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What Kind of a Constitutional Crisis Is Europe In and What Should Be Done About It?

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Abstract

What Kind of a Constitutional Crisis Is Europe In and What Should Be Done About It?

by Mattias Kumm

The central cause for the crisis in Europe is not undisciplined spending by profligate states, but the asymmetric structural symbiosis between states and banks. Under the current European regime states are lenders of last resort for banks and banks are lenders of last resort for states. That symbiotic relationship must be loosened. Banks must be regulated in a way that ensures that the financial sector does not depend on massive tax-payer financed transfers. The ECB in cooperation with the ESM must function as a lender of last resort for states.

Furthermore the public costs of bank-bailouts are to a significant extent the result of genuinely European risks, for which it would be appropriate to hold the European Union as a whole accountable. The mechanism through which to organize this European responsibility should not be inter-state transfer mechanisms, such as those foreseen by the ESM. Instead this money should be paid for by genuinely European funds, raised by European taxes or levies. And given the significant role of the Commission in monitoring national budgets, the case for having the European elections turn into a genuine competition for a European government has gotten even stronger.

Keywords: Europe, crisis, states and banks, ECB, ESM, European Union, European Commission

Contents

List of Abbreviations

ECB	European Central Bank
ECJ	Court of Justice of the European Union
EFSF	European Financial Stability Facility
EFSM	European Financial Stability Mechanism
EMU	European Monetary Union
EP	European Parliament
ESM	European Stability Mechanism
FCC	German Federal Constitutional Court
GDP	Gross Domestic Product
MS	Member States
OMTs	Outright Monetary Transactions
PIGS	Portugal, Italy, Greece, Spain
SGP	Stability and Growth Pact
TFEU	Treaty on Functioning of the European Union
T-Bills	US Treasury Bill

Executive Summary

The primary cause of the crisis is neither an original design flaw of the Treaty that established monetary integration without fiscal and economic integration, nor is it profligate spending of states. The primary cause of the crisis is the asymmetric structural symbiosis between states and banks. On the one hand states are lenders of last resort for banks. Banking risks in Europe are effectively socialized: According to Commission statistics the Commission authorized 4,5 Trillion Euros of state aid from Member States to financial institutions from Oct. 2008 to Oct. 2011, more than six times the original capital of the ESM and more than 30% of overall European GDP. There would be no Euro crisis without a massive transfer of public money to private financial institutions. On the other hand banks are lenders of last resort for states. There is no central bank as lender of last resort for states. This opens up states to speculative attacks by highly liquid and volatile financial markets, with fears of such attacks leading to increased lending costs for Member States. Other highly indebted countries, like Japan and the USA, with public debts respectively higher than Greece or Spain, can rely on the support of their respective central banks as a lender of last resort. This creates confidence on capital markets and reduces lending costs. The paper assesses how a number of measures taken by European institutions, from Directives relating to the restructuring and winding down of banks to the ECB´s "Big Bazooka" policy seek to address these concerns.

In the second part the larger implications of the analysis are assessed. First, once the causes of the crisis are clear, it not only becomes clear that the focus on austerity is largely misguided. The question of who should bear which losses and how solidarity should be organized in Europe also appears in a new light. Given the European legal framework, which limits domestic policy options as well as high interdependencies created by integrated financial markets, public costs for the bailouts of banks should be conceived as genuinely European costs, the result of the realization of risks appropriately assumed by the European Union. Second, to pay for these costs and address consequences of asymmetric shocks the European Union should be able to raise its own resources. European solidarity should not be channelled through interstate transfers. Interstate channelling of resources as foreseen by the ESM tends to foster misguided assumptions about who is responsible for banking debts and undermines rather than fosters European solidarity. Europe does not need a Transfer Union (with funds channelled from one state to another). It needs an Economic Justice Union (with the EU assuming financial responsibility for genuinely European risks and raising its own resources for that purpose).

Third, given the European Commission's important role under the ESM and Fiscal Treaty to address national budgetary issues, and given that the EU needs to be able to raise its own resources through taxes and levies, it is no longer appropriate that the Commission President is effectively determined by the Member States rather than the European Parliament. Instead the European parliamentary elections need to be turned into a genuine competition for a European government.

Introduction

It may be obvious that there is a crisis in Europe, but it is less obvious how to best understand it or what needs to be done to overcome it. This uncertainty is reflected in uncertainty over nomenclature: Is it a Eurocrisis? Is it a sovereign debt crisis? Is it a banking crisis? The choice of nomenclature in describing the crisis is often connected to a basic hypothesis about the primary cause of the crisis. Each of these hypotheses gives a different account of the problem that is at the heart of the crisis, and the constitutional problem it is connected to. And with each diagnosis comes a different approach to therapy. The first part of this paper argues that the primary cause of the crisis is neither an original design flaw of the Treaty that established monetary integration without fiscal and economic integration, nor is it profligate spending of states. At the heart of the crisis lies the asymmetric structural symbiosis between states and banks: States are lenders of last resort for banks (banking risks are ultimately socialized) and banks are lenders of last resort for states (there is no central bank as lender of last resort for states), opening up states to speculative attacks by highly liquid and volatile financial markets. In the second part I assess the implications of such an analysis. First, once the causes of the crisis are clear, the question of who should bear which losses and how solidarity should be organized in Europe appears in a new light. Given the European legal framework, which limits domestic policy options as well as high interdependencies created by integrated financial markets, public costs for the bailouts of banks should be conceived as genuinely European costs, the result of the realization of risks appropriately assumed by the European Union. Second, to pay for these costs the European Union should be able to raise its own resources. European solidarity should not be channelled through interstate transfers. Europe does not need a Transfer Union (with funds channelled from one state to another). It needs an Economic Justice Union (with the EU assuming financial responsibility for genuinely European risks and raising its own resources for that purpose). Third, given the European Commission’s important role under the ESM and Fiscal Treaty to address national budgetary issues, and given that the EU needs to be able to raise its own resources through taxes and levies, it is no longer appropriate that the Commission President is effectively determined by the Member States rather than the European Parliament. Instead the European parliamentary elections need to be turned into a genuine competition for a European government.

A. Three accounts of the crisis

I. A Eurocrisis as a result of faulty constitutional architecture?

For those who refer to the crisis as a Eurocrisis, the fundamental cause of the crisis is believed to be the architecture of the EMU. The EMU was an attempt to create monetary integration without deeper fiscal and political integration. That, it is claimed, was a misguided project destined to fail, because the problem of asymmetric shocks could not be effectively addressed. In case of a national crisis, like the bursting of a housing bubble in Ireland or Spain created by an influx of speculative capital, capital flows would cease abruptly, creating an economic shock that a state would not be able to effectively respond to. There would be no option to devaluate the currency on the national level given a common currency. Thus it would not be possible to increase productivity without having to make politically difficult distributive choices like cutting salaries or public pensions. Nor would there be sufficient labour mobility to ensure that surplus labour moves to areas where there are more jobs - notwithstanding a legal regime of free movement the informal cultural barriers to free movement remain high in Europe. Finally there are no significant federal transfers (for example in the form of social security payments) to soften the shocks that exist in federal systems (notwithstanding the modest role played by structural funds).

This is the classical critique of the EMU from economists like Hans-Werner Sinn or Martin Wolf articulated in the early 90s. It was an analysis that was in part shared by other analysts who nonetheless supported the EMU. They believed that, given political resistance to further integration in the form of a political and economic Union at the time, this would be the best that could be achieved for now, but that the EMU would in due course create spill-over effects that would create dynamics that would eventually tip the scales in favour of deeper integration.

If this is the correct diagnosis of the crisis, the suggested therapy would be to complement the monetary Union with a fiscal and political Union, or to give up on a common currency (with variations of proposals suggesting a Northern Euro and/or a Southern Euro).

There is clearly something in this analysis that is right. If the EU were a full-fledged Fiscal and Economic Union, a wider range of options would be available to soften the impact of, say, a bursting housing bubble in some Member States. But this analysis is nonetheless too general. Asymmetric shocks are not inevitable. They are the result of aggregate human actions. Institutions and policies can be designed in such a way as to make it highly unlikely that they will happen (asymmetric shocks are not natural phenomena like volcanic eruptions or asteroid strikes). If the designers of the EMU believed that the Euro would work, it was because they believed that they had created a legal regime that would make asymmetric shocks improbable. The preparatory period in which the fiscal and economic discipline of each joining state was to be tested, in conjunction with the Maastricht criteria and the Stability and Growth Pact were to ensure fiscal stability and provide incentives for reform, address problem of current account imbalances by restructuring of the economy and ensuring greater economic symmetry for the long haul. So the question is: What exactly went wrong? Why did the expectations of those whose designed the EMU turn out to have been misguided? Why did legal regime not prevent shocks from happening? What accounts for the specific asymmetric shocks the EU has suffered since 2008? What went wrong in the PIGS countries (and those that might join them, like Cyprus and Slovenia)?

II. A sovereign debt crisis as a result of profligate spending of some states?

One answer to this question is given by those who would refer to the crisis as a sovereign debt crisis. The core cause of the crisis is not the structure of the constitutional system, but the violation of its constitutional rules. Profligate spending by a number of states, in violation of Maastricht requirements concerning excessive government deficits under Art. 126 TFEU, as further specified in the Protocol on the Excessive Deficit procedure, is at the heart of the problem. Instead of undertaking structural reforms, macroeconomic imbalances between states were enhanced by the weaker states exploiting lowered borrowing costs as a result of Euro membership, violating their legal obligations under EU Law. The sovereign debt crisis is also a rule of law crisis.

Even though this account is ultimately unpersuasive, it does highlight a set of uncontroversial facts. The rules relating to fiscal discipline in the Treaty of Maastricht have been widely violated. By some counts 23 out of 27 countries are in systematic violation of its fiscal obligations under EU Law. Currently there are 21 states against which there are ongoing excessive deficit procedures. States chose an easy path to finance debts using the new common currency, which made borrowing cheaper for most, because lenders did not have to hedge against devaluation.[1] Greece was allowed to join become a Member for political reasons, even though it was widely suspected that its figures were fudged. When Germany and later France violated the rules, the Commission won an excessive deficit procedure case before the ECJ against the negligent Council, which was countered by a revision of the SGP strengthening the discretion of the Council. With France and Germany getting away with their violations, they would later lack the authority to insist on other states sticking to the rules.

For those who follow this analysis the therapy consists of some combination of two things. First to insist that national fiscal discipline is tightened up and that the supervision and European enforcement mechanisms are strengthened. (This is effectively what the Fiscal Pact does). Second, a permanent emergency regime – beyond what the original Art. 122 II TFEU offered as a loophole - has to be established, that allows struggling states access to capital provided by other Member States, but only subject to further intrusive conditions relating to structural reforms and only as a last resort. This is what the newly introduced Art. 136III TFEU in conjunction with the ESM does.[2] In this way a modicum of solidarity in the form of transfers between states and effective mutualisation of debt balances the common commitment to austerity.[3]

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[1] Yet the EMU provided no guarantees against a sovereign default or "restructuring". On the contrary, the no bailout clause in Art. 123 TFEU made it clear that a default risk remained. Yet the differences in yields between German and PIGS government bond at the time before 2008 were marginal, suggesting that the market assumed the marginal risk of default to be negligible. There are only two possible explanations of that behaviour. Either markets believed that in a crisis strong states would bail out struggling states, notwithstanding Art. 123 TFEU. Or they believed that default was unlikely (but why would they? The European provisions requiring fiscal discipline were widely discarded and the historical record provides no basis for such a belief).

[2] First this led to the establishment of the EFSF and EFSM as a preliminary remedy. The EFSF and EFSM were based on Art. 122II TFEU, which was argued by some to be in violation of the no-bailout clause of Art. 125 TFEU ("a MS shall not be liable or assume commitments of other public authorities..." . This claim is countered by two legal arguments in favour of legality: 1. This falls under the "external circumstances" exception, which allows temporary measures to be taken to address "severe difficulties" caused by "natural disasters or exceptional occurrences beyond its control" (something of a stretch since this was no unfounded speculative attack by financial markets) and 2. This does not constitute EU bailout, but sovereign decisions by nation states to provide support outside of EU mechanism, to which the bailout provision does not apply. The new Art. 136 para 3 TFEU, that authorizes the establishment of the ESM, solves this problem of a proper legal basis by effectively gutting the no-bailout clause.

[3] Those who share this analysis may well debate among themselves how much austerity/budgetary discipline is due (what type of sacrifices can plausibly be demanded of a self-governing Member State?), how much solidarity in the form of transfers between states and mutualisation of debt risks should be incurred (when does the moral hazard issue become too great?) and whether the balance was struck correctly in the ESM and Fiscal Compact. But notwithstanding differences in this regard (social democrats tend to be in favour of more lenience and greater debt mutualization, conservatives emphasize tough love

Note how this therapy comes with high costs: First, creditor states are asked to exercise solidarity for what is cast as the failure to act in a responsible and disciplined way by the debtor state. Why should states that acted responsibly and made the hard choices help out? Even within a national community, solidarity with those that are worse off is difficult to get political support for, if those that are to receive state aid through transfers can plausibly be cast as irresponsible actors that just fail to get their act together. Here too, the tendency in past decades has been to tie aid to demanding conditions. Transfers are resented whenever the need of the recipient side is easily connected to his/her own failure to make responsible choices. Second, countries struggling to meet requirements of the Fiscal Pact or the Conditions imposed by the ESM in conjunction with access to credits are likely to resent the EU and the leading states which are experienced as "imposing" highly contentious policies on them. This is easily cast as a form of economic imperialism in strong tension with democratic self-government. Incompatible positions between creditor states, who are reluctant to subsidize what they imagine to be irresponsible behaviour, and debtor states, whose citizens rebel against hardship in part grounded in external impositions, may turn out to be toxic and lead to significant political turmoil, first in Member States struggling to meet austerity requirements, but ultimately for Europe as a whole. Structurally organizing solidarity in a way that makes it look like money is flowing from virtuous states to states who fail to do their homework has already fostered resentful nationalism on all sides. This undermines rather than fosters European solidarity.

But the problem is not just that the prescribed therapy fosters resentment on all sides. The problem is that the diagnosis is itself seriously flawed. The diagnosis starts from a set of uncontested facts, but it draws the wrong conclusion from them. There may be a lack of fiscal discipline and a violation of European legal requirements by some Member States. But fiscal discipline turns out to be a remarkably inaccurate variable by which to predict which state is likely to get into trouble. The lack of fiscal discipline and noncompliant behaviour with EU norms simply does not explain the crisis: Ireland and Spain were among the most disciplined of the Member States, significantly more disciplined than, say, Germany. Portugal's numbers were largely comparable to France. And even when we take the Member States against whom the charge of profligate spending is most plausibly levelled, with Greece as exhibit A, and, as a significantly less severe case, Italy, there remains a puzzle: Greek overall debt is significantly

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and pulling yourself up by the bootstraps with aid only as a last resort), the issue is cast as striking a balance between disciplining states not to engage in profligate spending and to bring about reforms increasing productivity, thus decreasing the probability of asymmetric shocks in the future, while at the same time providing for a modicum of solidarity between states as a last resort in the form of the ESM.

lower than that of Japan, a country that is successfully placing bonds on the market at historically low yields. And Italy's debt is lower than that of the US, whose T-Bills are also selling for record low yields. If fiscal profligacy is not the cause, austerity is not likely to be the correct remedy. But what, then, is really going on?

III. It's the banks, stupid! On the structural symbiosis between states and banks

The central cause for the crisis in Europe is not undisciplined spending by profligate states, but the asymmetric structural symbiosis between states and banks. Under the current European regime states are lenders of last resort for banks and banks are lenders of last resort for states. That symbiotic relationship must be loosened. Banks must be regulated in a way that ensures that the financial sector does not depend on massive tax-payer financed transfers. And the ECB, in cooperation with the ESM, must function as a lender of last resort for states.

1. States as lenders of last resort for banks

Because of serious structural deficiencies in how the financial sector has been regulated, banks can generally depend on being bailed out by states. The scale of the problem is such that the sovereign debt crisis can be, to a large extent, understood as a knock-on effect of a banking crisis. Effectively this means that in the financial sector major risks are socialized, whereas profits remain privatized. This formula should not be put off as populist rhetoric. It is a straightforward description of reality. Here it must suffice to invoke one figure and one example to substantiate the strength of the relationship between sovereign debts and bank bailouts. According to Commission statistics, the Commission authorized 4,5 Trillion Euros of state aid to the financial sector between Oct. 2008 and Oct. 2011. That is more than a third of the EU's GDP and more than six times the original capital stock made available by MS to the ESM to bail out states. If you deducted the amount of public transfers from states to financial institutions from overall public debt, there would be no Eurocrisis. There might still be a Greek public debt problem, but there would be no problem with Portugal, Ireland, Spain, Italy or for that matter Cyprus and Slovenia. As a concrete example, take the most recent Member State facing serious problems: Slovenia. In August the major rating agencies Moody's and Standard & Poors massively lowered the Slovenian credit ratings and thereby significantly raised their financing costs.[4] Why? Slovenia was regarded as a model country when it joined the EU in 2004 and when it introduced the Euro in 2007. Slovenia's overall debt remains well under 60% of GDP. The main reason for the negative outlook and significantly higher financing costs is bad credits of major Slovenian banks. The three largest banks in Slovenia reportedly needed a capital injection to be provided by the state to the tune of 8% of GDP. In conjunction with lower growth prospects and higher lending costs the markets are losing confidence that Slovenia will be able to keep a grip on its financial situation going forward. The stories of Ireland and Spain are similar. Ireland raised its debt/GDP ratio by 25% overnight when the government decided to assume all bank debts in a dramatic decision at the height of the banking crisis. Spain has recently applied for help under the ESM to the tune of 100 Billion exclusively to ensure that money was available to bail out its banks (ultimately the required amount was reduced to 59 Billion).

2. *Banks as lenders of last resort for states*

The problem is further exacerbated by the fact that it is not within the ECB's mandate to serve as a lender of last resort for states. Even though its core purpose to ensure that states are prevented from simply printing money to cover ever-increasing debts is well taken, there are two consequences connected to this institutional choice. First, this opens up states to the possibility of successful speculative attacks by financial markets. The very possibility of such speculative attacks may, in times of high uncertainty and great financial market liquidity, create insecurity and volatility (a central bank in the background credibly pronouncing that, as a last resort, it would buy government debt in unlimited amounts makes all speculative attacks futile). This risk, which was believed to exist for Eurozone states, but not the US or Japan, is likely to be priced into bond yields, translating into higher lending costs for states. Second, given that in the absence of a central bank the capital markets and banks in particular are the lenders of last resort for states, states have an incentive to make it attractive for banks to buy sovereign debt. Partly this is done by exempting sovereign debt from capital requirements that generally apply to banks' proprietary trading. In Europe, the ECB makes available credit for banks at a very low rate, credit that banks use to invest in sovereign debt, which in turn is used as security for attaining further credit. Given that rules on capital requirements do not apply to banks as purchasers of sovereign debt, banks could gain considerable leverage. This means that in case of sovereign debt restructuring banks, highly exposed to the sovereign debt market, are more likely to be facing severe problems. The reason why Greek restructuring presented a serious

[4] http://www.moodys.com/research/Moodys-downgrades-Slovenias-government-bond-rating-to-Baa2-from-A2--PR_252281

problem for other countries was that major European banks, French and German banks among them, were significantly exposed to Greek sovereign debt. This would have meant that in case of a Greek default those banks, too, would have needed to be bailed out by their respective governments. This was a core mechanism through which contagion across the European economy could proceed. A case in point: The reason why Cyprus is applying for protection under the ESM is directly related to the losses of Cypriot banks incurred as holders of 22 Billion of Greek debt through the Greek restructuring in March 2012. As a result of this restructuring Cypriot banks had to be bailed out by the Cypriot government, ultimately forcing the government to consider protection under the umbrella of the ESM.

3. From diagnosis to therapy

On this diagnosis the basic structure of the therapy appears to be clear, even if a great many issues of detail might remain contested and complicated. The solution would have to have two basic prongs.

a) What a Banking Union must seek to achieve

First, the financial sector, and banks in particular, have to be regulated in a way that ensures that public-to-private sector transfers cease to be necessary. Risks should be allocated with management, shareholders and debt holders of banks, not the public. On the one hand this can be done by lowering the probability of difficulties arising in the first place. This requires stronger capital requirements as in the new Capital Requirement Regulation and Directive, which in its present form is still criticized as insufficient by the Basel Committee. Also in discussion are the legal separation of core financial and commercial activities and proprietary trading and other risky activities of banks (see High Level Expert Group Report/Barnier from October 3 2012). Furthermore the supervision of these rules must be improved, securing adequate independence and immunity from industry capture (whether the ECB should and legally can play a central role in this context, as is currently proposed, is a contentious issue). Second, in case difficulties do arise, it is necessary to ensure that banks of any size can be restructured or wound down in a way that limits taxpayer liability (see the Commission's proposed Bank Recovery and Resolution Directive). Also in discussion is a European insurance scheme that banks would be required to maintain.

b) The ECB (in cooperation with the ESM) as a lender of last resort

Second, the ECB, in conjunction with the ESM, would have to be able to credibly serve as a lender of last resort. This would ensure emergency funding for states in the absence of functioning markets. To prevent states from abusing this mechanism or inappropriately relying on it instead of making appropriate efforts themselves, a link between debt-purchasing through the ECB and conditionality requirements by the ESM should be established.

There are three ways of doing this, which can only be described and assessed in very basic terms here. The point here is not to provide a comprehensive legal and political analysis, but gain a deeper understanding of the options available and the types of concerns they would need to address.

1. Make the ECB the official lender of last resort by changing the constitutional prohibition on ECB buying state debt directly on the primary market. This is not an attractive option. It would leave the ECB, with its week democratic legitimation, strong independence protected by constitutional rules and not embedded in strong national cultural contexts, too powerful. Given the requirement to amend the Treaty, it is also politically not feasible.

2. The Draghi solution (presented Sept. 7, 2012): The ECB engages in outright monetary transactions (OMTs), purchasing sovereign debt on secondary market, to undercut "severe distortions" in government bond markets not justified by fundamentals. It would only do so in cooperation with ESM (and EFSM) supervision. In this way it would effectively cut borrowing costs of debt-burdened euro-zone members. The ECB would become fully effective backstop, providing the institutional assurance that the Euro is in fact irreversible and thus discouraging speculation against it.

There are two problems with this approach. First, it is a contested question whether these policies are covered by the constitutional mandate of the ECB. The German Constitutional Court in obiter dictum has already implicitly challenged Draghi's policies as ultra vires (see German Constitutional Court decision not to grant interim relief against the ratification of the ESM and Fiscal Treaty of Sept. 12 2012, recital 276-278 – the issue will come up in the court's decision on the merits). The court claimed such policies are in violation of the ECB's mandate to prioritize price stability over other objectives objective (Art. 127 TFEU) and amount to a circumvention of the prohibition against buying sovereign debt directly (Art. 123 TFEU). The ECB argues that it's policy is driven by concerns to effectively keep interstate rates low and that Art. 18 of the ECB statute explicitly authorizes the kind of OMTs the ECB expects to engage in. Second, beyond legal issues there are also policy concerns. Because the ECB only buys debt on the secondary market, banks continue to profit as middle-men to the detriment of the public. They take a cut, buying debt from the state and selling it to the ECB at a higher price, thus increasing cost for the public. Not surprisingly, on announcement of Draghi's policy, share prices of major European banks shot up (shares for Crédit Agricole and Société Générale were up 8, 44 and 7.76% respectively on the day, Deutsche Bank went up 7%).

3. An alternative or complementary path would be for the ECB to recognize the ESM as a commercial partner under Art. 18 of ECB Statutes. This would allow the ESM to lend money from the ECB with which it can buy ailing states debt on the primary market, which it then deposits as security with the ECB. Decisions to buy government debt would thus be made by the Governing Council. Here, too, there are complicated legal issues that would need to be worked out. On the one hand the ESM does not need to apply for a bank license (Art. 32 para IX ESM). On the other hand, Art. 21 of ECB Statute prohibits lending money to public entities, as does Art. 123I TFEU. Yet is plausible to argue for a narrow interpretation of Art. 21 and Art. 123I TFEU and insist that the ESM does not fall under its scope, but under the exception of Art. 123II TFEU. Unlike any other public entity that Art. 21 appropriately applies to, the ESM is a lending institution which not only financially, but also politically represents all participating Member States, thus ensuring appropriate checks and balances.

This may well be the most attractive solution. It cuts out the middle-men (banks) and reduces costs for public. Like the Draghi plan, this plan requires political endorsement through mechanism of ESM as well as ECB involvement, but it would put the ESM in charge. The ESM, not the ECB, would set the policy agenda. This solution is one which would neither inappropriately empower the ECB, nor makes it easy for political forces to effectively capture the levers of the printing press. On the other hand the question remains whether markets would trust a stop-gap mechanism that effectively required the potentially strife-torn Governing Council of the ESM to authorize purchases of sovereign debt. But in the end it might not matter whether option 2 or 3 will effectively define European practice. What is far more important is that one or the other is effectively adopted and legally endorsed.

B. Widening the perspective: constitutional reforms?

I. "No" to a Transfer Union, "Yes" to a Social and Economic Justice Union

1. On legacy loss allocation

The correct analysis of the crisis is not only important in order to understand what needs to be done to avoid a similar crisis in the future. Besides taking measures to ensure that states are adequately immunized from speculative attacks from financial markets and that in the future the financial sector can no longer count on bail-outs from the taxpayer, a correct analysis also provides the key to the question of how to appropriately allocate losses incurred. One thing that economists agree on is that in order to move out of the crisis rather than have it draw on indefinitely, losses have to be allocated sooner rather than later. Only once this politically painful step has been taken can Europe move on. But who should pay for the mess? If the crisis were the result of profligate spending of some states, then it seems logical that these states should first of all bear the burden of their actions before they could count on European support, and that this support should come with further strict conditions attached. This, in effect, is what the ESM and Fiscal Compact are meant to ensure. But if, as argued above, the sovereign debt crisis is to a large extent the result of a banking crisis, the answer may turn out to be very different. There is something arbitrary about burdening the states in whose jurisdictions the banks requiring bail-outs happen to have their seat. The banking crisis would not have had the same intensity and structure if it were not for the European common currency and European freedom of capital guarantees. The EU has exercised its concurrent competencies over the area of banking and financial markets and is in the process of deepening its involvement in the sector by the establishment of a Banking Union. Furthermore the bank-bailouts themselves have considerable cross-border positive externalities. Given the interdependence of the banking sector, the failure of major banks in one state would have had difficult to control contagion effects across Europe. Under such circumstances, it seems more plausible to allocate financial public sector risks resulting from financial sector failings at the European level. The costs of bank-bailouts are, to a significant extent, the result of genuinely European risks, for which it would be appropriate to hold the European Union as a whole accountable.

2. *From interstate transfers to the EU's own resources*

But if the European Union as a whole, rather than individual states like Spain, Ireland or Slovenia are to be held accountable for the costs of the bank-bailouts, the mechanism though which to organize this European responsibility should not be inter-state transfer mechanisms, such as those foreseen by the ESM. These costs should be paid for by genuinely European funds, raised by European taxes or levies. The way money is raised and the channels through which it is spent, comes with its own political presumptions and burdens of justification. It should not be understood as a neutral technical device. There is something deeply incongruous and misleading in first having individual states bail out banks, and then transferring money from one state to another, so that stronger states support weaker states to help them fulfil that task. This mechanism misguidedly creates the impression that stronger states have to bail out weaker ones, because the weaker ones can't handle their responsibilities, even when the original responsibility is more properly ascribed to the European Union from the beginning. Inter-state transfer mechanisms corrode solidarity in Europe, because they give the misleading impression that one state has to ultimately pay for the failures of another.

Note how interstate transfers corrode solidarity even in established federal systems, where in other contexts policies can rely on a background of national solidarity. Take the example of Germany's Länderfinanzausgleich, which can be roughly described as follows[5]: Rules of fiscal federalism in Germany allocates most federal taxes to the federal government that spends its money in line with federal policies. Here the question of how much money has flowed from one state to another is generally not a high profile political issue: federal taxes for federal policies help create and sustain a federal political community and its policies. A part of the taxes, however, is allocated to states according to the amount that was generated locally (örtliches Aufkommen). A small portion of these taxes allocated to states is again redistributed between states according to certain legislatively established criteria connected to need. As of last year, the Bavarians had to pay 3 billion Euros of the money originally allocated to them in the distributive pot, while the happy-go-lucky "poor but sexy" city-state of Berlin receives 3 billion. The nifty Baden-Württembergers support the socially generous and undisciplined Bremeners, etc. There is a lot of political theatre and a great deal of animosity and resentment on parade in the annual process of re-allocation. This inter-state reallocation creates significant resentment and effectively undermines solidarity. The reason for this is at least in part that Bavarians

[5] For details see Art. 107 German Basic Law.

assume that the money originally allocated to them is what is rightly theirs, and they don't want to have to exercise solidarity because other states apparently can't get their act together.

Whether or not the Bavarians and Baden-Württembergers have a point is not the issue here. The point here is that the mechanism through which money is distributed comes with assumptions about whose money is distributed. Once money originally allocated to A flows from A to B, A assumes the money transferred is its money and what needs to be justified is that B should have it. If money is distributed to all those living in A and B according to criteria determined in line with a jointly decided policy followed by C, and money is raised by applying general criteria related to the policy benefits bestowed, then the question of how much money flows from A to B becomes moot or at least secondary. Then the question becomes a different one: is this a policy for which C (rather than A and B) should exercise its competencies (assuming they legally have it)? If so, is it a good policy, worth the money that is spent on it? And is the money raised according to appropriate criteria? The way flows of money are channelled determines the nature of the debate.

Moreover, it is not a good argument to insist that a sufficiently strong identity – an identity that Europeans may be claimed to lack - is a prerequisite for the EU to raise its own resources. Identity may well be relevant for the allocation of competencies and the definition of policies. But once it is decided and accepted that competencies should be allocated and policies defined on a European level with regard to a particular set of issues, then it is unlikely that funding these policies in line with criteria that are meaningfully connected to the economic benefits bestowed would be regarded as unacceptable. Genuinely European resources, best raised from taxes or levies that burdens actors and transactions that are profiting financially from the internal market (e.g. shareholders, corporations, transactions with strong cross-border dimensions like certain financial transactions), appropriately connect regulatory responsibility with financial accountability. Furthermore, prioritizing the taxing of actors and transactions that have profited from regulatory competition towards lower taxes would reflect the promise of the European Union to ensure the fair distribution of burdens in the context of globalization. The European Union should not become a Transfer Union (this is not about transfers from one state to another), it should become an Economic Justice Union, in which the European Union accepts financial liability for the consequences of its regulatory responsibilities and is able to raise its own resources to do so.

II. Why the elections to European Parliament should be turned into a genuine competition for a European government

But it isn't only on the level of finances that Member States have inappropriately insisted on controlling the channels through which resources are funnelled. Member states, and in particular the executive branch of Member States, have also captured the European political process, and have successfully prevented autonomous European legitimacy resources from being mobilized. Think of the many emergency Council meetings in Brussels in the past two years, where late at night or early in the morning exhausted prime-ministers and chancellors declared agreement on another new mechanism or policy through which the crisis is to be addressed. Think of the ESM in which the Board of Governors, composed of the economics ministers of participating states, calls the shots. Throughout the crisis the European Parliament has not been publicly present. Conflicts were cast as inter-state conflicts, Germany and France against Greece or Spain, donor countries against receiving countries, even though in all of these countries there were structurally similar divides between left and right, which would have allowed for coalition building and the introduction of a very different kind of debate about the kind of Europe that is desirable. Why did those cross-national debates about alternative futures for Europe not take place? Furthermore Europe appeared not only as deeply divided along state lines, the ultimately agreed upon solutions were also cast as inevitable, without alternative, necessary. If you don't like these results, you're inclined to become a Eurosceptic. There is no public representation of an alternative Europe that you could support. Yet it should be clear from the above discussion there is much that is disputed about how to understand the crisis, what its causes are and what kind of resolution might be desirable. There is also the real danger that the solutions offered might not, in the end, work. Who is going to be held accountable then? How might Europe recover from such a blow?

It is high time to be serious about proposals endorsed among others, by current President of the European Parliament Martin Schulz and by Wolfgang Schäuble to make the elections for the European Parliament genuine European elections for the choice of the President of the European executive. For this to happen, it would be sufficient for the different European political groups to present competing candidates before the next election. If the election campaign would focus on this, the European Council would, in practice, have to appoint the winning candidate. Such a shift is of fundamental importance and the reasons sometime invoked against it are not persuasive.

It is of fundamental importance because we should not be surprised to see that European citizens disagree about the kind of policy measures that are the best response to the financial crisis and other political issues that the EU rightly addresses through legislation. It is a mistake to insist, as national politicians invariably do when they defend the measures taken at late night Council meetings under the current regime of executive dominated intergovernmentalism, that there is no alternative to the decision they have made. For many citizens, that is the reason why they turn their backs on Europe: They do not like the policy choices generated on the European level, and there is no alternative personnel and menu of policy options present to engage with on the European level, so they associate Europe with those policy choices they deem undesirable. If faced with a genuine choice in personnel, programmes and policies, disgruntled citizens would be able to articulate their dissent not by turning away from Europe and seeking refuge in populist recipes. They might instead, as European citizens, vote or mobilize for an alternative Europe, personified in a different President, committed to different policies. Tying the outcome of the European elections to the determination who will be the next Commission President will lead not only to a surge of interest in European parliamentary elections and allow the Commission to more effectively fulfil the functions assigned to it, it is also likely to be the best antidote to the spread of nationalist populism and Euroscepticism.

Furthermore under the Fiscal Treaty, the Six-Pack and to some extent even the ESM the Commission gains considerable powers to intervene in the budgetary processes of Member States, once a Member State has shown itself unable to meet the strict budgetary requirements imposed on them. For those powers and the discretion that comes with these powers to be exercised effectively and legitimately, the Commission must be able to rely on the kind of legitimacy that comes with direct link to the outcome of European elections. Budgetary questions were at the heart of the historical parliamentary struggles for control over a democratically unaccountable executive – they are the inner sanctum of parliamentary prerogatives - and it is unlikely that national Parliaments will give much weight to a Commission that is seen as the instrument of the collective executives of Member States.

The arguments against such elections are ultimately not persuasive. The current role of the national executives in the European decision-making process is not something that enhances the democratic legitimacy of that process. It is the result of the executive branches having captured the European decision-making process, with the accountability to national parliaments, even though not without significance, ultimately limited for structural reasons. The claim that small Member States would lose too much influence is also misguided. On the contrary, a stronger Commission President might be a more plausible counterweight to the tendency of two or three large states effectively dominating the decision-making process in Europe. The claim that European elections can't be meaningful, because statistics relating to electoral participation clearly indicate that European citizens are just not interested in European elections, that there are no genuine European parties and there is no robust European public sphere etc., gets it the wrong way around. The issue is one of sequencing: Only once European elections are appropriately structured so as to allow citizens to choose between different leadership personnel, programs and policies are the incentives in place to develop an interest in elections, to restructure parties around European agendas and to have the media focus more strongly on European themes. Finally, the degressive proportionality of the allocation of parliamentary seats in the EP, does not – contra the German FCC – suggest that it can't play a central legitimatizing role. On the contrary, in conjunction with the weighted voting in the council such an institutional choice is appropriately sensitive to the nature of the European Union as a Federation of nation states.

C. Conclusion

There are those who might be wary of a European Union that can raise its own resources through taxes or levies and that establishes genuine electoral politics at the heart of the European political system. Would this not effectively turn the EU into a state? Of course one could point to all kinds of ways in which the EU would still remain distinguishable from the classical state such as France or Britain: Its limited competencies across a wide range of core areas of political concern, from social security to defence; its correspondingly relatively low budget in terms of Europe's GDP, compared to national budgets in terms of their national GDP; the remaining very powerful role of the Council in the European legislative process. This would clearly not be a European superstate (whatever that might be).

But it would be a significant shift. For those conceptually wedded to a sui generis account of the EU[6], it might come as a shock that there is more conceptual and political continuity between the

[6] Attempts to work out in conceptual and normative terms how to make sense of Europe's sui generis character include a "conflicts of law" approach (Christian Jörges) or „democracy“ (Kalypso Nicolaides), or the idea of „constitutional tolerance“ (Joseph Weiler), or some accounts of "constitutional pluralism" (Maduro, Kumm, Halberstam). Those approaches and conceptualizations might well remain relevant, but to the extent

EU and traditional political forms than they might have thought. Our thinking about how to progressively develop the European Union for it to better realize its underlying ideals, however, should not be burdened by ontological precommitments concerning its nature. Following in Jean Monnet's pragmatic footsteps, we should simply ask whether, given the values we are committed to, a particular reform would enable the European Union to function better to serve its citizens as a framework for self-government than available alternatives. If a European Union that can raise its own resources through taxes or levies and that establishes genuine electoral politics at the heart of the European political process would make it a better Union, effectively overcoming the crisis and making its recurrence unlikely, while reflecting and helping realize its basic values, then that is the direction in which it should constitutionally evolve. If this makes the European Union appear more like a federation of nation states, so be it.

they do, they would remain so because they describe features that are relevant in federal settings more generally.