renders him blind to the nitty-gritty of the miscarriages of European constitutional law resulting from the triumph of the single market conception of the European Union.

To start from the beginning: The labour constitution. The first section of the chapter is indeed telling of the way in which the author understands the labour constitution. By that he does not seem to mean whatever provisions governing labour or industrial relationships in the constitution or derived from the fundamental law, but a material constitution which reflects the functional logics prevalent in the social field of production and employment. In that sense, one is left to guess

⁹ At p. 406

the soundness of the formal constitution can be assessed by reference to whether or not it properly contains the material labour constitution:

the collective dimension of labour law is the labour constitution, not because it can be found in the written constitution itself, but because, from a substantive point of view, its formal foundations have a constitutional function¹⁰

Indeed, Rödl seems to suggest that it is the labour constitution that is constitutive of politics, and not the other way around:

The labour constitution does not only restrain the power of the private owner-employer, rather it constitutes the societal actors within the societal field of labour themselves, and determines their relationship.¹¹

There we have, thus, a pre-political conception of the labour constitution which is not so different from that of the economic constitution in, say, Frank Böhm.¹² The difference may lie in the normative substance which is said to be contained in that peculiar material constitution, but not in the idea that there is an order intrinsic to societal subsystems which is prior to the formal, conscious and willing order agreed by citizens in the written constitution. This conception is at odds with the normative underpinnings of national constitutional law (and thus of European constitutional law, as I will claim that latter is but the synthesis of national constitutional norms). Not only because constitutional law in the national constitutional traditions is regarded as the *lingua franca*, the normative pidgin which allows us to talk across societal subsystems (if the reader wishes to use that term to refer to different aspects of political and social life), but also because the constitution is premised on its being created and recreated by the general political will, not by objective social circumstances.¹³ What is left of democratic constitution-making if we

¹⁰ At p. 365.

¹¹ *Ibid.*

¹² A. Peacock and H. Willgerodt, *Germany's Social Market Economy: Origins and Evolution*, Basingstoke, MacMillan, 1989

¹³ This does not imply that the constitution has to remain aloof of societal circumstances, only that it is premised on the capacity to change societal practices

consider that all societal subsystems have a material constitution as the labour constitution described by Rödl? Not much, I am afraid. Democratic constitution-making would be a matter of scribbling in the margins of the Luhmannian accounts of what the subsystems logics are.

And even more to the point, what are the trumping arguments which give priority to one subsystem over other subsystems? If those arguments are functional, it is not obvious why the smooth functioning of a capitalist economy requires sheltering the labour constitution (from a systemic perspective, there is also a specific configuration of the market and the labour constitutions, and it is not obvious why it is less efficient, measured by GDP growth; Barro's argument may be bizarre, but if functionality is what counts, I am at a loss to defeat them).¹⁴ To reveal the nonsense of a purely functional approach one must seize the normative ground; but the normative ground in modern, pluralistic societies can only be democratic legitimacy through democratic law.¹⁵ But again, democratic legitimacy is not easy to reconcile with the idea of pre-political sectorial sub-constitutions. To rehearse the previous claim: democratic legitimacy presupposes that we have a language (constitutional law) which can solve conflicts across societal subsystems, and thus integrate society, by actually integrating individuals and also social subsystems, from a normative, not a functional standpoint. But if that is so, we cannot simply stick to the pre-political understanding of the labour constitution without being vulnerable on both empirical and normative grounds.

Besides the problematic normative implications and pedigree of this particular conception of the labour constitution, it could be wondered whether it provides the proper lenses to understand European law and European labour law. We could acknowledge and even admire

and structures, even if in that long run in which all are dead. But as Jean Robinson aptly put it, the fact that we are all dead in the long run does not mean that we all die at the same time.

¹⁴ See for example R. J. Barro and X. Martín i Sala, *Determinants of Economic Growth*, Massachusetts, The MIT Press, 1998.

¹⁵ J. Habermas, *Between Facts and Norms*, Cambridge, Massachusetts, The MIT Press, 1996, at p. 110.

the intellectual tradition of the labour constitution as Rödl describes it, and still recognise that if taken too literally (if I may so, if the labour constitution loses its original Sinzheimerian flavour and gets intoxicated by a peculiar Luhmannian vision), it is a poor fellow traveller, as gets rather seasick once it leaves the coasts of Germany (perhaps not by coincidence, the very coast in which the alleged founding father of modern international law capsized). If the implicit model of the German labour constitution at work here is to be sheltered by European constitutional law, that is not on account of the peculiar institutional arrangements it consists of, but on account of the fact that such institutions ensure the proper realisation of a set of fundamental rights and collective goods, which correspond to the fundamental rights and collective goods that the common constitutional law should foster. If we focus on the key normative principles which underpin the German labour constitution, *they can and should travel across national legal borders*. If we stick to the specific institutional arrangements of the German model, they travel very poorly, and there are no obvious reasons why they should be protected on account of their claimed functional coherence; provided (and that is what I would say the European decision-making has utterly and shamefully failed to do, in an argument à la Bercusson, to make myself clear)¹⁶ equivalent institutional arrangements could be established ensuring the realisation of the said rights and goods.

Furthermore, this conception of the labour constitution translates to the lofty functional language what seems to me a much simpler constitutional problem. The original democratic legitimacy of European integration was fundamentally anchored to national constitutions, on the basis of which, as already hinted at, my claim is that it is proper to recharacterise European constitutional law as a form of synthetic constitutional law. This normative basis explains the peculiar shape and limits of European integration. The common market project was indeed not geared towards the imposition of a homogeneous socio-economic order at the European level, but at the non-discriminatory reconfiguration of each of the national socio-economic orders. It is only when the common market is replaced by

¹⁶ See the post-homous edition of *European Labour Law*, Cambridge, Cambridge University Press, 2009.

the single market as the underpinning conception of the Union that both the deep democratic problems that plague European integration and the 'social' deficit of the European Union become obvious to everybody to see. In reality, it seems to me that the latter can indeed be explained as essentially a consequence of the democratic shortcomings of integration. Rödl himself seems to come close to that when he affirms that indeed the premises and operative parts of *Laval* and *Viking Lines* are essentially counter-majoritarian. But I may add that Community law is not only problematic from a democratic standpoint because of the lack of congruence to which the author of this chapter refers, but because of the interplay between the institutional structure, the division of competences, and the division of labour between decision-making processes. But all this, again, has nothing to do with pre-political objective functional requirements, but is indeed reflective of political decisions (or series of non-decisions, to be more precise).¹⁷ That are, indeed, the kind of research questions at the core of RECON. Indeed, this only proves that the article is paradoxically perhaps a trifle too kind on the European Court of Justice. Besides the fact that the Court lacks the formal authority to have the last word on the interpretation of European constitutional law, it is clear that no court should have that authority. But then, could it be the case that *Viking* and *Laval* are but the last in a rather long list of judgments which put forward a wrong understanding of European constitutional law? Or at least, an understanding hard to reconcile with the proper democratisation of the European Union?

Indeed, the attachment to the material conception of the labour constitution, especially when coupled with a plea for national constitutional autonomy, seems to betray a nostalgic state of mind, which may cause this too generous assessment of what the Court has been doing.¹⁸ Rödl gets it exactly right when he talks about the instrumen-

¹⁷ See A. Menéndez, 'The European Democratic Challenge', 15 (2009) *European Law Journal*, pp. 277-308.

¹⁸ That does not imply a questioning of German labour law as interpreted by Rödl because it is national, but only because it is highly idiosyncratic. As already hinted at, European constitutional law is in my view properly reconstructed as a *synthetic constitutional law*, in which national constitutional traditions play a key and decisive role. Among all these traditions, the German one is rightly perceived as the most

talisation of economic freedoms at the service of capital. This is what we have been witness to, as documented in all chapters of the first section of this report. And still, the peculiar form of hyper, *über* or supercapitalism that has been endorsed in a fit of absent-mindedness by the ECJ is hardly dissolved by a return to the cosy world of national labour relationships. That seems to me as ineffective, even if motivated by much more noble intentions, as the strategy of marginal constraining market freedoms through the doctrine of abuse of economic freedoms.¹⁹ Paraphrasing what Rödl rightly says about the Open Method of Coordination, the problem is not one of constitutional limits, but one of reconfiguring the relationship between market, polity and insurance community in a transformed societal context, where there are very good reasons why we do not want to recreate separate national economies. Indeed, he grants that by recognising the emancipatory potential of the principle of non-discrimination, and in general, of realising equality through Community law. This presupposes a degree of integration beyond the mere separation of European constitutional law and national labour law. As several of us claim in the first section of the report, the million euro question is how European constitutional law is to be understood. By regarding the functional logic of the internal market as an immutable one, Rödl is playing in the hands of the most neo-liberal judges and Advocates General. But there is no intrinsic functional logic to the internal European market, because indeed it is the case that there have been several such logics in different moments

prominent one (together with the French). The incoming tide of European constitutional law has been also a German tide, with many borrowings from German constitutional law into the constitutional law of other Member States and of the European Union as a whole. But if the European tide has been German was not out of respect or veneration to the German tradition as *German*, but because it incorporated the soundest articulation of the constitutional principles common to all Member States. But can that be said of what Rödl claims is the German labour constitution, if as he himself claims, is to be constructed as a pre-political, pre-constitutional order constitutive of democracy, and not the reverse? That in itself discredits the German labour constitution as a candidate to play the role of common labour constitutional law for Europe.

¹⁹ An account in P. Schammo 'Arbitrage and Abuse of Rights in the EC Legal System', 14 (2008) *European Law Journal*, pp. 351-76. The way in which the Advocates General and the Court have articulated abuse of rights fits into a neo-liberal understanding, not in a sound constitutional theory of fundamental rights, or so I argue in the introductory chapter of this report.

of the history of European integration. When the ECJ decided that it will start defining restrictions of economic freedoms as to encompass non-discriminatory obstacles, the Court was not responding to the inner logic of the single market, but was reacting to a series of political signals.²⁰ And by doing so in the absence of the kind of 'congruence' between constitutional norms and legislative competences, it was bound to stretch its institutional capacities and legitimacy credit. But to summarise, there is nothing pre-given or intrinsic in these developments, but they are the result of decisions the appropriateness of which can be judged, and which can eventually be reversed, either through a clever reconfiguration of the law by the ECJ itself, or, at this point less probable, by acts of constitutional decision-making. Once we focus on the gritty-nitty of the case law of the Court, it seems that we are confronted with a more banal reality. Namely, a series of *dérapages*, perhaps properly translated as constitutional miscarriages. A conclusion which is aesthetically unpleasant, but life is, after all, unfair.

²⁰ And making a mistake, as the late AG Geelhoed reminded the ECJ with increasing urgency. See J. Bellingwout, 'Amurta, A Tribute to (the late) Advocate General Geelhoed', (2008) *European Taxation*, pp. 124-132.

Chapter 13

The European Republic Utopia or logical necessity?

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Introduction

Fifty years after its foundation, the European Union is in crisis. Public support for the Union is waning. The 'permissive consensus' which allowed the gradual deepening of European integration for the first three decades, has turned into 'blocking dissent' by veto players. Governments can score higher points with their electorates by 'drawing red lines in the sand'¹ than by promoting benefits from European policies. Voter turn-out at European parliament elections is falling and negative referenda on European Treaties are becoming more frequent. For some observers, European integration has gone too far, while, for others, it is not going far enough, but evidence points to the fact that voters often reject '*this* Europe', not 'Europe' as such.² The rejection of the Constitutional Treaty by the French and

¹ This was the formula used by the British prime minister in the negotiations of the Constitutional Treaty and then in the Treaty of Lisbon, see <<http://www.independent.co.uk/news/uk/politics/pm-draws-his-lines-in-thesand-before-debate-starts-on-eudraft-treaty-541276.html>>.

² M. Gauchet and R. Rémond, 'Comment l'Europe divise la France. Un échange', (2005) 136 *Le débat*, Paris, Gallimard; M. Larhant, 2005, 'La crise institutionnelle de l'UE: Au fait... qu'en pensent les nouveaux Etats membres?', *Notre Europe - Etudes*

Dutch referenda in 2005 has put European constitution-making on hold, but it does not prevent the gradual improvement of the governance of the European Union. The Treaty of Lisbon is a step towards more efficient policy-making, but it does not necessarily solve the problem of democracy in Europe, which many see at the root of *Euro-malaise*. There are structural reasons behind the legitimacy issues of EU institutions. They cannot be solved by 'explaining Europe better', or by finding 'more European-minded leaders'.³ The slow and timid reaction to the financial crisis in 2008⁴ or the regularly laborious negotiations about the Union's budget prove not only how difficult it is to come to a decision among 27 countries, but also that the present system starves the European Union of the resources needed to pursue its common objective of prosperity. Under these circumstances, how can the EU do what citizens expect and gain support for what it does?

Many researchers have observed that democratic procedures could improve the legitimacy of European policy-making. Some have asked whether a democratically viable institutional framework can still rely on state-based democratic theory, or whether it is necessary to reconstitute democracy in Europe and reconfigure a new theory of democracy suitable for the transnational character of the EU.⁵⁶ Three models compete for recognition. The first, intergovernmental, model posits representative democracy at the member state level and sees national governments as delegating policy-making competences to the EU. In this model, the EU is conceived as a functional organisation set up to solve the problems which the member states

et Recherches, *Compte rendu du séminaire Notre Europe*, 9 December 2005; A. Alesina and R. Wacziarg, 'Is Europe Going Too Far?', National Bureau of Economic Research Working Paper Series, NBER, Cambridge, 1999; and S. Collignon, 'Is Europe Going Far Enough? Reflections on the Stability and Growth Pact, the Lisbon Strategy and the EU's Economic Governance', (2003) 1 *European Political Economy Review*, pp. 222-247.

³ These are proposals that are frequently heard in the public debate. See, also, J. Klabbers' book review of F. Chalties, 'Naissance du peuple européen', (2009) 15 *European Law Journal*, pp. 142-150.

⁴ International Monetary Fund (IMF), *World Economic Outlook*, 2008, Washington DC, IMF, 2009; IMF, *World Economic Outlook*, October 2009, Washington DC, IMF.

⁵ E. O. Eriksen and J. E. Fossum, 'Europe's Challenge. Reconstituting Europe or Reconfiguring Democracy?', in E. O. Eriksen and J. E. Fossum (eds), *RECON – Theory in Practice*, ARENA Report No 2/09, Oslo, ARENA, 2009.

⁶ This is the focus of the RECON Research Project.

cannot resolve by acting independently. Thus, European institutions act as government agents, and governments are their principal. Controlling the agents by the principal requires some form of *audit democracy* to prevent *agency slack*.⁷ In this perspective, member states should strengthen the role of their national parliaments in monitoring European policies.⁸ The second model seeks to establish the EU as a multinational federal state. It emulates existing democratic constitutional states in which legitimacy for European policy-making is founded in the people, who have a sense of common destiny. We may distinguish between 'old style' European federalism, as first advanced by A. Spinelli, and 'new style' regionalist federalism, as described by Eriksen and Fossum.⁹ The old model sought to overcome nationalism by integrating European nations into a European people. If a common pre-political European identity does not exist, it needs to be 'created'.¹⁰ Federalists insist on common values. The regionalist version of federalism preserves the different nations as the cultural base-unit, but integrates nation states into a federation, which generates legitimacy through democratic mechanisms. Old style federalism never really got very far, because national allegiances remained stronger than the idea of a European identity.¹¹ New style federalism stands in the long tradition of the anarcho-communitarianism that has shaped German and Swiss federalism.¹² It resembles the intergovernmental model of agency, because nation states, rather than citizens, are seen as the sovereign. The federation is the result of a *constitutional Treaty* in which states agree to cooperate, and not of a *social contract*, in which the individual citizens are the sovereign and agree to manage their common affairs

⁷ D. G. Hawkins, D. A. Lake, D. L. Nielson and M. J. Tierney, *Delegation and Agency in International Organizations*, Cambridge, Cambridge University Press, 2006.

⁸ Bundesverfassungsgericht, *Entscheidung zum Lissaboner Vertrag*; BVerfG, 2 BvE 2/08 vom 30.6.2009, Absatz-Nr. (1-421), 2009, available at <http://www.bverfg.de/entscheidungen/es20090630_2bve000208.html>.

⁹ Eriksen and Fossum, *supra*, note 5.

¹⁰ Reference is often made to the famous sentence ascribed to Massimo d'Azeglio, one of the founders of Italian unification: 'Abbiamo fatto l'Italia, si tratta adesso di fare gli italiani.'

¹¹ S. Collignon, 'Three Sources of Legitimacy for European Fiscal Policy', (2007) 28 *International Political Science Review*, pp. 155-184.

¹² S. Collignon, *The European Republic. Reflections on the Political of a Future Constitution*, London, Kegan Press, 2003, available at <<http://www.stefanollignon.de/PDF/The%20European%20Republic-text1.pdf>>.

jointly.¹³ The third model reconfigures the European Union as a post-national Union with cosmopolitan characteristics. It assumes that European citizens are able to consider themselves as self-legislating individuals within a functional domain that is exclusively reserved for a European government.¹⁴ The model therefore articulates agency in terms of popular sovereignty and implicitly calls for a social contract. Yet, although it opens new perspectives for democracy in Europe, the third model is hampered by ambivalence between local loyalties and cosmopolitan principles.

In this chapter, I propose a republican version of the third model, which starts with public goods, rather than identities and loyalties. I believe that this approach can overcome the shortcomings of a purely cosmopolitan model for Europe. I will argue that the answer to the EU's governance problems requires a political union with full democracy. I have previously coined the term *European Republic* for such a political union.¹⁵

Academic discussions about Europe's democratic deficit go back a long way,¹⁶ but few authors dare to suggest a European government.¹⁷ Such ideas may seem utopian, but I will argue that a

¹³ G. Frankenberg has emphasised the difference between *organizational contracts*, such as the German Imperial Constitution of 1871, in which the 'pouvoir constituant' depends on membership in another body (for example, the EU's member states), and the Hobbesian or Rousseauian *social contract*, in which a society of individuals is transformed into an agreement of general will through a multiplicity of more or less fictitious individual agreements. The first kind of contract may preserve communitarian identities and partisan interests, the second may more easily support the vision of a common good or common wealth. See G. Frankenberg, 'The Return of the Contract: Problems and Pitfalls of European Constitutionalism', (2000) 6 *European Law Journal*, pp. 257-276. A similar normative cleavage exists between communitarian and republican federalism. See S. Collignon, *supra*, note 12.

¹⁴ Eriksen and Fossum, *supra*, note 6, at p. 31.

¹⁵ See Collignon, *supra*, note 12.

¹⁶ See A. Follesdal and S. Hix, 'Why There Is A Democratic Deficit In The EU: A Response to Majone and Moravcsik', (2006) 44 *Journal of Common Market Studies*, pp. 533-62, and the literature quoted there.

¹⁷ Active policy makers seem to have less problems with this idea. Maybe practical experience creates wisdom. See G. Verhofstadt, *The United States of Europe*, the Federal Trust, London, 2005, or the *Grundsatzprogramm* of the German Social Democratic Party (SPD, 2007), which states: 'Our model is a political union granting all European citizens democratic rights of participation. The democratic Europe needs a government answerable to parliament on the foundation of a European constitution.'

democratic political union is the logical necessity resulting from the normative context of European history and the process of European integration.¹⁸ The true utopia is the idea that today's intergovernmental European governance could sustain and govern the European Union efficiently. In order to understand this logic, I will first look at the limitations of the present system, and then develop the argument for why a democratic government is necessary for the EU.

The limitations of the European Union governance without government

In this part, I will first discuss the nature of European public goods and their externalities. We will then look at the forms of policy cooperation that they require. We will terminate with the issues of legitimacy that result from these forms of governance.

European integration and public goods

European integration owes its success to Jean Monnet's stepwise method of gradually building institutions with the purpose of making individuals cooperate consistently over time. In line with British functionalist thought of the inter-war period, his basic conviction was that when individuals are working together, interact in trade, and exchange ideas, they are less likely to wage war. The emblematic sentence 'We do not create coalitions among states, we unite human beings' described the project, which was then gradually implemented by Schuman, Adenauer, de Gasperi and Spaak. This realisation has become a historically unprecedented success. But as Monnet already anticipated, this success now requires institutional change.¹⁹

Practical cooperation has a purpose. The post-war objective of European unification was peace and prosperity, freedom and democracy. But Morgan has argued that European integration is now in a crisis of justification and needs a re-definition of purpose.²⁰ The question is: How can this be done? Europe seems to be returning into

¹⁸ C. Dieterman, Book Review, (2004) 41 *Common Market Law Review*, pp. 894-897.

¹⁹ F. Duchêne, *Jean Monnet: The First Statesman of Interdependence*, New York, Norton, 1994.

²⁰ G. Morgan, *The Idea of a European Superstate. Public Justification and European Integration*, Princeton NJ, Princeton University Press, 2005.

a world in which partial, rather than common, interests prevail. Nevertheless, the interests of individuals are often derived from what they perceive as their common purposes, because these common ideas serve as benchmarks or focal points for the coordination of individual actions.²¹ This does not mean that all individuals agree on what to do, but that their disagreements are defined by reference to both shared ideas and collective intentionality and purpose that are common knowledge. We will see below that strategic behaviour by some actors may, in certain cases, induce them to do exactly the opposite of what would be in the common interest. Nevertheless, the question of how public and shared preferences emerge remains crucial for the viability of political and economic integration. Modern political theory has shown that the generation of common understanding, concerns and interests requires public debates, communicative action,²² and open deliberation,²³ from which some form of general will, or a vague sense of potential consensus of what seems reasonable, will emerge. No collective action is possible without such prior agreement on what the collective interest is. Economists call the object of common interest a *public good*. This concept received a precise theoretical foundation by Samuelson.²⁴ It has the advantage that it takes the political discourse from the level of principled generalities down to the hurly-burly world of real policy-making, where individuals conflict over ideas with regard to what should be done in the common interest.

Since the Treaty of Rome in 1957, the range of European public goods has grown considerably. An increasing number of European citizens are affected by policy decisions in specific sectors, and they therefore share common (and sometimes contradictory) interests. Numerous theories have tried to explain this phenomenon,²⁵ and, although they

²¹ T. C. Schelling, *The Strategy of Conflict*, Cambridge MA, Harvard University Press, 1980; D. Lewis, *Convention*, Oxford, Blackwell Publishing, 2002.

²² J. Habermas, *Theorie des kommunikativen Handelns*, Frankfurt a. M., Suhrkamp Verlag, 1981.

²³ J. Bohman, *Public Deliberation. Pluralism, Complexity and Democracy*, London, MIT Press, 1996.

²⁴ P.A. Samuelson, 'The Pure Theory of Public Expenditure', (1954) 36 *Review of Economics and Statistics*, pp. 387-389.

²⁵ E. B. Haas, *The Uniting of Europe. Political, Social and Economic Forces, 1950-1957*, University of Notre Dame Press, Indiana, 2004; A. Moravcsik, *The Choice for Europe. Social Purpose and State Power from Messina to Maastricht*, London, UCL Press,

disagree about the motives and limitations underlying this process, most analysts would probably agree that functional interdependencies between different public goods have generated enlarged collective policy responsibilities. Examples of the functional spill-over include: the European Customs Union, which could not function without the joint management of revenue; the Common Agricultural Policy, which required the joint administration of prices and quality standards for agricultural products; the Single Market, which needed a common competition policy in order to prevent distortions; the Single Currency, which was the necessary complement to the Single Market, and the foundation for successful macro-economic stabilisation policies; and the Schengen Agreement, which abolished internal border controls within the European Union and not only facilitated the free movement of persons, but also implied that a common external border needed to be secured. Thus, once the freedom of movement was accepted as a common value, the European dimension of justice and home affairs became part of European public goods. Similarly, foreign policy is the classical *topos* of public goods. Although this is probably the least developed part of European integration, it is increasingly prominent and finds approval with a large majority of European citizens.²⁶ As the scope of these externalities broadened, the *acquis* of European policy arrangements was also extended to an increasing number of member states that wished to benefit from these public goods. This 'widening' demands in return the 'deepening' of the EU, in order to ensure the efficient administration of these public goods. The deepening and widening of the European Union are inter-related processes. The process of a growing domain of public goods is, however, not linear; it interacts with political ideologies, and, on frequent occasions, the responsibility for administering European public goods has been re-nationalised. We will discuss below the consequences of decentralising policy-making for efficiency and legitimacy.

European public goods are created by laws, but, as we will see below, their administration may require discretionary actions by governments. A precise measurement for the growth of the EU's

1998; G. Majone, *Regulating Europe*, London, Routledge, 1996; Alan Milward, *The European Rescue of the Nation-State*, London, Routledge, 1992.

²⁶ According to Eurobarometer, 2005, No. 63. 'Public opinion in the European Union', September 2005, the figure is 77 per cent.

public goods is difficult, as they are linked to qualitative jumps in responsibilities. But some figures may serve as an indicator. For example, the total number of regulations, directives and decisions by the EU has increased from 2 612 in the period 1971-75 to 11 414 over 1996-2000.²⁷ The number of pages in the Official Journal of the EU has increased from 16 500 pages in 1995 to 24 800 in 2004.²⁸ One may dispute whether all these texts are actually necessary. In fact, many regulations specify exemptions for member states in specific areas. But the growth clearly shows the greater involvement of policy-making at European level. Referring to a remark by former Commission President Jacques Delors, it is often claimed that 80 per cent of all economic legislation in the EU originates today at the level of European institutions.²⁹

With the quantitative growth in the importance of public goods, of Europe's *res publica*, and with the enlargement of the European Union, the need for a coherent regime of common governance has emerged. Coherent collective action is not without problems, because public goods are related to externalities. An externality exists when the decisions and actions of one actor affect the utility of other actors without them having to bear the costs and responsibilities for their actions.³⁰ These policy externalities may be caused by laws or discretionary policy decisions. A positive externality exists if the decision by one actor increases the utility of all others; a negative externality decreases the utilities of the other actors because of the first actor's behaviour. Typical examples for positive externalities are synergies and economies of scale. The classic example of a negative externality is environmental pollution, but policies can also cause external effects. The larger a group becomes, the less likely it is to make optimal decisions in the common interest.³¹ This problem can be overcome by more coordinated and centralised decision-making.

²⁷ A. Alesina, I. Angeloni and L. Schuknecht, 'What Does the European Union Do?', (2005) 123 *Public Choice*, pp. 275-319.

²⁸ G. Tremonti, *La Paura et la Speranza*, Milan, Mondadori, 2008.

²⁹ A. Moravcsik and A. Töller have questioned this figure, see 'Brüssel regiert nicht Deutschland', *Financial Times Deutschland* 10 February 2007; but T. Hoppe has recently confirmed it for Germany, in 'Die Europäisierung der Gesetzgebung: Der 80-Prozent-Mythos lebt', (2009) 6 *Europäische Zeitschrift für Wirtschaftsrecht*, at p.169.

³⁰ S. E. Holtermann, 'Externalities and Public Goods', (1972) 39 *Economica*, pp. 78-87.

³¹ M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*, Cambridge MA, Harvard University Press, 1971.

Thus, the success of European integration has not only brought about *more* European goods, but it has also changed the *quality* of European political action. The frequent European Treaty changes since Maastricht have been the consequence of the political events that have transformed Europe since the fall of the Berlin Wall: integrating the unified Germany into monetary union would have been impossible without better coordination of macro-economic policies; adapting the old institutions to a Union of 27 member states required less unanimity in decision-making in the Council, etc. These institutional adaptations have sought to preserve the traditional model of autonomous ('sovereign') member states cooperating voluntarily amongst each other, but they are not sufficiently far-reaching to deal with legitimacy issues.

When externalities exist, individual actors cannot be excluded from the consumption of, or forced to contribute to the collective provision of, public goods. They may shirk and let others do the job. Because they do not have to assume full responsibility for their acts, they can shift some costs onto someone else or lose the motivation to manage their common interests. As actors seek to maximise their own benefits by interacting strategically, given the behaviour of all other members in a group,³² *strategic complementarities* prevail, when each actor's behaviour increases his or her own utility *and* the utility of all others. In technical terms, this means that the cross-derivatives of marginal utilities are positive. Collective goods characterised by strategic complementarities are called *inclusive public goods*. They provide positive externalities, which are incentives for voluntary cooperation between independent actors because each actor would benefit from making a contribution to the collective objective. However, despite this potential for gain, coordination failure is possible when information asymmetries prevent individual actors from properly perceiving their optimal benefits. Coordination failure occurs when policies that could improve welfare are not implemented. For game theorists, such coordination failures occur in situations of 'prisoner's dilemmas', in which one actor does not know what the other intends to do. The resulting sub-optimal equilibrium can be pareto-improved by an independent agent that ensures the removal of informational bottlenecks. In other words, cooperation can be hampered by

³² R. Cooper and A. John 'Coordinating Coordination Failures in Keynesians Models', (1998) 103 *Quarterly Journal of Economics*, pp. 441-463.

cognitive and insurance problems, which require institutional solutions. With a supportive institutional framework, voluntary cooperation may be capable of supplying the desired amount of inclusive public goods. In the European Union, examples for inclusive public goods include: peace and prosperity (which attract countries to join); the euro, which contributes positively to the stabilisation of the macro-economy; or concrete projects such as the production of Airbus and the Galileo satellite system. In all these instances, member states are benefiting their own interests by complying with policies which simultaneously increase the utility of all others. Often, the European Commission has taken on the role of a supportive coach which ensures that informational asymmetries do not block the pursuit of such beneficial policies.

However, in the case of *strategic substitutabilities*, this approach does not work. Here, collective action problems prevent the optimal provision of collective goods by generating negative externalities. Any individual government could increase its own utility by going against the stream, provided that all other actors behave optimally in the collective interest. Such a government would be able to reap extra gains at the expense of all other members of the group. Hence, any individual actor has an incentive to do the opposite of what the collective interest requires. Technically, this means that the cross-derivative of marginal utilities is negative. Public goods that give rise to these incentives are called *exclusive public goods*, sometimes also *common resource goods* or *common-pool resources*.³³ The classical example for collective action problems with exclusive goods is the 'tragedy of the commons',³⁴ but Ostrom³⁵ has shown that the tragedy can be avoided by setting up appropriate institutions. This is relevant for European integration. While public goods, which generate strategic complementarities, allow us to interpret the European Union as a problem-solving institution, strategic substitutabilities will turn it into a 'problem-creating' institution. Initially, European integration generated inclusive public goods, but, over the last two decades, a growing range of policies have become prone to strategic

³³ M. Olson, *supra*, note 31; E. Ostrom, 'Commons', in D. Cuff and A. Goudie (eds) *The Oxford Companion to Global Change*, Oxford, Oxford University Press, 2009.

³⁴ G. Hardin, 'The Tragedy of the Commons', (1968) 162 *Science*, pp. 1243-1248.

³⁵ E. Ostrom, *Governing the Commons: The Evolution of Institutions for Collective Action*, Cambridge, Cambridge University Press, 1990.

substitutability. In the case of monetary policy, the logic was acknowledged by the creation of the European Central Bank as the sole decision-maker; other, less recognised, but equally important, fields include the structural economic reforms under the Lisbon Agenda and fiscal policy in monetary union. In the next section, I will show that the different natures of inclusive and exclusive public goods require different forms of rules and government.

Policy coordination

As, by definition, property rights do not exist for public goods, positive or negative externalities cannot be directly assigned to those who are responsible for causing them, and the originator cannot be asked for compensation. Therefore, externalities must be 'internalised' by making individual actors accountable to those who are affected by their decisions. A democratic law-making government is the classic institution by which the externalities of a broad range of rights are internalised.³⁶ But it is also possible to internalise externalities by the voluntary cooperation of governments. However, this solution does not work in all circumstances. We now need to analyse why this is so.

A growing amount of literature has been studying the effects of 'Europeanisation', a term that describes both the policies aimed at internalising externalities through voluntary cooperation, and the impact that these policies have on state institutions and modes of governance.³⁷ No doubt, Europeanisation has successfully dealt with many externalities resulting from the creation of the single market legislation. But the method has also reached its limits. The Service

³⁶ One may argue that *government* is sufficient to internalise externalities and that *democratic* government is only one of several institutional arrangements. However, while centralised government may render decision-making more efficient, it does not necessarily internalise externalities, for this requires that the government responds to the preferences and interest of those who are affected by government decisions. A democratic government is a sufficient condition for internalising externalities.

³⁷ J. J. Anderson, 'Europeanization and the Transformation of the Democratic Polity, 1945-2000', (2002) 40 *Journal of Common Market Studies*, pp. 793-822; J. P. Olsen, 'The Many Faces of Europeanization', (2002) 40 *Journal of Common Market Studies*, pp. 921-952; K. Featherstone and C. M. Radaelli (eds), *The Politics of Europeanization*, Oxford, Oxford University Press, 2003; and A. Töller, 'The Europeanization of Public Policy - Understanding Idiosyncratic Mechanisms and Contingent Results', (2004) 8 *European Integration Online Papers*, available at <<http://eiop.or.at/eiop/index.php/eiop/index>>.

Directive or the Cardiff and Luxembourg Processes are policy areas in which governments seek, with little success, to complete the integration of the single market for goods and services. Similar problems hamper macro-economic policy coordination or the acrimonious negotiations between the member state governments regarding the European budget. Clearly, there are signs of under-provision of public goods.

For years, the Commission has propagated 'massive potentials gains' from wider and deeper integration; it has emphasised the 'cost of non-Europe' and pushed for more integration. Nevertheless, the member states are slow or even resist implementing these apparently beneficial policies. Take the Lisbon strategy, for example, which has formulated a programme of reforms to turn Europe into 'the most competitive economy in the world', a programme that should clearly benefit everyone; but very little has been achieved.³⁸

The reason for this is that many of the public goods promised by the Lisbon Agenda are subject to strategic substitutability: if reforms are politically painful and costly, but everyone would be better off provided all member states complied with the reform programme, then each government might have an incentive to hold back the implementation of reforms until their colleagues have done their homework, because that would lower their own costs. The Lisbon Agenda is making little progress, because the incentives for free-riding on the actions of others are reducing each member state's effort to comply with policies which support the common purpose, and, consequently, nothing gets done.

The same applies to fiscal policy in the European monetary union, where strategic substitutabilities prevail in many areas. In the single currency area, central bank liquidity is a common-pool resource. When governments wish to borrow, they tap the same capital market. Their actions affect interest rates and the borrowing costs for all. Hence, fiscal policies are an exclusive public good. The Stability and Growth Pact (SGP) attempts to regulate the externalities of national

³⁸ S. Collignon, 'Why Europe is Not Becoming the World's Most Competitive Economy. The Lisbon Strategy, Macro-Economic Stability and the Dilemma of Governance without Governments, (2008) 3 *International Journal of Public Policy*, pp. 72-99.

fiscal policies by obliging member states to *balance* their cyclically adjusted, i.e., structural deficits, but only few countries have complied.³⁹

This compliance problem can be explained by the strategic substitutability, which derives from the fact that, in a monetary union, the central bank provides liquidity subject to a hard budget constraint (price stability) and the funds obtainable in capital markets are limited, while market access is free for all. The scarcity of resources drives up the price of money, i.e., the interest rate, when governments borrow excessively. The euro-area has, therefore, a collective interest in constraining public deficits in an aggregate manner, and the Stability and Growth Pact rightly requires all member states to balance their structural deficits; however, individually governments could borrow at very favourable terms if all other member states were balancing their budgets. Hence, each national government has an incentive to go against the European interest and this prevents the proper implementation of the SGP.

The concept of strategic substitutability helps us to understand why voluntary cooperation amongst the governments in the European Union is systematically handicapped. One approach for overcoming this problem is to restrict access to the common resource.⁴⁰ This was the purpose for setting the Maastricht convergence criteria, but once member states have joined, compliance is again subject to the collective action problem. In environmental economics, the problem is resolved by specifying property rights for tradable pollution permits. This idea was adapted by Casella to improve the implementation of European fiscal policy rules.⁴¹ The advantage of this model is that markets 'audit' the behaviour of member state governments; the drawback is the difficulty of assigning property rights in the permissible deficit to member states. A second solution would be fiscal federalism, in which macro-economic policy is centralised in a federal government. But these ideas are blocked, as governments pretend to serve the national interest and do not wish to

³⁹ Collignon, *supra*, note 38.

⁴⁰ For this reason, public goods subject to strategic substitutability are called 'exclusive'.

⁴¹ A. Casella, 'Tradeable Deficit Permits', in A. Brumila, M. Buti and D. Franco, *The Stability and Growth Pact, The Architecture of Fiscal Policy in EMU*, London, Palgrave, 2001.

relinquish their power. In reality, the national interest, i.e., the interest of all citizens in a country, would be optimised if positive externalities could be maximised and negative externalities minimised. Yet, as policy-making in the European Union is based upon the sovereignty of national governments, and governments seek extra gains at the expense of their partners, welfare-optimising policies are institutionally-inhibited.

Welfare in the European Union would improve if national governments coordinated their actions and avoided the distributional effects of negative externalities. This is fundamental rationale for policy coordination in the EU. But voluntary policy coordination only works well for strategic complementarities, and, hence, for inclusive public goods. When public goods are exclusive, and actors are many, and their incentives are dominated by strategic substitutability, collective action problems will cause coordination failure. Collective action problems have become more salient in the EU, as the negative costs of non-compliance for the individual member state are diminishing in an enlarged Union, while the potential benefits of the public goods are available for all. The temptation for free-riding has increased as a consequence of the successive enlargements of the EU.⁴² In a large European Union, in which governments are autonomous, while their policies affect all member states and are subject to the logic of strategic substitutability, voluntary intergovernmental cooperation is not producing efficient results.

Policy coordination regimes must address the specific nature of the externalities, and the strategic incentives for non-cooperation that they cause. In this context, one should distinguish two dimensions: (1) conflicting interests between actors (governments) will derive from heterogeneous preferences and require mechanisms for overcoming policy blockages through preference convergence; and (2) the time dimension of having positive externalities today *versus* negative effects tomorrow may cause dynamic inconsistencies.⁴³ When an actor's best plan for the future will no longer be optimal as that future arrives, and when other actors have built their own behaviour on the expectation of what each group member had

⁴² For a formal model, see Collignon, *supra*, note 12, Annex II.

⁴³ F. Kydland and A. Prescott, 'Rules Rather Than Discretion: The Inconsistency of Optimal Plans', (1977) 82 *Journal of Political Economy*, pp. 473-492.

planned to do, their interactions will lead to coordination failure. Rules and laws are then required for coherent policy-making over time, while discretionary actions by a single executive are more suitable when policy actions must adapt to new circumstances. Thus, different policy regimes are necessary to deal with these potential coordination failures. These regimes reflect, to some degree, the three models of European integration, described by Eriksen and Fossum.⁴⁴ The optimal provision of *inclusive* public goods may simply require some form of soft coordination to overcome informational asymmetries, when individual actors are unaware of the behaviour of others. The European Commission has successfully played this role for many policy areas that cover inclusive public goods. Under these conditions, intergovernmental cooperation linked to some forms of 'audit democracy' will ensure welfare gains. The EU will be able to work efficiently and legitimately as a problem-solving institution. However, preventing deviant behaviour in the case of *exclusive* public goods will require hard coordination policies. Constraining rules must ensure compliance with the coordination regime, and sanctions must be imposed when policies are not implemented. If the decision of imposing sanctions is itself subject to a collective action problem ('I do not sanction you today, if you will not sanction me tomorrow'), policy implementation needs to be centralised in a single authority. This can be interpreted as a call for centralising federalism, but, as I will show below, federalism is not solving the problem of legitimacy. Putting these two dimensions of policy regimes together, we obtain the matrix in Figure 13.1.⁴⁵

If policy preferences converge to a common consensual equilibrium, in which the interests of all participating parties are enhanced and benefits increased, *voluntary* coordination is successful and arrangements like the Open Method of Coordination (OMC) under the Lisbon Strategy are appropriate for achieving the desired outcomes. If, however, there is a danger of dynamic inconsistency, at least some form of *soft coordination by binding rules* is also required, so that peer pressure will lead individual member states to behave in accordance with the general interest. In Europe, this is the logic that has justified administrative procedures such as the Broad Economic Policy Guidelines, the Luxembourg and Cardiff Processes, etc.,

⁴⁴ Eriksen and Fossum, *supra*, note 5.

⁴⁵ See, also, Collignon, *supra*, note 12.

because, even if the policy content is not necessarily binding, the coordinating procedure does constrain member states. On the other hand, in order to maintain time consistency and prevent individual actors' from non-compliance in the presence of strategic substitutability, *rule-based policies with the possibility of sanctions*, as in the Stability and Growth Pact and the Excessive Deficit Procedure under the Treaty of Maastricht, are the appropriate policy regime. But if discretionary policies are desirable, *delegation to a unified policy-maker* is necessary.

		Time consistency		
		Discretionary policies	Rule-based policies	
Preference consistency	Disjunct	I. Delegation to unified actor	II. Hard co-ordination with sanctions	Exclusive public goods
	Converging	III. Voluntary co-ordination	IV. Soft co-ordination by guiding rules	Inclusive public goods

Figure 13.1: Policy coordination regimes

This analysis brings out one important point: different public goods require different policy regimes. A lot of confusion about European policy-making results from the fact that the strategic incentives dominating different policy domains are ignored. As a consequence, inappropriate policy regimes are applied to solve problems that require different arrangements, and the political discourses give rise to expectations which cannot be met. Voluntary policy coordination amongst independent governments should be confined to inclusive public goods, because only here can the EU serve as a problem-solving institution. This is where intergovernmentalism has its role to play and a model of 'audit democracy' could ensure the efficient and legitimate administration of these public goods. Exclusive public goods require much stronger forms of governance, because the EU is becoming a problem-creating institution, if national governments remain fully autonomous in this domain. It is then necessary to impose rules with sanctions, or, if discretionary policies are desirable, to delegate and centralise decision-making at European level. This is

where the federalist model provides an efficient solution, although it ignores the torrid question of legitimacy. Unless a centralised European policy-making authority has the consensual backing of European citizens, it is unlikely to remain sustainable over time. The republican model formulates an answer where the federalist model remains silent, namely, to the question of how this consensual backing can be achieved.

Legitimacy

The problem of legitimacy is related to the efficiency of government. As mentioned above, European integration used to draw its legitimacy from producing good results: peace and prosperity, freedom and democracy. But as collective action problems increase and the efficiency of intergovernmental governance declines, this output legitimacy is diminishing. Other reasons for legitimacy need to be found. I shall now examine this link.

Legitimacy is the explicit or implicit *acceptance* of policies by those to whom they apply. Illegitimate policies are resented, avoided, circumvented, or outrightly rejected, because people do not accept them. Legitimacy is in crisis when citizens cannot bring themselves to say 'yes' or remain indifferent to the policies pursued by governments. Legitimacy therefore depends on what people want and what governments produce. When people's preferences matter as input into the policy-making process, we say they generate input-oriented legitimacy; if the output corresponds to what people have charged their representatives to do, the government has output-oriented legitimacy.⁴⁶

In intergovernmental policy-making regimes, these two domains are systematically separated, because policy decisions are the outcome of a two-level game,⁴⁷ in which governments provide policy output collectively, but take policy input nationally. At the intergovernmental or secondary level, rational governments negotiate agreements on common objectives and policy actions, but, at the primary level, they are constrained by the preferences of their

⁴⁶ F. W. Scharpf, *Governing in Europe: Effective and Democratic?*, Oxford, Oxford University Press, 1999.

⁴⁷ R. D. Putnam, 'Diplomacy and Domestic Politics: the Logic of Two-Level Games', (1988) 42 *International Organization*, pp. 427-60.

home constituencies. In conformity with principal-agent models, national governments have some margins of autonomy, within the constraints set by the nation state. This relative autonomy allows them to seek 'win-sets' for solutions, which simultaneously accommodate both the preferences of national constituencies and of their Council colleagues. National governments may decide to sacrifice some input legitimacy if they consider that the output will ultimately be beneficial to themselves and their principal. Output legitimacy could, therefore, compensate for loss of input legitimacy. However, if collective action problems reduce the scope for output legitimacy, as I have argued above, this diminishing return from efficient intergovernmental cooperation needs to be compensated by higher input legitimacy. Hence, the issue of preference formation becomes paramount.

In models of liberal intergovernmentalism, the policy preferences of governments are derived from the social purposes that emerge from societal ideas, interest groups and institutions. They underlie and structure the strategic calculations of policy-makers, who seek to get elected.⁴⁸ In these models, social or societal preferences are *prior* to the preferences of states ('bottom up') and government representatives have to accept them as policy input in order to retain the legitimacy of their power. Different national constituencies have different preferences and governments negotiate with the intention of maximising their utility, taking what their partners do into consideration. Note that, in this system, citizens' preferences are aggregated through *national* deliberation processes, which take place in a fragmented EU polity. The results of these segregated deliberation processes can be modelled by the policy preferences of national median voters. But *across borders, citizens' preferences are not aggregated, because deliberation remains confined to national public spheres.* Hence, there is no European median voter that matters, although the intergovernmental decision may reflect the median voter in the Council. As a consequence, collective preferences are distorted by the most powerful group, i.e., by large member states. National preferences are traded-off by governments seeking compromises,

⁴⁸ A. Moravcsik, 'Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach', (1993) 31 *Journal of Common Market Studies*, pp. 473-523; *Id.*, 'Taking Preferences Seriously: A liberal Theory of International Politics', (1997) 51 *International Organisation*, pp. 513-553.

which reflect some overlapping consensus at the secondary level.⁴⁹ Given this framework, preference heterogeneity increases as the Union becomes larger and includes more countries. Hence, in addition to the collective action problems discussed above, the win-sets for feasible policy outcomes are shrinking as the Union becomes larger, and this compounds the perception of a democratic deficit.

Liberal intergovernmentalism can be criticised for not taking into account how societal preferences are transformed by the process of European integration itself. This changes if we ask ourselves how collective preferences and the positions of median voters are formed. The third, cosmopolitan, model for European democracy, mentioned by Eriksen and Fossum,⁵⁰ overcomes the constraint of assuming preferences as being given by recognising that public preferences are formed by deliberation and debates in different *public spheres*, or in, what I call, *epistemic constituencies*. They are epistemic because public debates change individuals' understanding and knowledge of what they want. If these epistemic constituencies remain segregated, they are likely to yield heterogeneous preferences. A fragmented public sphere describes a situation in which different epistemic constituencies deliberate in isolation of each other, so that they become separate communities with different, and sometimes contradictory, comprehensive doctrines and preferences.⁵¹ But, if these constituencies are connected through the exchange of the information and arguments that takes place in public debates, preferences will become endogenous to the European decision level, and national preferences will change over time and converge to some form of European consensus. The win-set of feasible cooperation

⁴⁹ Moravcsik correctly points out: 'Preferences, unlike strategies and policies, are exogenous to a specific international political environment. Thus, for example, the phrase "Country A changed its preferences" in response to an action by Country B misuses the term [...], implying less than consistently rational behavior.' Moravcsik, *supra*, note 25, at pp. 24-25. The concept of 'overlapping consensus' is due to J. Rawls, 'The Domain of the Political and Overlapping Consensus' (1989) 64 *New York University Law Review*, pp. 233-255.

⁵⁰ Eriksen and Fossum, *supra*, note 5.

⁵¹ J. Rawls (*Political Liberalism*, Columbia University Press, 1996) defines *community* as 'a society governed by a shared comprehensive religious, philosophical or moral doctrine' (at p. 42), while 'comprehensive doctrines of all kinds - religious, philosophical or moral - belong to what we may call the 'background culture' of civil society' (at p. 14).

strategies will then expand, as policy preferences between member states converge.

Despite the static assumptions of some intergovernmental models, there is evidence that this convergence does take place, but, as the model of stochastic consensus will demonstrate below, the process is slow in the present day institutional framework.⁵² In the European Union, policy deliberation is systematically – and institutionally – segregated by national borders, because democratic processes are restricted to the nation state. Diverging preferences and policy dissent between member state electorates will, therefore, continue to exist as long as citizen representation at the EU level remains weak. This is why the intergovernmental model with its audit democracy cannot generate significant input legitimacy. But the persistence of preference heterogeneity is also a problem for federalism, and especially for German-styled federalism, which is based upon the subsidiarity principle.⁵³ We therefore need a model that combines the efficiency of centralising federalism, which is generated from direct democratic sanctions with the epistemic efficiency of cosmopolitanism, which does not require preference homogeneity *a priori*.

One solution is European representative democracy. If European citizens could choose a European executive or government when they elect the European Parliament, national public spheres would become connected because candidates and parties would need to form winning alliances across borders in their competition for the European median voter. A unified European epistemic constituency would emerge, because the institutional structures would require deliberation at European level. Thus, the lack of policy debate in today's fractured EU-polity contributes to persistent preference heterogeneity, which affects the effectiveness of policy-making; democracy, in contrast, would increase both the effectiveness, and the (input) legitimacy, of Europe's governance.

⁵² For the full proof of this statement, see Collignon *supra*, note 12, Annex I; S. Collignon and M. Al-Sadoon, 'A Theory of Stochastic Consensus', Center for European Studies (CES), Harvard University, Working Paper, 2006, Working Paper, Harvard CES, available at <www.stefanollignon.eu>.

⁵³ Centralising federalism *à la* Spinelli is, of course, only possible if preferences are *a priori* assumed homogenous because then everyone will agree to the new system.

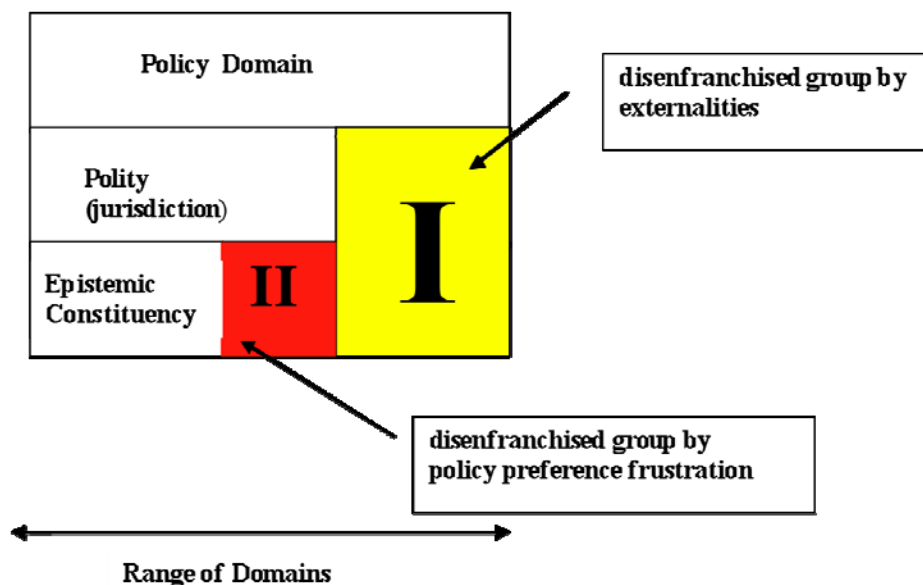


Figure 13.2: Policy-making inefficiencies

The logic of this argument allows us to find institutional solutions to the efficiency-legitimacy trade-off problem. Because *efficiency* measures the *cost* of realising one's preferences, the efficiency of policy-making depends not only on the means of achieving the goals, but also on the preferences themselves. If different people wish to pursue different heterogeneous goals, a centrally determined policy will be more costly in welfare terms, than if they all agreed on the same goal because frustration is a cost. This is where the centralising federalist model has difficulties in generating input legitimacy.⁵⁴ We can illustrate this logic as in Figure 13.2. We distinguish three layers in a collective decision-making process. First, we call *policy domain* the set of all citizens who are affected by specific policy decisions.⁵⁵ Second, the *polity* is the political organisation that makes laws or takes discretionary decisions. At European level, this organisation

⁵⁴ See Alesina and Wacziarg, *supra*, note 2, who derive the legitimacy of the EU's governance from the cost benefit ratio between efficiency losses caused by preference heterogeneity versus the economies of scale from larger economic units. However, their concept of efficiency losses covers only the partial aspect of preference input into policy-making. Yet, what matters is the overall inefficiency cost, which is the combination of input and output effects on policy making.

⁵⁵ Although Collignon, *supra*, note 12, derived the concept of policy domain from simple welfare economic concepts, it bears significant resemblance with Dewey's definition of the 'public'; J. Dewey, *The Public and its Problems*, Athens, Swallow Press, 1954, at p.15.

may take different forms. For example, it may be a unified government, as in the federalist model, or a Council decision made by national governments, as in the intergovernmental model.⁵⁶ Finally, the *epistemic constituency* is the group of citizens, who have the sovereign right to authorise policies, and who provide input into the decision-making process by debating arguments and contribute to public preference formation through public deliberation.

In the ideal case of a democratic nation state, these three layers are congruent, meaning that they cover the same set of citizens. But in the European Union, and to a lesser degree in all modern nation states, this is not necessarily the case, because states are frequently exposed to political externalities. What is special about the EU is the fact that the domain of public goods has become so thick, that the incongruence requires new institutional arrangements. If the European polity is smaller than the policy domain, policy externalities are generated, because decisions made at European level reflect only the partial interests of a subset of EU member states. For example, a national government may insist on 'red lines' that express the preferences of its national constituency, but not those of another member state. It thereby creates external effects for the welfare in the partner country's constituency. We call this externality Type I, or output inefficiency. For example, in negotiations about the EU's Financial Framework, the British government has frequently refused to give up or re-negotiate the rebate that Margaret Thatcher obtained in 1984. Other member states would then have to pay more, or the overall budget would have to be cut, and this causes Type I welfare inefficiencies. Or the French and Dutch referenda rejecting the Constitutional Treaty disenfranchised the majority of citizens who had voted in favour of the Constitution.⁵⁷ Unanimity rules can cause large Type I inefficiencies, because the minority can dominate the majority. But if the set of citizens who are entitled to authorise a government as their representative is the same as the set of citizens who are affected by the decisions of this government, then Type I inefficiencies disappear, and we may speak of *output congruence* of the political system.

⁵⁶ I refer here to the three models described by Eriksen and Fossum, *supra*, note 5.

⁵⁷ Referenda took place in Spain, France, the Netherlands and Luxembourg. The total number of votes in favour was 26 661 082, against 22 668 594, hence, the majority in favour of the constitution was 3 992 488 votes.

On the other hand, if the polity is larger than the epistemic constituency, Type II, or input inefficiencies emerge. Political authorities are taking decisions, which may violate the preferences of some minority group of citizens. For example, if the British rebate for EU budget contributions could be abolished by (qualified) majority voting in the Council, and assuming the British median voter does not want to pay for French or other farmers, the preferences of the majority of British taxpayers are neglected.⁵⁸ Type II inefficiencies result from the policy preference frustration of disenfranchised groups. These inefficiencies increase with the heterogeneity of preferences in a society. For this reason, it is often suggested that subsidiarity or decentralisation could eliminate Type II inefficiencies.⁵⁹ In fact, subsidiarity implies reducing the policy-making competences of the polity to the scope of the epistemic constituency. If the set of citizens who are deliberating about the collective preferences is the same as the set of citizens who are electing their representatives in the polity, then Type II inefficiencies disappear and we may speak of *input congruence* of the political system.

Hence, the issue of electoral franchise is crucial for Type II inefficiencies. Historically, the struggle for democracy was about enlarging the electoral franchise, especially to non-property owners and to women, but, in the intergovernmental system, the franchise is systematically reduced to citizens who belong to a specific nation state. The subsidiarity argument claims that citizens will 'feel closer' to policy-makers at decentralised levels, because local representatives are more 'like them' (they share an identity), and citizens would therefore more easily accept decisions made at national or local level, rather than at the 'distant' EU level. But, the subsidiarity solution has two major drawbacks, leaving aside the fact that there is no evidence that people trust low-level politicians more than higher level ones,

⁵⁸ Another way express this logic is to say that the median voter position of the intergovernmental policy compromise is different from the national median voter. Of course, one may argue that any majority vote frustrates minorities. But in a well-functioning democracy minorities do 'accept' the majority's decision as legitimate, because they consider the system as fair. And fairness implies that the minority is not *systematically* excluded.

⁵⁹ Alesina and Wacziarg, *supra*, note 2; W. Oates, 'An Essay on Fiscal Federalism', (1999) 37 *The Journal of Economic Literature*, pp. 1120-1149.

and also the fact that law and democracy are not about closeness, but about mediating structures, which ensure equality. First, it is clear from Figure 13.2 that, for a given policy domain, decentralising the polity and reducing the scope of the jurisdiction would increase Type I inefficiencies. It would increase the disenfranchised group of citizens that are subjected to externalities resulting from decisions taken by lower level governments. Contrary to what subsidiarity advocates claim, decentralisation may augment the feeling of insufficient political representation, of dominance by remote political forces, and, therefore, the perception of a democratic deficit in a given policy domain, i.e., for all those citizens that are affected by the decentralised policy. Second, as we have seen, by decentralising European policy decisions, the group of decision-makers becomes larger, so that collective action problems will increase, and output legitimacy will suffer. Thus, subsidiarity is not an optimal solution to the EU's legitimacy dilemma. The proper criterion for decentralisation is the size of the policy domain, and not of the epistemic constituency.

But Europe is caught in a dilemma. If one seeks to increase output legitimacy by increasing the decision-making polity to the size of the policy domain, this will only lower input legitimacy, unless the problem of preference heterogeneity is addressed: reinforcing policy cooperation by more intergovernmental coordination would internalise externalities and, therefore, reduce Type I inefficiencies, but intergovernmental compromises almost inevitably shift the negotiated equilibrium away from the preferences of national median voters, and this increases Type II inefficiencies. For example, the Lisbon Strategy improved cooperation between member state governments, and the exchange of information between national administrations has led to the Europeanisation of the European polity (i.e., the polity has become more coherent with the policy domain). But because national epistemic constituencies remain largely isolated, the process of preference convergence remains slow, and policy dissent remains dominant. Thus, the impression of remote policy-making in Brussels without the necessary democratic input by European citizens is reinforced. Intergovernmental policy coordination, therefore, decreases Type I and increases Type II inefficiencies without solving the fundamental dilemma between legitimacy and efficiency. Simply shifting competences for policy-making without simultaneously considering the scope of the

externalities and the size of the epistemic constituency does not change the importance of policy inefficiencies, and the legitimacy of the regime will not improve. Neither subsidiarity nor technocratic policy coordination are capable of supplying legitimacy to European integration. This is Europe's dilemma.

A different solution, which I call *European republicanism*, would simultaneously increase the epistemic constituency to the size of the European polity, and the polity to the size of the policy domain. This solution requires an institution that is *responsible* for the whole range of (exclusive) European public goods, and also *responsive* to the preferences of all European citizens affected by these goods. The only institution capable of fulfilling this function is a democratic government for the EU. It must assume responsibility for the provision of all European public goods (so that the polity covers the full policy domain) and be elected by all European citizens (so that the epistemic constituency becomes European). Hence, instead of taking the trade-off between input and output inefficiencies as given, a European government would *shift the trade-off curve* by extending the epistemic constituency and the polity simultaneously.⁶⁰

The key to shifting the inefficiency trade-off is the creation of democratic structures; citizens, rather than governments, must be the ultimate authority for policy choices. One may think that, in a modern society, this idea imposes itself; it has been a commonplace, since the American and French Revolutions, that *citizens*, and not states, are sovereign. Modern democracy emphasises the individual rights of free and equal citizens, rather than the rights belonging to *peoples*. However, in Europe, the idea of democracy is becoming confused with cultural identities. Individuals are treated *as if they belonged to their country*, and not as if their country belonged to them. This holistic fallacy is the categorical mistake that prevents Europe's governance from being structured efficiently. Once it is understood that individual citizens are the owners of public goods, there is no

⁶⁰ The idea of extending the sphere of government is old and even anchored in Roman Law. Similarly, in the Federalist Paper No. 10, (A. Hamilton, J. Madison and J. Jay [edited by R. Clinton], *The Federalist Papers*, Mentor, Penguin Putnam, at p. 42) Madison argued in favour of a large republic, because it reduces the likelihood of agency capture by sections, i.e., by state coalitions. I take the argument further by reducing the size of sections in the Union to the number of citizens in society.

difficulty in thinking of the republic as '*une et divisible*',⁶¹ in which individuals own different collective goods, just as they own cars and bicycles. In order to manage their European goods efficiently, citizens need to appoint a government at European level; for local goods, they use local governments. However, shifting the trade-off curve will only work if citizens can express their ownership rights in full and equal autonomy, and this implies that they can appoint a representative government as their agent. A centralised EU government must be based upon unambiguously democratic institutions. But how realistic is it to establish such democratic governance for Europe?

Why a democratic government is necessary for the EU

In this part, I will first discuss the shortcomings of European integration without democracy. The second section will discuss two concepts of deliberative democracy. I will argue that collective preference formation is crucial for reconstituting democracy and this gives a republican flavour to the cosmopolitan model of European democracy that was discussed by Eriksen and Fossum.⁶² The chapter terminates with a discussion of objections raised against the idea of a European Republic, and how this idea fits into the three models of intergovernmentalism, federalism and cosmopolitanism.

Europe without democracy

Most analytic work about the European Union focuses on what the Union is, and what it is not. Rarely do scholars make normative prescriptions, unless they write policy papers. However, all social institutions have normative content,⁶³ and, if functional norms are mutually inconsistent within a given system, they will, in the long run, undermine society's capacity to sustain and reproduce itself. Although the European Union's capacity to function is not (yet) in question, normative contradictions manifest themselves today in the EU's crisis of legitimacy and could threaten the system's sustainability. If I am now turning to the normative necessity of setting up a European government, I do not wish to make policy

⁶¹ T. Chopin, *La République une et divisible: Les Fondements de la Fédération américaine*, Paris, Plon, 2002.

⁶² Eriksen and Fossum, *supra*, note 5.

⁶³ J. R. Searle, *The Construction of Social Reality*, Harmondsworth, Penguin, 1995.

recommendations. Instead, my purpose is to demonstrate how the contradictions, which are causing the legitimacy crisis, can be normatively resolved while preserving the system's overall intention of securing peace and prosperity, and freedom and democracy. In other words, the necessity of a European government is derived from the overall objective of European integration. If this objective is abandoned, a subject which is beyond the scope of this chapter, there is no longer a necessity for a European government.

My solution to the dilemma of legitimacy in the European Union is strikingly simple. It sets up a *political union* that realises the fundamental principles of *democracy*; I have called it the *European Republic*. This political union consists in appointing a European government responsible for administering those (and only those) European public goods which affect *all* European citizens, and this government would be subject to the general suffrage of all Europeans, thereby making sure that it acted in accordance with the preferences of European citizens. This solution is not the federal model, as I will show below. It describes a republican approach to European integration, because it builds upon the participation of free and equal citizens, and not upon cooperation between governments. It also rejects the holistic idea that citizens can be seen as culturally homogenous representative agents of nations. Democracy is a regime in which *citizens as the sovereign* make political choices and authorise governments to act in their name.⁶⁴ This implies that people (citizens) have authority, while governments have power. Traditionally, this concept of democracy has been realised in the framework of nation states, and, as a consequence, democracy has become confused with the identity of the *demos* and is no longer understood as an instrument for defending the interests of citizens. But this association is in no way necessary. If we derive the nature of the republic from the existence and the scope of public goods (the *res publica*), we describe republican democracy as a regime in which people (the principal) control governments (their agents).⁶⁵ Governments are assigned functions; they are not representations of identity feelings.

⁶⁴ The sovereignty of the people does not, therefore, only show up in a 'constitutional moment', but also every time citizens can express their will by voting, and, indeed, every time the representative agents refer to the people when making their policy decisions.

⁶⁵ This interpretation also clarifies why even regimes with constitutional monarchs may be called *republics*.

Moving to the European Republic and appointing a democratic government for the EU would return authority and power to where it belongs: European citizens are the ultimate authority; the European government exercises power as their agent. Notice, however, that such European democracy does not *replace* the traditional nation state or member state governments, which remain in charge of all the policy issues that affect their citizens at national level. The European Republic is a complement, and not a substitute, to the nation state, because European public goods are complementary to national goods. Nevertheless, there will be a range of public goods that cannot be assigned exclusively to either the European or the national level. For example, the organisation of social security is a national matter, but it may affect conditions of fair competition, which are a European issue. Such overlapping not only necessitates cooperation between nation states and the European Republic, but it will also require a transformation of the traditional nation state. Hence, nation states become member states in the European Republic.⁶⁶

The republican approach to European democracy is a form of cosmopolitanism, because it recognises the importance of political communities and states, without assigning priority or exclusiveness to them, and rejects the ‘one-sidedness and limitedness of “reasons of states”’.⁶⁷ Our version of republican cosmopolitanism is, however, closer to the Stoic than to the Kantian account, because it postulates the ‘public use of reason’ with Kant, but it is also aware of people’s cognitive limitations, their bounded rationality, which assigns a role to local *as well as* wider communities. I will return to this issue in the next section. At this point, we simply derive the nature of the republic from the nature of the *res publica*, the public goods.⁶⁸

⁶⁶ For example, the French V Republic may become the VI Republic in the context of the European Republic. This VI Republic must specify the rules by which the national polity interacts with the polity in the European Republic. See S. Collignon and C. Paul, *Pour la république européenne*, Paris, Odile Jacob, 2008.

⁶⁷ D. Held, ‘Principles of Cosmopolitan Order’, in G. Brock and H. Brighouse (eds), *The Political Philosophy of Cosmopolitanism*, Cambridge, Cambridge University Press, 2005.

⁶⁸ For the distinction between Stoic and Kantian cosmopolitanism, see Held, *supra*, note 67. For a value-driven, rather than a functionalist version of republican cosmopolitanism, see J. Bohman, ‘Republican Cosmopolitanism’, (2004) 12 (3) *The Journal of Political Philosophy*, pp. 336-352, at p. 10.

The argument for establishing a true representative democracy in the European Union refers to the basic democratic *principle of congruence*, which says that a government is accountable to citizens for all actions that affect them. I have shown above that this principle implies the absence of Type I and II inefficiencies. Habermas has formulated it like this:⁶⁹

The democratic constitutional state, by its own definition, is a political order created by the people themselves and legitimated by their opinion and will-formation, which allows the addressees of law to regard themselves at the same time as the authors of the law.

Consequently, if there are policy tasks that affect all European citizens, democratic theory postulates that they, the citizens, and not national governments, must have the ultimate authority over deciding what needs to be done. This ultimate authority is their sovereignty. In the European Republic, voters must be able to exert their authority by choosing between competing parties and their proposed EU-policy bundles. Political competition would not only allow voters to accept or reject leaders, but it would also promote policy debate, deliberation, innovation and preference change.⁷⁰ In today's European Union, the process of political contestation and European-wide deliberation is severely constrained, because policy choices are made by intergovernmental bureaucracies, and citizens provide little or no input into these public choices.⁷¹

The problem is institutional. The European Commission, effectively a weak European executive, is nominated by the European Council of

⁶⁹ J. Habermas, *The Postnational Constellation, Political Essays*, Oxford, P, MIT Press, 2001.

⁷⁰ S. Hix, *The End of Democracy in Europe? How the European Union (As Currently Designed) Restricts Political Competition*, LSE Working Paper, LSE, London, 2003, available at http://personal.lse.ac.uk/hix/Working_Papers/HixEnd_of_Democracy_in_Europe.pdf.

⁷¹ It is true that NGOs and lobbying groups provide feedback and technical knowhow for European policy makers (for a discussion, see S. Collignon, and D. Schwarzer, *Private Sector Involvement in the Euro. The Power of Ideas*, London, Routledge, 2003). But the segregated debates in such epistemic *communities*, even if they are European epistemic communities, disenfranchise ordinary citizens and prevent the emergence of an epistemic *constituency* that defines a democracy.

the heads of states and governments, and, although the European Parliament (EP) has to approve the nomination of its members, the Commission is less concerned with obtaining political party support in Parliament, than with ensuring the consent from important governments. Essential legislation is made in the European Council, with the EP as a co-legislator, but members of parliament rarely dare to go against the *explicit* will of their national governments.⁷² Thus, European political orientations do not systematically reflect the political majorities in the European Parliament, and are therefore not controlled or controllable by EU citizens. Because European elections do not allow citizens to choose an EU-government, they remain of 'second order', and the voters are more likely to express dissatisfaction with their national government in EU elections.⁷³ National governments control political orientations⁷⁴ and political debates reflect the interests of states and national political classes. Thus, Europe's epistemic constituencies are national and segregated. Partisan debates about what is the proper direction and orientation of European policies are framed in terms of opposing state interests, and not in terms of citizen's interests, and the electoral choices of citizens reflect national policy debates. Thus, the intergovernmental governance is a major factor which contributes to the democratic deficit and to the growing de-legitimisation of EU institutions.

⁷² There is evidence that the ideological left-right dimension dominates voting in the European Parliament (see A. Noury, 'Ideology, Nationality and Euro-Parliamentarians', (2002) 3 *European Union Politics*, pp. 33-58) and that national parties dominate votes in the EP party groups (See S. Hix, 'Parliamentary Behavior with Two Principals: Preferences, Parties, and Voting in the European Parliament', (2002) 46 *American Journal of Political Science*, pp. 688-698. This dependence on national parties can be used by governments to force their own MEPs to vote against the European party line, as was witnessed when the Portuguese and Spanish Socialist governments requested their MEPs to vote for the conservative Barroso as Commission president in 2009.

⁷³ S. Hix, A. Noury and G. Roland, *Democracy in the European Parliament*, LSE Working Paper, LSE, London 2005, at p. 31, available at: <http://personal.lse.ac.uk/hix/Working_Papers/HNRDemocracy_in_the_EP-11July05.pdf>.

⁷⁴ The Treaty of Lisbon explicitly stipulates: 'The European Council shall provide the Union with the necessary impetus for its development and shall define the general political directions and priorities thereof. It shall not exercise legislative functions' (European Union, 2008).

For many years, the existence of a democratic deficit has been the subject of heated debates among scholars.⁷⁵ But the issue of democracy goes further than whether citizens can choose policies *at European level*. In fact, intergovernmentalism perverts democracy even *within the nation state*. Democracy is 'perverted' if governments can escape domestic mechanisms of democratic accountability.⁷⁶ But this is precisely what happens when governments use the relative autonomy of their agency status in negotiating with other governments. Clearly, agency problems and the question of how to monitor governance are as old as representative democracy itself, but, as we have seen above, the EU is unique, in that it institutionally generates a gap between citizens' preferences and policy decisions made by governments. Because the intergovernmental compromise is a Nash-equilibrium, governments can justify this escape from accountability by claiming that 'there is no alternative' (TINA), and that 'pacta sunt servanda'. When legislation is issued by the European Council or the Council of Ministers, national parliaments must endorse it to make it enforceable law. Governments argue that their parliaments 'have to' implement the agreed policies, because, otherwise, the whole European edifice would fall apart. But this argument marginalises national policy deliberation and empties debates in national parliaments of any substantial content. By 'perverting' domestic politics in this way, governments lose the argument that cooperation between member states is legitimised by the 'indirect' democracy in the Council, where only democratic governments are represented. The reason for this perversion of democracy is, therefore, inherent in intergovernmentalism. Demands that national parliaments should assume greater responsibility for European policies, as recently formulated again by the German Constitutional Court,⁷⁷ cannot solve the problem, because they reproduce the subsidiary dilemma discussed above. The fundamental

⁷⁵ For references see J. H. H. Weiler, U. R. Haltern and F. C. Mayer 'European Democracy and its Critique', in J. Hayward (ed.) *The Crisis of Representation in Europe*, London, Frank Cass, 1995; F. W. Scharpf, *supra*, note 46; A. Moravcsik, 'In Defense of the "Democratic Deficit": Reassessing the Legitimacy of the European Union', (2002) 40 *Journal of Common Market Studies*, pp. 603-634; Follesdal and Hix, *supra*, note 16.

⁷⁶ D. Wincott, 'Does the European Union Pervert Democracy? Questions of Democracy in New Constitutionalist Thought on the Future of Europe', (1998) 4 *European Law Journal*, pp. 411-428.

⁷⁷ Bundesverfassungsgericht, 2009. 'Entscheidung zum Lissaboner Vertrag'; BVerfG, 2 BvE 2/08 vom 30.6.2009, Absatz-Nr. (1-421), available at <http://www.bverfg.de/entscheidungen/es20090630_2_bve000208.html>.

problem with democracy in Europe is that, *as a rule*, citizens have no choice over the policy output that the intergovernmental European governance system produces at European level.⁷⁸ As a consequence, European citizens are not the authors of the law although they are subject to it.⁷⁹

Overcoming preference heterogeneity

If the principle of congruence is to be applied to the European polity, European citizens must authorise the agent that administrates their public goods, i.e., they must be able to elect a government by universal suffrage. We must now discuss the conditions under which such government would be legitimate. As Bohman rightly argues, it would be naïve to think that democracy can bring about its own pre-conditions.⁸⁰

One objection to creating a European government is the argument that the variety of many nations and the people in Europe with different beliefs, ideas, identities, and preferences, prevents imposing a single set of policies legitimately. There are too many *demoi*, but no single *demos*. Without a pre-existing *demos*, the federalist dream of a European state also vanishes. Some thinkers have drawn the conclusion that the European construction must accommodate the persistence of the many *demoi* in Europe.⁸¹ However, preference heterogeneity is a matter of time. In the short run, beliefs, opinions, and preferences are given. But, over time, they change. As people learn from each other, their views converge. When new ideas appear, the (potential) consensus is 'shocked', and noise and dissent emerge. I call this process stochastic consensus.⁸²

⁷⁸ The salience of the problems disappears when the system produces output legitimacy, because citizens are then happy with what member state governments decide.

⁷⁹ I am aware that agency problems may also pervert classic democratic systems in nation states. How to minimise this danger is a matter for constitution writing. But in the EU, democracy-perverting inefficiencies are systematically produced by intergovernmental policy cooperation.

⁸⁰ J. Bohman, 'Democratizing the Transnational Polity. The European Union and the Presuppositions for Democracy', RECON Online Working Paper 2007/02, ARENA, Oslo.

⁸¹ Bohman, *supra*, note 80; K. Nicolaïdis, 'The New Constitution as European "Democracy"', (2004) 7 *Critical Review of International Social and Political Philosophy*, pp. 76-93.

⁸² Collignon, *supra*, note 12; Collignon, *supra*, note 53.

What is important for the foundation of political authority is, first of all, under what conditions political preferences converge to an equilibrium, which we may call the 'general will'. And, secondly, we need to know how long it takes for this general will to emerge and what determines the speed of preference convergence.

These issues are only addressed by the republican-cosmopolitan model of European integration. The intergovernmental model can ignore them, because it assumes preferences as being exogenously given. The static approach to collective preferences pushes the project of European integration back to intergovernmental cooperation, to representative democracy in the nation state with accountability as 'audit democracy'. The federalist model assumes a federal identity *ex ante* and appeals to symbolic acts of affirming this identity without being able to demonstrate how consensus will come about. In our republican model, the communitarian identity of the *demos* is the *consequence* of public deliberation, because the consensual identity emerges from the process of pondering the weights of arguments, and not just from the values and beliefs alone that individuals hold.⁸³ An individual will change his or her beliefs if he or she thinks another person has better arguments. The weights of arguments are not necessarily equal, although all individuals in a consensual community are likely to attach the same weight to the same argument.⁸⁴ In fact, this is the reason why they believe themselves to be 'identical', i.e., possessing an identity, despite being very different individuals. I will now show that establishing a democratic government is a necessary condition for policy preferences to converge towards greater homogeneity.⁸⁵ The key to this argument is a re-interpretation of the theory of deliberation.

⁸³ We therefore propose an individualistic concept of community, where the comprehensiveness of ideas emerges from individual *choices* (the decision and assignment to trust), and not from community *membership* and the assignment of *status* to individuals, as it is usually done in holistic-communitarian conceptions.

⁸⁴ K. Lehrer and C. Wagner, *Rational Consensus in Science and Society*, Dordrecht, D. Reidel Publishing Company, 1981.

⁸⁵ A necessary and sufficient condition would be a democratic constitution that protects individual and human rights and ensures the practical validity of principles of justice.

How are collective preferences generated? Why are they often heterogeneous over different groups? For economists, preferences are exogenously given.⁸⁶ For liberal realists such as Moravcsik,⁸⁷ preferences change with structures, but structural change remains exogenously determined. There is, therefore, little that institutions or human agency can do to change them. In contrast, theories of deliberative democracy explain preference change as a consequence of communication.⁸⁸ The notion of deliberative democracy is rooted in the Kantian cosmopolitan ideal of the democratic association of rational individuals, in which the justification of the terms and the conditions of this association proceeds through public argument and reasoning among equal citizens.⁸⁹ The most convincing argument wins. This is useful because it allows public choices in terms of non-instrumental rationality, and makes it possible to see preferences not as static pre-conditions for choice, but as the outcome of a dynamic process.⁹⁰ We need to understand the conditions under which this process becomes possible, and the conditions which structure the flow of information and, therefore, the speed of preference change. If the theory of deliberative democracy could help us to understand *how preferences change*, it will supply us with reasonable arguments as to why and how the epistemic constituency of the European Union could be enlarged. As we have seen, this enlargement is a necessary condition for restoring the principle of congruence and solving the legitimacy problems in the EU. This makes the cosmopolitan model attractive for reconnecting democracy with Europe.

The theory of deliberative democracy, as discussed in the literature, has some well-known weaknesses. What matters for us, here, is that it postulates the existence of a public sphere as a *pre-requisite* for democracy and sets ambitious standards for the conditions under which deliberation can acquire universal validity. In the European context, reality is seen wanting when compared to those standards.⁹¹

⁸⁶ G. Becker, *Accounting for Tastes*, Cambridge, Harvard University Press, 1996.

⁸⁷ Moravcsik, *supra*, note 25.

⁸⁸ Habermas, *supra*, note 22.

⁸⁹ J. Habermas, 'Further Reflection on the Public Sphere', in C. Calhoun, (ed.), *Habermas and the Public Sphere*, Cambridge, The MIT Press, 1992, at p. 446.

⁹⁰ J. Heath, *Communicative Action and Rational Choice*, Cambridge, MIT Press, 2001.

⁹¹ U. Liebert and H.-J. Trenz, 'Between Norms and Practices of the Public Sphere: Assessing the Infrastructure for Democracy in Europe', in E.O. Eriksen and J. E.

Thus, if the European Union lacks an integrated public sphere, then, there can be no European democracy. The argument hinges on the assumption that the public sphere is founded on some form of cultural or constitutional identity,⁹² without which individuals would not accept political equality. What the argument boils down to is: 'we' do not want to be outvoted by 'them'. The issue becomes important in the context of integrating 'big' and 'small' countries into a European democracy. If preferences were given and unchanging, the bigger countries will always dominate the smaller, or the tyranny of the majority would oppress minorities. This is one of the most powerful arguments against centralising federalism.

But, if preferences change because individuals discuss arguments in favour or against a given policy, the identity dissolves and new identities are created, because people change their views, attitudes, values and preferences. However, the willingness to form beliefs on the basis of information communicated to others, and the capacity to communicate information to others with the expectation that it will be believed, requires a *generalised system of trust*.⁹³ Hence, what matters for policy consensus, i.e., for the acceptance of political choices, is an institutional framework that allows citizens to debate policy issues and ponder the weight of arguments which other people put forward. In other words, trust is generated in the process of communication and this leads ultimately to agreement. Democracy does not require national or cultural identity as a pre-requisite for setting up a common government; it needs institutions that generate debate and empower public audiences to turn to *broad constituencies* for legitimating collective decision-making.^{94,95}

Fossum (eds), *RECON – Theory in Practice*, ARENA Report No 2/09, Oslo, ARENA, 2009.

⁹² J. Habermas has called this attachment to constitutional identity 'constitutional patriotism'; J. Habermas, *Between Facts and Norms*, Cambridge, MIT Press, 1996.

⁹³ Heath, *supra*, note 90, at p. 83ff.

⁹⁴ Liebert and Trez, *supra*, note 91, at p. 166.

⁹⁵ Democracy needs the broadest possible constituency, namely all citizens concerned by policy decisions, i.e. in the policy domain. This is why deliberation in restricted epistemic constituencies, for example through committees, the Open Method of Coordination in the Council or in the civil society of NGOs, cannot become a substitute to genuine democratic debate. For a discussion of supra-national deliberation through committees, see the different contributions in E.O. Eriksen, C. Joerges and J. Neyer (eds), 'European Governance, Deliberation and the Quest for Democratisation', ARENA Report 02/2003, ARENA, Oslo.

If, in Europe, there is no integrated public sphere, it must have institutional reasons. Most of the academic literature on the European public sphere argues that the fault is on the supply-side: there are no actors, there is no language, no media, and no formal or informal institutions which could carry the deliberative process across the continent. But the supply-side only responds to the demand-side. Gathering information, participating in public debates is costly in terms of time and money. Bearing these costs only makes sense if one can reasonably expect to gain from it, be it in terms of better policy decisions, swinging majorities in favour of one's own preferences, or simply because understanding the world improves one's standing with others. Participation in political debates and deliberative processes depends on the balance of the costs and benefits necessary to make choices and decisions. When political institutions do not allow citizens to make political choices, the benefits from participating in trans-European debates are close to zero. Hence, if people do not bother about policy deliberation, it is because the benefits that they expect are insignificant, given how the EU polity works.

In a democracy, sovereign citizens authorise governments to act on their behalf. What they authorise, and what they reject, is the *object* of public debates among free and equal citizens. Europeans are equal in their status as owners of European public goods, but not because they all think alike. They have shared interests, but distinct identities. If European citizens could exercise their sovereign rights over European public goods and take sovereignty away from states, their preference heterogeneity and different 'identities', which are the main arguments for subsidiarity, become less of a problem for democracy. However, this argument is only valid if we can show how the process of political deliberation within an integrated polity would contribute to preference convergence. One way to make this point is to trust a Kantian view of procedural rationality: people convince each other by the power of the best argument.⁹⁶ But this approach has been criticised for its idealistic and unrealistic assumptions.⁹⁷ The theory of

⁹⁶ C. Calhoun, 'Introduction: Habermas and the Public Sphere', in C. Calhoun, (ed.), *Habermas and the Public Sphere*, Cambridge, The MIT Press, 1992.

⁹⁷ C.R. Sunstein, 'Deliberative Trouble? Why Groups go to Extremes', (2000) 110 *The Yale Law Journal*, pp. 71-119; L. Sanders, 'Against Deliberation', (1997) 25 *Political Theory*, pp. 347-76; J. Knight and J. Johnson, 'Aggregation and Deliberation: On the Possibility of Democratic Legitimacy', (1994) 22 *Political Theory*, pp. 277-296.

stochastic consensus⁹⁸ provides an alternative to the idealistic weaknesses of deliberative democracy.

In this framework, consensus about collective preferences is the result of real, and not ideal, communication processes which are always going on in every society. This realism shifts the focus from substantial arguments to procedural conditions of communication. Stochastic consensus on policy preferences, i.e., convergence on the *likelihood* that proposed policies are accepted by citizens, is seen as the *expected equilibrium* of the views or preferences that individuals are likely to adopt under conditions of bounded rationality. It emerges, as the communicative inter-actions between individuals will influence the readiness of citizens to accept specific ideas.⁹⁹ There are two necessary and sufficient conditions for this stochastic consensus to emerge. First, *bounded rationality* implies that individuals are aware of their limited cognitive resources. They do not know *everything* perfectly, and are, therefore, willing to learn from others, whose cognitive capacities they evaluate and whose judgements they trust. They are, therefore, open to being influenced by those whom they trust, although the likelihood of accepting another person's view may vary from issue to issue and from person to person. Nevertheless, people learn from each other, not for altruistic motives, but because it serves their interests, given their limited cognitive resources. Second, *connectedness* implies that information circulates through the specific patterns of connection and trust that exist between persons in the society. Individuals gather information that is useful for them through networks of people. What one person does not know may be learned through accessing another person he or she trusts, even if it is indirectly through a chain of connections. The connectedness condition is fulfilled when all the individuals of a society are directly or indirectly connected through a network of relations, or, in the same manner, through a network of influence. This is a fairly simple and realistic assumption, for if it were not fulfilled, society would split into separate units. These two assumptions overcome the highly stylised conditions of ideal discourse settings, which characterise the Kant-Rawls-Habermas model of rational deliberation. As Lehrer and

⁹⁸ Collignon, *supra*, note 12.

⁹⁹ See Collignon, *supra*, note 12, at p. 135, for a simple and practical example for policy deliberation on economic policies in a democratic setting.

Wagner have shown,¹⁰⁰ consensus will emerge as individuals learn from each other, because, if these conditions are fulfilled, rational people *cannot but agree*. If they have doubts about the appropriateness of their own preferences, intellectual coherence requires that they take each other's views into account and that makes them converge to consensus in the process of exchanging information. This is the core idea of stochastic consensus.

In this model, *institutional structures are important for the speed by which consensus emerges*. This is where stochastic consensus adds to the republican model a degree of practical realism that purer models of cosmopolitanism do not provide, for it integrates the emergence of communities into the broader process of preference convergence in society. If the process of convergence to consensus is slow, noisy dissent prevails in the public sphere. It looks as if preferences are quasi-permanent and exogenously given. This makes the acceptance of centralised policy decisions at European level more difficult. The denser the network by which individuals are connected is, and the flatter the hierarchies of communication are, the faster information will spread across society. And the more rapidly information travels and influences people's opinions, the faster consensus will emerge. In today's non-democratic system of European policy-making, policy debates are concentrated in closely connected local or national communities which elect their 'own' government, while cross-border connections are loose. Thus, political life in nation states is characterised by a dense network of communication and the resultant local consensus is the foundation for national policy identities. In contrast, the flow of information between countries is strongly concentrated in the intergovernmental transactions of policy networks, and this fact slows down the flow of information between the populations in different member states. This structure of communication leads to the rapid emergence of local consensus in national political community, but only to very slow consensus among European citizens. As a consequence, political preferences seem to be tied to communitarian identities, and the likelihood of accepting common policies is low. However, the structure changes in the European Republic. Democratic institutions could facilitate and accelerate the emergence of policy consensus across the European Union, because people need to choose a government on Election Day

¹⁰⁰ K. Lehrer and C. Wagner, *supra*, note 86.

and in order to make a decision, they will talk, connect and deliberate with people whom they trust and to whom they are connected. This flattens the hierarchy of communication. On the other hand, political candidates and parties need to win a majority of voters, and this forces them to build cross-border political alliances around (reasonably) coherent programmes. Candidates seek to influence voters in electoral campaigns. So, they must communicate with voters, and citizens will demand information and explanations prior to making up their minds upon whom they should elect. If European citizens must choose a European government, this task will connect them, not by civic virtue but by selfish interest, and, as a consequence, the emergence of policy consensus will be more rapid. A European government could not exist without cross-border communication. Hence, democratic institutions and elections at EU level matter, because they provide choices that foster mutual respect across borders. It is precisely this that Jean Monnet sought to achieve.¹⁰¹

Collignon and Schwarzer have described how private citizens and NGOs contributed to the enhancement of trust across borders during the creation of European Monetary Union.¹⁰² But such civil society structures are lacking the permanence of constitutional arrangements. They form what Eriksen called 'weak public spheres'.¹⁰³ By establishing citizens' rights to vote and to choose their government, democracies anchor democratic debates and deliberation in the citizenry. It has often been observed that the emergence of the public sphere has been historically correlated with that of the nation state. But, in fact, the public sphere only developed once the absolutist state turned into a representative democracy. The right to elect a European government would remove the institutional separation which today inhibits the emergence of an integrated public sphere and prevents the circulation of ideas and information in European policy debates. The democratic right to choose a government establishes the European public sphere.

¹⁰¹ See the quotation at the beginning of the chapter.

¹⁰² Collignon and Schwarzer, *supra*, note 71.

¹⁰³ E. O. Eriksen, 'Conceptualising European Public Spheres', in J. E. Fossum and P. Schlesinger, *The European Union and the Public Sphere. A Communicative Space in the Making?*, London, Routledge, 2007.

In my books *The European Republic. Reflections on the Political of a Future Constitution*¹⁰⁴ and *A Theory of Stochastic Consensus*,¹⁰⁵ I have simulated some stylised facts to study the implications of the governance structures in the European Union for the speed by which policy consensus will emerge.¹⁰⁶ I have distinguished three models: in the intergovernmental, model citizens are directly related to their government, but only their governments communicate across borders through diplomatic channels. In the second model, intergovernmental connections are strengthened by communication through the work of the European Commission. Finally, in the European Republic, a European government is directly accountable to its citizens and to member state governments. Policy dissent is measured as the standard deviation of preferences at any point in time from the latent consensual equilibrium. The results of these simulations show that the likelihood of more rapid speed of preference convergence is significantly increased if a European government is accountable to all European citizens. Policy dissent dies out most quickly under the regime of the European Republic and is most persistent under pure intergovernmentalism. Thus, the theory of stochastic consensus provides useful theoretical underpinnings for the argument that setting up a democratic government at European level and creating a political union with full democracy would help to overcome the problem of preference heterogeneity.

Objections

The project of the European Republic raises many questions. Is the idea not utopian? Does it not lead to a dreadful and dreaded European super-state? Is it not federalism, and threatening the existence of European nation states? Is the European Republic a Leviathan that stifles markets? Will it end democracy as we know it? In response to such questions, I will now match the concept of the European Republic against the three models of European integration developed by Eriksen and Fossum.¹⁰⁷

The intergovernmental model sees European integration as a task for the member state governments. It assumes that *states are sovereign* and

¹⁰⁴ See *supra*, note 12.

¹⁰⁵ See *supra*, note 52.

¹⁰⁶ Collignon, *supra*, note 12; Collignon, *supra*, note 52.

¹⁰⁷ Eriksen and Fossum, *supra*, note 5.

governments will cooperate when they reap the benefits that exceed the cost from the given cooperation. Integration is legitimised by the good results that it produces for citizens. Our republican approach agrees with this reasoning for the limited range of inclusive public goods. For the first two or three decades of European integration, strategic complementarities generated incentives which were able to drive the process of European construction. But, since the implementation of the single market and the Treaty of Maastricht, this is no longer the case. A whole new range of exclusive public goods has been created and here the old governance logic no longer functions properly. Strategic substitutability prevents the optimal provision of European public goods. Thus, the intergovernmental model is no longer an efficient method for administering a large range of European public goods today. But the republican approach to European integration not only criticises the sub-optimal provision of public goods, and, therefore, the reduced output-legitimacy that this model yields, it also demonstrates that intergovernmentalism cannot transcend the important preference heterogeneity between different member states. Diverging policy preferences between member states hamper the efficiency of the policy-making process itself. But, in addition, intergovernmentalism undermines the democratic process at both national and European level. This is a normative violation of the big picture of European integration, namely, that one of its objectives is the preservation of freedom and democracy. Intergovernmental policy-making with a technostructure of remote-controlled, opaque and sly bureaucrats resembles more to the *Ancien régime*, in which a paternalistic aristocracy pretended to know best what was right and good 'for the people', than to a modern democracy. Today, the perception of being ignored as citizens is the root-cause of the popular disenchantment that fuels euroscepticism.¹⁰⁸

European federalists seek to remedy the efficiency problems of the intergovernmental model by more policy delegation to the European level and, ultimately, by setting up a federal state. This is the second model in the Eriksen-Fossum framework. Our republican approach argues that the centralising federalist solution is unnecessary and inappropriate for the range of inclusive public goods, because, in this

¹⁰⁸ R. Teboul, *Contre l'Europe: l'après referendum*, Paris, L'Harmattan, 2005, at pp. 14-16.

case, sufficient incentives exist for the voluntary cooperation between national governments to produce the benefits of European public goods. Centralising federalism would, however, improve the governance of exclusive European public goods. In certain policy areas, such as monetary, trade, or competition policies, the federalist logic already applies today. However, there are flaws in federalism, which become apparent when one turns from output legitimacy to input legitimacy. Centralising federalism requires a highly developed sense of collective identity *a priori*, and there is little evidence for it. Decentralising federalism promotes the concept of subsidiarity in order to accommodate the prejudices (in the literal sense of the word) of the existing local communities and nation states. In the first case, preference heterogeneity is statically preserved. The holistic communitarianism of regional identities, combined with the principles of subsidiarity, prevents efficient policy-making as well as democratic accountability. In the second case, the federalist model fails, because citizens usually identify more with national, than European, traditions and preferences. Nevertheless, the European Republic shares with federalism the assignment of different government levels. But while federalist ideology derives this assignment from epistemic arguments of identity, the European Republic follows the functionalist logic of public goods.

The European Republic is not the same as a federal state. While European federalism seeks to integrate people's identity, the European Republic articulates common interests, and acknowledges that citizens can have *any identity* that they wish to adopt and at the same time share common interests. Citizens are simultaneously the sovereigns for decisions taken at the level of the Union and at the level of member states. The fundamental principle is that individual citizens are the ultimate authority for decision-making. Governments, be they at regional or federal level, are citizens' agents charged with administering public goods that affect them through different scopes of externalities. However, the European Republic is not a state, for it does not require the thickness of norms and traditions that characterise states. Nor does the European Republic have to recreate the coercive power apparatus, which is typical of states. It is a republican version of federalism, because it realises the basic democratic principle of congruence, whereby different groups of citizens become the authors of precisely those laws that are addressed to them: or, to put it differently, everyone shares the right to

authorise exactly those policies, which have an effect on his or her life. Citizens collectively control fundamental policy orientations and thereby become the masters of their destiny. But policing these policies can, to a large degree, be delegated to the member states. Europe is built on nation states. Their roles and identities are different from the states in the United States of America, and Europeans have long and varied historical traditions of government and policy-making. These differences need to be addressed when designing the European republic.¹⁰⁹

The European Republic is also no superstate, because it does not appeal to the concept of state. As MacIver pointed out, one can distinguish between the government and the state, when constitutional law binds the legislator in the making of law.¹¹⁰ The European Republic requires a European government for policy-making, but it does not focus on the coercive functions of the state, which can be delegated to the member states. Contrary to the concept of the unitary state that prevails in the UK or in the French Republic, the European Republic recognises that the republic can be 'one and divisible' because there are many different public goods that do not affect all citizens equally. This fact allows us to see the European Republic as an articulation of the third model of European integration, which Eriksen and Fossum call cosmopolitan.¹¹¹

The cosmopolitan model has the advantage that is rigorously founded in methodological individualism and thereby avoids the fallacies of political holism,¹¹² which prevents European citizens from defending their interests beyond the nation state. Individual citizens seek to advance the common good by deliberating publicly about what is best for them. They are not inhibited to opt for what is reasonable by considerations of identities, traditions, *Sitte* (Hegel), or by the authority of states. However, the primordial focus on public deliberation can backfire when insufficient attention is given to the institutions of democratic *choice*. Associating citizens through NGOs and other civil society organisations to the policy deliberation of

¹⁰⁹ For fuller details of how to conceive the European Republic, see Collignon and Paul, *supra*, note 66.

¹¹⁰ R. M. MacIver, *The Modern State*, Oxford, Oxford University Press, 1926, at p. 277.

¹¹¹ Eriksen and Fossum, *supra*, note 5.

¹¹² K. Popper, *The Open Society and its Enemies*, London, Routledge, 1995.

élites, without giving them the right to choose and elect, can become a manipulating device to reduce dissatisfaction in the intergovernmental model of policy-making. The republican approach overcomes this handicap by placing deliberation at the broadest possible constituency. At the same time, our concept of European republicanism is non-communitarian and anti-holistic, because it recognises individuals as the owners of public goods. As owners, they have a right to appoint governments to manage their collective property. They are the sovereign, governments are their agents. This is the modern conception of democracy.

The European Republic covers more than many single public goods. It bundles them to the *res publica*. This is necessary because the range of externalities has grown so large and become so diversified that the usual mechanisms of policy coordination are no longer capable of coping. The traditional nation state has become dysfunctional in the European Union. Constructing the European Republic is a device for internalising external effects by democratic choice mechanisms.

This is why the European Republic is not a Leviathan. It delegates policies to the European level in accordance with the nature of specific public goods. The question of 'who is affected by policy decisions' decides which jurisdiction should be competent. This criterion solves the problem of proximity, which is often used to justify decentralising subsidiarity: if citizens know that they are affected by European policy decisions and can influence these decisions, then Europe is not distant. Furthermore, only exclusive public goods need to be fully within the domain of the European government, while inclusive public goods may well be provided by voluntary policy cooperation amongst the individual member states. For the rest, the question of how much government interference is appropriate for maximising the welfare of citizens is a matter of public debate and political controversy, and will be decided by party competition and the votes of the citizens.

The republican approach to European integration is not utopian, but has practical implications. For example, the Treaty of Lisbon (European Union, 2008) defines in Part I, Title I, categories and areas of Union competence. Art. 2 confers *exclusive* competence on the Union (essentially for competition rules, monetary policy, foreign trade), where 'only the Union may legislate and adopt legally binding acts'. Subsequent articles stipulate forms of interaction between the

Union and the member states. In many traditional policy areas of the European Union (mainly internal market, social and cohesion policies, agriculture, environment, energy, transport, freedom, security and justice, etc.), Union competence is *shared* with member states. In some areas, such as research, technological development and space, the Union is to have competences *co-existing* with those of member states, and in health, industry, education, and culture, the EU may *support* national policies with complementary competences. This categorisation becomes useful when we match it with our characterisation of inclusive and exclusive public goods. Exclusive goods should fall under the exclusive competence of the EU. For inclusive public goods shared, co-existing or supporting competences between member states and the EU may be appropriate. However, the Treaty of Lisbon does not allocate competences in accordance with the externality problems. It has two major shortcomings. First, the match between the exclusive competences and exclusive public goods is deficient. For example, fiscal policy coordination is not classified as an exclusively European policy area. Other areas, such as foreign policy are also given different regimes. It is, therefore, necessary to redefine the content of these exclusive competences and the Treaty of Lisbon would allow this to be done at least in some areas. Verhofstadt has provided a sensible list for where the EU should have exclusive competences:¹¹³ (1) Macro-economic management of the Euro Area, including the European budget; (2) Large European projects for technological research and development; (3) A single European area of justice and security to fight crime more effectively; (4) European diplomacy; and (5) A European intervention force. These are broad categories, which need to be translated into the specifics of daily politics.

Secondly, the Treaty of Lisbon remains unclear with regard to who will be the representative agent of European citizens in the long run: the Council or the Commission? In other words, the Treaty does not give the European Union a democratic government. It has strengthened the power of the Parliament and this is often claimed to represent democratic progress. But more power to the European Parliaments is not sufficient to manage exclusive European public

¹¹³ G. Verhofstadt, *The United States of Europe*, London, The Federal Trust, 2005.

goods efficiently when discretionary policies are required.¹¹⁴ The European Republic approach calls for a European executive, a government. Given that the European Commission already operates a well-functioning administration, it would be logical that it both assumes responsibility for administering exclusive public goods, and implements policies that are democratically authorised. But such a re-allocation of competences would be resisted by member state bureaucracies. Yet, the Treaty gives the European parliament the power to confirm the European Commission and a broad range of laws. There is, therefore, ambivalence as to where the real power is, and from where it derives its authority: from governments or from citizens? One day, the conflict of interests between citizens and bureaucracies will require clarification. A power struggle between the Council, representing national governments, and the Parliament and the Commission, representing European citizens, will have to push the issue to a point at which the present ambivalence of the Treaty of Lisbon will be overcome.¹¹⁵

Conclusion

How realistic is the European Republic? Utopia is the land that will never be. Our analysis has shown that a European Union based upon intergovernmental coordination fails to be an efficient actor and a legitimate policy-maker. Collective action problems, prisoner dilemmas and the lack of legitimacy, are all preventing the Union from having power, defined as the collective capacity to act, and from having legitimacy for its pursued policies. The true utopia is, therefore, the idea that the European Union can be run by an intergovernmental mode of policy-making and simultaneously remain capable of acting as a powerful world player.

¹¹⁴ The American Articles of Confederation, the first Constitution after Independence, failed precisely because Congress was a law-making, but not an executive, institution. It was the 'Miracle in Philadelphia' in 1787 that established a federal government capable of pursuing discretionary policies.

¹¹⁵ The English revolution is the classic example for the power struggle between Parliament and autocratic rule, which ended with the solution of representative parliamentary democracy, even though, at first, the Parliament was far from being truly representative. In Europe, the battle has to be between the European Parliament, representing all European citizens as the sovereign and partial interests of nation states' élites.

In this chapter, I have argued that the way in which Europe is governed is unsustainable in its present form. In the new environment of 27 member states and a deeply-integrated range of public goods, the risk that fifty years of European integration might unravel is high. I have shown that European republicanism could resolve the normative contradictions that haunt the European Union today. These contradictions result from the growing externalities of public policies due to globalisation and Europeanisation, and the need to manage their effects according to the principles of modern democracy.

In democracies, power resides ultimately with citizens. The rise of euroscepticism has been a sign of the disenchantment of citizens with Europe's present-day governance. So far, this silent rebellion has had no voice. No spokesperson has turned resentment into improvement, or given voice to create loyalty and, therefore, help to avoid exit. The importance of Europe's common public goods, and the depth of Europe's already existing *res publica*, merit more than merely accommodating the *status quo*. This chapter indicates a direction. In the end, it is up to European citizens to make the European Republic the democratic reality of our time.

Appendix

Socialism and federation¹

Barbara Wootton

I

The term socialism is constantly bandied about in debate with reckless disregard for consistency of meaning. There are now sects within sects, and a bewildering variety of orthodoxies and heresies. In consequence it would be easy enough in all sincerity to write a tract on socialism and federation, of which many professing socialists would say that it was all very well, but that it had nothing to do with socialism. Indeed, it is already nearly impossible to write anything on this subject without provoking some socialists to say this.

In the hope, however, of minimising that supremely barren form of controversy in which the disputants use the same word in contradictory senses, I shall begin writing down a few broad principles which seem to me to be the most clearly distinguishing characteristics of socialism, as the term is generally used by socialists themselves. For the purposes of this tract, then, a socialist is a person: (1) who wishes to see available resources used in the way that will provide the best possible life and living for everybody; (2) who sets a particularly high value upon economic and social equality for its own

¹ ['Socialism and Federation', World Federation Library, Aundh Publishing Trust, Swatantrapur, 1944, with kind permission of the Federal Union as copyright holder. Additional comments by the editors of this report are included in the footnotes.]

sake (i.e. a socialist is not content with establishing a minimum standard for everybody, if a minority enjoy positions and privileges of gross superiority); (3) who believes that these first two ends cannot be attained without extensive, collective and conscious planning of economic life, and particularly by far-reaching substitution of collective for private ownership of industrial resources; and (4) who sees in the existing inequality of distributing of economic, social and political power (which he calls a class system), a major obstacle to the successful use of the instrument described in (3) for the purpose of achieving the ends described in (1) and (2).

To these propositions it must be added that a socialist always claims to be an internationalist; and that, if there are socialists who set no store by civil and political liberty, or who would cheerfully "sacrifice these in what they conceive to be the interests of their socialist objectives, then this pamphlet is not written for them; because a socialist who is not also politically a democrat cannot be interested in plans for democratic federation. The appeal in these pages is to the great body of socialists who both respect and accept the title of democrat.

Inevitably, these rough definitions still leave a good many loose ends lying about; but I hope that they will do something to tidy up what might otherwise be a very untidy discussion. It is obvious, of course, that assent to one or two of the above propositions in isolation does not make a socialist. They must be read as a whole. For instance, it is not only socialists who would endorse the first of the propositions. The anti-socialist would also say (to-day; but not a century ago) that he too wants everybody to have a decent life and decent living; but he would add that the best chance of achieving this is to give free play to ordinary commercial enterprise, and to prevent the socialistically wrongheaded from putting spokes in the wheel of an economic system which would do the job admirably, if it was only given a chance. It is also plain enough that planning and collectivisation can be (and are) used for purposes which would be altogether horrifying to any one to whom socialism means respect for social equality, for liberty and for the welfare of the common man. Planning and collectivisation are neutral instruments. The socialist is convinced that they are necessary tools for his purpose; but he is aware that, as with other powerful weapons (such as the aeroplane), potential usefulness is apt to be matched by potential noxiousness.

Turning now to Federation, we need be much less worried over problems of definition. For Federation, being less ambitious in its pretensions, is correspondingly more precise in its meaning than is a general concept like socialism. Federation means the establishment over more than one previously independent state of a supra-national government with strictly limited functions. Those functions may be ranged in a sort of priority as follows: First is the rock-bottom minimum, without which a federation is not a federation, namely federal control of armed forces and of foreign policy. Next come powers which a large body of federalist opinion wishes to see federalised, but the lack of which would not actually destroy the distinctively federal character of a supra-national state. These are control of tariffs and other trade restrictions, control of migration, and of currency, and administration of any dependent territories. In this paper it is assumed that these powers will, in fact, be in the hands of any federal authority with which we are concerned. Finally, comes a third group of powers, such as the right to initiate public works and operate public utilities, and to enforce standards in working conditions and social services, The range of these, as we shall see, will largely depend upon the attitude of the socialists themselves.

Within these limits the exact constitution of our Federation must be left unprecise till we know who is likely, to federate with whom in what circumstances. So must its geographical area. Things change appallingly fast nowadays; but at the time when these words are written, interest is concentrated upon Federation as a possible solution of European, and particularly of Western European, problems at the end of this war; and as an objective upon which movements that are revolutionary in Germany and constitutional in this country, might focus their efforts to shorten the war, by removing the conflicts from which it sprang. It is, therefore, particularly a European, or at least a Western European, Federation that I have here in mind; though much of what is said may well have a more general reference, and be relevant to any and every Federation that is democratic, in the sense that the governments of the Federation itself, and of every member state, can be changed without recourse to force. This last qualification must be understood to be implied throughout. There is no occasion to dirty valuable paper by discussion of federated dictatorship.

II

Now the socialist's interest in such a European Federation is the interest, which he shares with every one who lives on this distressful continent, in the establishment of stable peace; but to the socialist, thanks to his urgent desire for social reconstruction and his international sympathies, this common interest appears plus a little something which others have not got. Let us see what the absence of peace and of a stable international order, particularly in Europe, has meant to the socialist movement,

Before the war of 1914 socialists had built up what looked like a powerful international movement. The socialist Second International (Second, because it followed Marx's abortive first attempt in the eighteen-sixties) boasted twelve million affiliated members in the socialist parties of twenty-two countries; and it had no rival. In the tension of international politics in the early years of this century the International set itself to meet the impending threat of war. In 1910 nearly 900 socialists, representing twenty three nations, met at Copenhagen to speak the mind of international socialism on this issue. The conference demanded disarmament, active working-class propaganda for peace, and an end to secret treaties; and it remitted to its executive the task of testing opinion on the possibility of using the general strike as a weapon to prevent war. The report on this last matter was to be submitted to a further conference called for August 23rd, 1914.

On August 1st Germany declared war on Russia. The same day the German socialists sent an envoy to their French comrades in an attempt to agree that both sides should vote against war credits. The French refused this assurance. On August 4th the German Social Democratic Party declared its acceptance of the "grim fact of war" and its refusal "to leave the fatherland in the lurch" in the face of "the horrors of hostile invasion".

From that day to this there has never again been an Undivided international socialist movement. And, except for minute minority parties, there has never again been an international socialist movement which has not at one time or another taken sides in international disputes, and even exhorted its members to take up arms. The greater part of the inter-war period was filled with the unedifying spectacle of internecine disputes between the

reconstituted Social-Democratic Second, and the new-born Communist Third, Internationals. For many years the Second and its affiliated parties struggled to resurrect their traditional pacifism, based on belief in the need for common men and women, the world over, to recognise a community of interests that transcends national distinctions and flouts national boundaries. But after the rise of Hitler came a complete reversal. The British Labour Party, the most influential of all the members of the Second, swung over from complete opposition to the "rearmament of any country in arty circumstances"² to support for a collective security system based upon the armed force of its members. In the war of 1939 the majority socialist parties in the Allied countries followed this policy to its logical conclusion when they lined up behind, or joined hands with, their governments in the conduct of the war.

Meantime, the Third International, after more than a decade of fulminating against the "great betrayal "of 1914, against "imperialist war" and the "robber" League of Nations changed its tune also, with the entry of the Soviet Union into the League. In 1935, anticipating "the attack of a Great Power on a small one, "it was instructing communists to" place themselves in the front ranks of the fighters for

² These were the actual terms of a resolution (underline mine) passed unanimously at the Party Conference of 1932. [Wootton refers to the resolution adopted during the 32nd Party Conference of October 1932 [a contemporary account can be found at *Manchester Guardian* October 3, 1932; for a scholarly account, see M. Worley, *Labour Inside the Gate*, London, Tauris, 2005, pp. 146ff]. It should be kept in mind that the world economic crisis of 1929 and the not unrelated crisis of the League of Nations distabilised Labour. Ramsay MacDonald, who had become the first Labour Prime Minister in British history in 1924 (and served again as such after Labour victory in 1929), resigned in 1931 to form a "national government" supported by the Tories (MacDonald was expelled from Labour). Still, the Party was hardly beaten in the general elections of 1931. A number of MPS from the affiliated Independent Labour Party put an end to the affiliation and reaffirmed the independence of their party, favouring policies to the left of Labour. (on this, see G. Cohen, *The Failure of a Dream. The Independent Labour Party from Disaffiliation to World War II*, London, Tauris, 2007). All these events had the consequence of leaving the leadership of the party in the hands of its most vocally pacifist members. As a result, Labour softened its commitment to multilateral security through the League of Nations and proclaimed a fully unequivocal commitment to outright pacifism. The recent failure of the League in Manchuria was also not without effect in the rank and file of Labour. The policy was bound to be shortlived in an international context marked by the rise of Nazism and fascism. See also J. Callaghan, *The Labour Party and Foreign Policy*, London, Routledge, 2007, especially chapter 4.]

national independence and to wage the war of liberation to a finish". The moral is plain. International socialism cannot stand up against international anarchy. The claims of national security, if not of rampant nationalism, are too strong. As long as there is no machinery other than war to deal with political gangsters, the socialist is faced with an intolerable dilemma. Either he must take up arms against his comrades, or he must lie down before aggression. He has generally chosen the former alternative. And socialism as an international movement is in ruins.

Nor is this all. The socialist is interested in equality and in the standard of the common man's living. It is, thanks to the socialist parties, that an impressive machinery of services has been set in motion (particularly in this country and in the Scandinavian States) which can at least claim to have done something to redress the crazily tilted balance as between rich and poor. But the greatest enemy of such social progress is always war and war preparation. In England, in September 1939, we had just reached the stage when we were prepared to keep all our children at school at least till fifteen, so that the schooling of the majority should only be three, not four, years shorter than that of the prosperous few. Instead, thanks to the war, compulsory school attendance, which had been part of our law for over sixty years, came to an end altogether, and has never since been fully restored. Again, in England, in the budget of April 1940, the cost of one year's war was reckoned at £2,000 millions (an estimate that has already proved quite insufficient). How much is £2,000 millions? In Great Britain there are altogether some fifteen million insured wage-earners. The money assigned to war purposes would therefore suffice to raise the wages of every man and woman, boy and girl, amongst those millions by something like fifty shillings a week. I do not, of course, for one moment, suggest that such a flat redistribution would be the best use for that money, should the abolition of the war menace make any such sum available for social purposes. The figure is quoted merely to give an idea of the colossal possibilities which are closed to us by the persistence of international anarchy.

Thus, twice in half a century socialists have seen the social progress of years shattered in a single night. Twice in half a century they have seen money desperately needed for the homes and health of the people diverted to the hideous business of war. So long as we have to carry burdens of this magnitude, so long shall we have, not socialist

prosperity and equality, but poverty, malnutrition and colossal waste both of human and of material resources. It is intolerable that we should have to put up with this merely for lack of the machinery to stop it. But so long as socialists have no constructive international policy, so long will these burdens have to be carried.

In other words, the notion that you must get socialism first, after which all things international will be added unto you, is a notion which ignores the lessons of experience. By that method you do, to be sure, get certain things which have a place in the list of socialist essentials with which this paper opened. You get conscious collective planning of economic life-but planning in war for war. Planning for equality, planning for construction and for the daily welfare of the common man-these are indefinitely postponed. Everything is held up, or, worse still, put back, owing to our failure to deal adequately with the problem of international, and particularly of European, order. Hitherto the socialist movement has attempted to tackle this problem by two alternating and mutually inconsistent phases. First a phase of pacifism, of assertion of the international solidarity of the working-class and of their determination not to arm against one another; then a complete swing round to popular fronts, to support of programmes of national or collective security and finally, in the case of the majority socialists, to wholehearted participation in war. And all that has been won is the bitter taunt that it is, thanks to the socialists: that, if fight we must, we fight always unequipped and unprepared; The question is then: Can Federation get us out of this impasse? Federation proposes to establish an authority whose business it is to deal with warmongers personally, to take the instruments of warfare out of their hands, and out of the hands of the national states, on whose behalf, legitimately or illegitimately, they profess to act. Federation proposes to establish elementary order in the international field; and to do for states what the state did for individuals, when it put an end to the settlement of personal disputes by knife or bludgeon, bottle-end or pistol. When that kind of elementary order is established, then we can talk about socialism to some purpose. But not before.

Still, however, many socialists are suspicious. They are suspicious because they do not believe that Federation will eliminate the causes of war. War, on this view, is economic in origin. It is, due to the

internal and external stresses of capitalist societies.³ Says Lenin: "The question arises, then, is there, under capitalism, any means of eliminating the disparity between the development of productive forces and the accumulation of capital on the one side, and the partition of colonies and 'spheres of influence' by finance capital on the other side, other than war?" Says Pritt: "States fight to keep or to win markets and fields of investment, to distribute or redistribute the spoils of Imperialist exploitation of colonial territories', They fight with quotas and tariffs, with prohibitions and trade agreements; and in the end they fight with shells and bullets and the bodies of Working-men." Says Laski: "States do not cling to their Sovereignty without cause. They do so to protect a body of vested interests within those boundaries able effectively to invoke its protection."

Now war is a very ancient institution. People have been fighting wars for a very long time – much longer than they have been talking about capitalism and socialism; though not longer than there has been poverty and injustice in the world-which is always. It is reasonable to suppose that at different times in this long history, there must have been different kinds of wars originating in different ways. And it is also possible that, in the nineteenth century, economic conflict, and the desire to exploit less highly developed peoples, were primary causes of war: that it was the conflicts of interest between "a comparatively small group of extremely rich men" which resulted in "one destructive war after another."⁴ But even in that period this is not an entirely satisfactory theory. There were plenty of occasions on which, as in the disputes which led up to the Russo-Japanese war,⁵ fake capitalist interests were deliberately invented by governments as

³ The term capitalism, which has become quite as chameleon-like as its opposite number, socialism, had best be understood to mean anything in English, or American, or any other contemporary Society (except the Soviet Union and the Fascist states), which conflicts with the socialist requirements set out [at the beginning of this pamphlet].

⁴ Dennis Nowell Pritt, *Federal Illusion? An examination of the proposals for federal Union*. London: F Muller, 1940, pp. 82 and 83 [Pritt was a Labour MP with open sympathies for the Soviet Union; by the time the referred book was published he had been expelled from the Party on account of his public defence of Soviet Invasion of Finland. He lost his seat in 1950, in the apex of the Cold War. He was then to receive the Stalin Prize some years afterward].

⁵ [For these and another examples, see L. Robbins, *The Economic Causes of War*, London, Jonathan Cape, 1940.]

a smoke-screen to hide their own political ambitions; and plenty of occasions on which "high finance shook at its knees when any political complications cropped up;" just as, on the other side, there were plenty of genuine examples of financial intrigue luring governments into war in defence of vested interests.

But theory must keep pace with facts. In modern conditions the theory of the exclusively economic causation of war becomes more and more unreal a state which plunges into war in the hope of winning new, or safeguarding old, markets is embarking on a hopeless enterprise; because, whatever else modern war may do, it does not get or keep you markets, not even if you are victorious. The British were victors in the last war, and have been in trouble ever since for loss of the markets which the winning of that victory cost them. And "the small group of extremely rich men" must be stupid beyond belief, if they seriously imagine that total war is going to be good either for their political power. If they have not yet learned from experience that modern war is no respecter of life or property, surely the aeroplanes will teach them soon! But the zeal with which many of these rich men supported Chamberlain's appeasement and peace-at-any-price policy suggests that, on the contrary they already see well enough that their bread is not buttered on the side of war; Economically, modern war is the unmistakable ruination (as that word is variously understood in various stations of life) of rich and poor alike.

It is true that an economic colour has been given to the present war by the immense fuss made by the German government about the hardship due to the loss of their colonies. Facts and figures, however, have established beyond dispute that the economic resources of colonial areas have been greatly exaggerated; although those who supplied these answers were not always quick to draw the obvious conclusion that what would be so little advantage to the Germans to acquire must be equally little loss to its present owners to surrender. All this sham economics, however, fits in with a much more realistic explanation of modern war, namely that it is a completely irrational survival, which persists because it is traditional in our culture; because pride in one's country means, first and foremost, if not exclusively, pride in its fighting strength; because no steps have been taken to prevent neurotics and gangsters from wielding power in international politics; and because (alas!) war satisfies a certain desire

for working together in a common cause, to which our peace-time way of living is stupidly inattentive. War is a monster, in fact, which feeds on itself. Colonies are not now, generally speaking, economically of first importance. You can point out to the Nazis a thousand times over that the value of the precious materials which they imported from their colonies, when they had any, was less than one-hundredth part of what they got from the rest of the world – and still they will not be satisfied, because colonies are prestige, and colonies are the sinews of war. Access to rubber and oil does not mean just the certainty of always being able to buy tyres for buses, and petrol for family cars. It means military security. We must have empire to protect us against the risk of war. We must have war to protect our empire. That is the vicious circle. It is now twenty-five years since Bertrand Russell proclaimed war as the offspring of fear and went to prison for his-opinions. That did not prevent him from being right, any more than the same treatment prevented Galileo from being right, when he said that the earth " went round the sun and not Vice versa. Men fight less for markets than for fear, for national glory, and for fighting's sake.

So we come back to it that the only way to break this circle is to establish a supra-national authority with the power and the duty to keep order. Whatever the root causes of war may be (and it is most important that we should probe further into these) the immediate step is to deal with the fact of war. The domestic analogy still holds here. It is vitally important to probe into the causes that make burglars burgle and murderers murder, and, if possible, so to change the structure of our society that people cease to do these things. But you cannot wait to establish a judicial and police system which will deal with the/ad of burglary and murder until these far-reaching researches and changes have been, carried through; if only because these researches and changes themselves depend upon immunity from murder and burglary. And the problem is the same with international, as with domestic, crime.

III

The fact that social progress is contingent upon international order is the primary reason for socialist interest in Federation; but it is by no means the only one. There are more positive grounds also. Conscious and planned direction of economic life over a wide area, is essential, in the opinion of socialists, in order to achieve the equality and

prosperity for which they hunger. They have therefore, a particular concern with the economic aspects and possibilities of Federation. For the scale of plans is hardly less important than their content. Commonsense suggests that the appropriate scale must vary enormously according to what you are dealing with. Common sense also suggests that it is extremely unlikely that the nation-state is the largest unit in this shrinking modern world of which constructive economic planning should ever take account. To take only two examples, the planning of transport and the planning of power on a purely national scale is quite out of keeping with reality. Western Europe at the very least is, or rather ought to be, a single power-cum-transport unit. Some years ago the socialist Labour Party in England produced a scheme for a publicly-owned and publicly-operated combined coal and power industry. Within its own limits it may have been a wise enough plan; but it would have been far more effective, had it been able to link up British coal and power production with that of states across the water (some of which had played their part in bringing the British mines and miners to their sorry plight). A European Federation would be thinking in terms of such things as a publicly-owned European grid and (most decidedly) European airlines. Only under the settled and ordered government of a Federation is it possible to create interstate public utilities that are operated for the common welfare. In the Soviet Union the economic unit ranges from the All-Union enterprise to the village co-operative. In the (much smaller) area of non-Soviet Europe international anarchy condemns us always to stop short at the intermediate stage.

Other economic problems now also require a larger canvas. The socialist state is a social service state. Hitherto, tentative efforts have been made to raise international social standards through the activities of the International Labour Organisation. Like the League of Nations, the I. L. O. has no authority and no sanction behind its decisions. Its history is a pitiful record of work begun, but left undone for lack of power of enforcement. During the first (and most successful) ten years of its history only about one-third of the possible total of ratifications of twenty-six agreed conventions had been secured. Twenty-five countries had ignored every single convention, and the majority had ratified less than half of the total. In other words the I. L. O. method of " legislation " has been, at best, less than thirty percent effective.

A government with authority behind it does not tolerate thirty per cent observance of the law! What the International Labour organisation tried to do for Labour standards, a Federal government could do, within its own territory. It is not necessary that the Federation should have exclusive power of legislation in this field. In view of the great variety of local conditions and possibilities, it is not even desirable that it should. What is wanted is a federal constitution which gives concurrent powers to both state and federal governments to legislate on labour matters, provided only that in cases of conflict the latter must prevail. In this way a system of federal minima can be combined with higher standards in states where socialist practice is more advanced; and the citizens of the latter can be relieved of their perpetual fear of the low-standard neighbour across the frontier.

Finally, Federation smooths the path for that great ally of international socialism, an international Trade Union movement. Experience has shown that it is possible to build Trade Unions that are capable of concerted action over vast geographical areas, provided that they do not extend beyond the boundaries of independent states. Only in the case of the (unfortified) Canadian border has this limitation been overcome; and that only in certain industries. But over the great territories of the United States the Railway Workers, the Mine Workers, the Garment Workers, to mention only a few, have built powerful nationwide societies; whereas in Europe the international Trade Union movement has suffered exactly the same disasters as have the socialist internationals. It, too, cracked in 1914, under the stress of patriotic loyalty, when the German Trade Unions "accorded the most loyal support to the civil and military authorities;" and the British and French followed suit in their respective countries. And it cracked again in the stormy nineteen-thirties. Even during the intervals of comparative peace, its activities have been confined to consultation and conference (always without power to act) and to occasional mutual financial assistance in a modest way. Its conferences were conferences, -not of fellow citizens, but of foreigners. Even in cases of the gravest social injustice, in Europe continental solidarity of the workers, even in a single industry, has remained always a dream. Yet from the Atlantic to the Pacific coast continental solidarity is both practicable and practised.

IV

The foregoing arguments are not affected by the immediate events of the present war. They would have equal force even if the independence of Poland, Belgium, Holland, Norway, Denmark and France, and all who went before or may come after, had never been lost. But, paradoxically enough, the tragic plight of Europe actually adds point to socialist-federalist case. For today (November 1940) the European peoples from the Baltic to the Atlantic on one side, and to the Mediterranean and the Black Sea on the other, live under what is substantially one rule. The continent has indeed been unified by conquest and under tyranny.

Sooner or later, we who reject that tyranny hope to be in a position to decide what is to be done that unity. One course is simply to break it up: to restore the pre-war European chess-board and to re-establish the independence of as many of the old jealous, frightened states as possible (Frontiers might perhaps be drawn with a little more regard to professed principles of national self-determination, and a little less strategic cynicism. But these are details). We can, if we wish, forget both the logic of twentieth-century technique and the wider horizons of twentieth-century citizenship, and set to work to break the Nazi Empire into at least as many pieces as went to its making we wish. But is it conceivable that any socialist really does wish to take this line? To do so means to re-establish at least eight separate tariffs; at least eight different currencies; and at least eight different sets of rules for excluding the workers of one state from entry into the territory jealously reserved for their comrades in another—all within an area which measures only three-fifths of that of the United States and less than one-third of that of the Soviet Union. It means also to re-open the door to all the old quarrels between the go-called haves and have-nots, as well as to the shameful system under which exploited colonial peoples are bandied about as the prize in the hideous game of European power politics. It is hard to believe that a movement which was launched with an exhortation to the workers of the world to unite, and which has consistently condemned the political tutelage and economic servitude of the 'black man, can put its influence behind a programme so narrow and so exclusive. The other course is to accept the fact that, by foul means if not by fair, the old disorder is gone for ever; that it is not the disintegration, but the transformation of the far-flung Nazi empire which must be our aim; and that the common welfare of all who have suffered under Nazi

rule is the basis on which a new and wider order must be built.

That transformation cannot, however, be accomplished except within a political framework. Economic common sense, to be sure, takes no notice of political frontiers. But economic common sense cannot operate by itself. The history of the past ten years should be enough to knock the bottom out of the simple view that economics are always the master, and never the servant, of politics. For all those years the states of Europe have been engaged in a gigantic and suicidal game of competitive self-impoverishment. And they have played that game partly because their economic policies were subordinate to the greater and still more dreadful game of power politics, the rules of which none dared to defy; and partly because there was nobody with authority to stop them. The unity of Europe did not come about, and will not maintain itself, merely because it has economic advantages. It will be maintained so long, and only so long, as an established political government is in a position both to give expression to the need for that unity, and to support it with the force of law. For the anti-Nazi there is only one question: what sort of a government is that to be?

V

The plain truth of the matter is, then, that socialism and federation are complementary parts of the same whole. Recently the persuasive pen of Mr. Strachey⁶ has sought to present them as alternatives. It is an unnatural and unnecessary choice. One might as well assert that in housedesigning the choice is between kitchen and bathroom. It is true that a house can be built which lacks one or the other entirely possible. To the socialist, a federal government which disregards the social values which he rates so highly, and neglects to use the instruments on which he relies, is admittedly as poor a substitute for a socialist federation as is a house without a bath-room for one with kitchen and bath. Again, it is true that, within a limited national area, conscious economic planning can achieve some approximation to the

⁶ In his book *Federalism or Socialism*, London, Gollancz, 1940 [John Strachey is perhaps better known as the co-founder, with Gollancz and Laski, of the Left Book Club, and was active as a staunch opponent of fascism in the interwar period, abandoning Mosley's party as it started flirting with fascism, and abandoning its original progressive leanings. He served as a junior member in the first postwar Labour government].

socialist ideal of equality. But to accept this restriction to the national plane is like fussing so much over a bathroom that one entirely forgets the need for a kitchen.

The position that the socialist has to face amounts, in fact, to this. Political federation is now a necessary condition for ordered political activity of any kind. Indeed, it is probably a condition of mere survival. Federate or perish, as Attlee said. But the nature and the possibilities of any Federation, if and when it comes, will depend upon the aims and objects of the men and women who are instrumental in bringing it to birth. That is why to boycott the idea of federation on the ground that that idea is not inherently and inescapably socialist is a most short-sighted policy; because in that way the danger of non-socialist or antisocialist elements dominating the drive towards larger political units is gravely magnified. For a socialist to demand, on this account, a boycott of federalist movements is like refusing to ride in a bus because buses can be used to carry people to anti-socialist meetings. Federation itself, like planning and collectivisation, is a neutral instrument. It is the job of the socialist to direct its great possibilities towards his own particular ends. To do that job effectively, the time to begin is before, not after, Federal Europe is an accomplished fact.

For the time has come when we have to recognise that the needs of the common man and woman can only be met by a programme in which there are three equally essential elements. First comes civil and political freedom—the common platform of all professing democrats, socialist or nonsocialist, from the eighteenth century onwards. We must have the right to speak our own minds and to listen to what is in the minds of others, to be free from spying and arbitrary arrest, and to say our say in the choice, and in the criticism, of those who exercise political power.

Next come our social and economic needs. We must be freed, in this age of plenty, from the tyrannous spectre of want and insecurity. We must not be the victims of economic power concentrated in the hands of an irresponsible minority. We must not suffer exclusion, on grounds of birth or poverty or other social inferiority from opportunity to make the most of our talents in the service of the community. We must not be exposed to the indignity and humiliations (or corrupted by the arrogance and narrowness) which

every system of social stratification brings in its train. It is in this struggle for social and economic security that the socialist has given most conspicuous service. It is for these ends, and no others that he wants his planning and his socialisation, his redistributive taxation and his generous social services.

The third element is the creation of a supra-national authority partly, as we have seen, as a means of putting an end to the incessant mutual destruction of peoples who claim to stand in the front ranks of civilisation; and partly as itself the indispensable instrument of socialist planning, on a scale commensurate with the technical and economic realities of the age in which we live.

No; socialism and federation are not the true alternatives. The true alternatives which face the socialist are these. He can continue to socialise and plan and equalise within his own particular territory and under his own particular flag, leaving his (still foreign) comrades in equal isolation to do the same. He can shut his eyes to the yawning gap in socialist programmes which the decay of internationalism has torn open. He can follow the road of the past twenty-five years in which the socialists of this continent have twice abandoned their class struggles and their social programmes, in order to take up arms against their comrades: twenty-five years in which "socialism in our time" has been degraded into the bastard parody known as National Socialism.

Or he can reject what has proved itself to be only the socialism of the battlefield and of the war cabinet. He can admit in Laski's phrase "the necessity for world control where the decision is of world concern, "recognising that the sovereignty of the State is incompatible with a just system of international relations."⁷ He can demand the "concepts not of imperialism but of federalism."⁸ In the graves of France and Flanders and the ruined homes of London he can read the implications of international anarchy in a shrinking world; and he can consign the nation-state to the limbo of out-worn political systems, as he has already consigned the private bank and the workhouse to the limbo of economic anachronisms. That way alone

⁷ Laski: *Liberty in the Modern State*.

⁸ [H. Laski, *Grammar of Politics*, London: Allen and Unwin, 1926].

can he, at last, release the creative socialist internationalism that has been so long and so painfully frustrated.

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The process of European integration and the establishment of the welfare state were for a long time regarded as the two sinews of European peace. In the first three postwar decades, they seemed to be mutually supportive. Since the eighties, they seem to be on the path to clash. How could that be? In line with the overall design of the RECON project, the contributions to this report elucidate the extent to which these two great European transformations are related to the constitutional design of the institutional structure and the decision-making processes of the European Union. Special attention is paid to the relationship between the most prominent part of the economic constitution of the Union (the economic freedoms) and the key socio-economic policies of the Union (from fiscal policy to labour relationships).

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Reconstituting Democracy in Europe (RECON) is an Integrated Project supported by the European Commission's Sixth Framework Programme for Research. The project has 21 partners in 13 European countries and New Zealand and is coordinated by ARENA – Centre for European Studies at the University of Oslo. RECON runs for five years (2007–2011) and focuses on the conditions for democracy in the multilevel constellation that makes up the EU.

