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## THE CRISIS OF FUNCTIONALISM AND THE REFORM OF EUROPEAN ECONOMIC GOVERNANCE

**ABSTRACT** This paper studies the impact of the sovereign debt crisis on the development of the process of European integration and the constitutional framework of the EU. The first section focuses on the causes of the sovereign debt crisis, analysing the structural deficits and weaknesses of the Economic and Monetary Union (EMU). The second section looks at the reforms, which have been progressively adopted by the Eurozone to overcome the crisis and prevent the collapse of the single currency. The third section reflects on the longstanding contradictions of the integration process, in terms of its legitimacy and effectiveness, which the crisis has definitely highlighted demanding an effective solution. In this regard, the paper argues that the sovereign debt crisis represents a turning point in the history of European unification, marking the limits of the functionalist approach of integration and demanding a re-launch of the constitutional project in order to provide the monetary union with a veritable economic government.

**Keywords:** Sovereign Debt Crisis, Functionalism, Economic and Monetary Union

## INTRODUCTION

The sovereign debt crisis represents a turning point in the history of European integration. The creation of a single currency not provided with a veritable economic government<sup>1</sup> and full democratic legitimacy has progressively generated imbalances between Member States and has weakened the stability of the union itself. We are experiencing an economic and financial crisis in the Economic and Monetary Union (EMU), which is a result of a more serious identity crisis of the European Union. Stuck in the middle of an integration process, which has no clear direction, Europeans are searching for a way out of the tunnel of the crisis.

Despite political difficulties, the solution of current problems can be found by tackling those longstanding issues on democratic deficit and the shift of sovereignty, which have been ignored for a long time leaving the integration process to develop with a set of ambiguities. The crisis has then obliged Europeans to deal with the existential questions of their being together. What is the European Union for? How much solidarity should we feel towards citizens of other Member States? Is the EU that necessary? How can the European Union work better? The solution to the crisis will depend on the responses to these questions.

The purpose of this paper is to reflect on the impact of the sovereign debt crisis on the development of the process of European integration and in particular on the constitutional framework of the European Union. In the first part, we will briefly recall the roots of the sovereign debt crisis considering the structural deficit of the Economic and Monetary Union. In the second part, we will analyse the reforms that have been implemented since 2010 to overcome the crisis. In the final section, we will reflect on those fundamental contradictions of the integration process, which the outbreak of the crisis has underlined exposing the limits of the functionalist approach of integration and requesting a re-launch of the European constitutional project.

## THE DEFICITS OF THE ECONOMIC AND MONETARY UNION AND THE OUTBREAK OF THE CRISIS

The process of integration represents the greatest success in the history of Europe. First, it has provided citizens with durable peace and prosperity, after the disaster and the shame of world wars and totalitarianism. Second, it has remedied, at least in part, the inevitable decline of European national states, which accelerated after the end of the Second World War. For more than 60 years, EU citizens have shared a common

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<sup>1</sup> The concept of government should not be confounded with that of governance. If government describes a hierarchic administration, which is ruled by a single authority, economic governance consists more of a cooperation between equal authorities without a clear division of competences. Economic governance is therefore mainly based on soft law and coordination of separate policies. The limit of the governance lies therefore in the loss of accountability and democratic legitimation.

path working together on important projects, which have ensured their welfare and security. The construction of the internal market, the development of the common trade and agricultural policies, the abolishment of borders, the cooperation in the field of security and justice are some important steps of the long process of economic, social and political integration of the continent. At the same, while these transformations have strongly influenced the lives of citizens, the progressive construction of the EU has not overcome the primacy of national states, which remained the engine of the integration process and the source of political aggregation. Europeans still feel, in the first instance, members of their own national community and loyal to their national governments.

Some things have changed, however, with the signing of the Maastricht Treaty. The creation of the Economic and Monetary Union has been in all respects the most important achievement in the history of European integration. With the introduction of the single currency Member States have accepted to transfer an important part of their national sovereignty to the European Union providing the European Central Bank (ECB) with the power to develop a monetary policy independent from national vetoes pursuing the objective of price stability.<sup>2</sup> The Euro has become a common good for hundreds of millions of European citizens, increasing their loyalty to the Union and producing new expectations. Monetary unification has increased interdependence between Europeans, as well as the awareness of belonging to the same community. This has also raised a stronger demand for accountability of European institutions to the citizens. In other words, the creation of a European power in charge of managing the single currency in the public interest has strengthened European integration and developed a new constitutional culture within the Union.

The establishment of a single currency by transferring monetary sovereignty at European level has not been followed by a parallel process in the economic and budgetary field. The ability of Member States to raise taxes and redistribute resources consists indeed of the core national sovereignty that governments are extremely reluctant to give up. Therefore, at the intergovernmental conference of Maastricht, Member States refused to provide the EU with fiscal competences, leaving the economic and monetary union *de facto* asymmetric. The necessity to ensure the financial stability of the EMU, however, obliged member states to accept some kind of economic coordination, which has been disciplined by the European Treaties and the Stability and Growth Pact,<sup>3</sup> introduced in 1997 on a German initiative.

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<sup>2</sup> Art. 127.1 TFEU mentions the aims of the monetary policy of the ESCB, which should be pursued in accordance with the general principles of art. 3 of the TEU and the principle of an open market economy with free competition. The objective of price stability prevails on the support of the general economic policies in the Union.

<sup>3</sup> The Pact includes three legal acts: Resolution of the European Council on the Stability and Growth Pact (Amsterdam, 17<sup>th</sup> June 1997), Regulation (EC) n. 1466/97 "on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies"; Regulation (EC) n. 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure".

The economic union has been based on two methods of coordination.<sup>4</sup> The open method of coordination consists of the development of non-binding rules, which Member States shall respect under the supervision of the Commission and the Council. This is in particular the case of the broad guidelines of macroeconomic policy and the multilateral surveillance provided in art. 121 of the TFEU. At the same time, the European Commission has also developed long-term economic plans, which have been endorsed by the European Council, such as the Lisbon Agenda and the “Europe 2020” Strategy.<sup>5</sup> The closed method of coordination is based instead on binding rules, such as the stability criteria<sup>6</sup> and the procedure for excessive deficit under art. 126 of the TFEU. The Treaty provides the enforcement of these provisions through the application of economic sanctions.<sup>7</sup> Nevertheless, the implementation of these rules depends in large part on the will of the Council, which is an intergovernmental body provided with wide margins of political discretion.

The economic constitution of the EMU also provides for other rules, which prevent the commixture of economic and monetary policy in order to ensure the objective of price stability and push Member States to provide sound public finances. First, EU institutions, bodies, offices or agencies, as well as the national governments and public authorities are not allowed to receive monetary financings from the ECB and national central banks.<sup>8</sup> At the same time, the Treaty also prevents any measure, not based on prudential considerations, establishing privileged access to financial institutions by European and national administrations, bodies and authorities<sup>9</sup>. Finally, the Treaty foresees the so-called no bail out clause,<sup>10</sup> which affirms that the states and the Union are not responsible for obligations assumed by another member. This means that each country is responsible for its own debt. The purpose of the no bail out clause is to oblige

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<sup>4</sup> F. Amtenbrinck, J. de Haan, ‘Economic Governance in the European Union – Fiscal Policy Discipline versus Flexibility’, *Common Market Law Review*, Vol. 40 (2003), p. 1075, at <<http://dx.doi.org/10.2139/ssrn.1349103>>.

<sup>5</sup> The “Lisbon Strategy” launched in 2000 by the European Council aimed at making the European economy more dynamic, competitive, prosperous, fair and environmentally sustainable. It was based on the open method of coordination. In June 2010, the European Council has adopted a similar 10 years strategy called “Europe 2020”.

<sup>6</sup> Annual deficit must not exceed 3% of GDP and public debt must not exceed 60% of GDP (or at least diminish towards this parameter).

<sup>7</sup> In accordance with art. 126.11 of the TFEU, the Council may decide to apply or, as the case may be, intensify one or more of the following measures: to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities; to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned; to require the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the Union until the excessive deficit has, in the view of the Council, been corrected; to impose fines of an appropriate size.

<sup>8</sup> In accordance with art. 123.1 TFEU, which states the prohibition of monetary financing.

<sup>9</sup> In accordance with art. 124 TFEU, which affirms the prohibition of privileged access to financial institutions.

<sup>10</sup> Art. 125.1 TFEU affirms the principle of no bail-out.

Member States to contain their deficit and to ensure the soundness of their public finances. In fact, the drafters of the Treaty expected financial markets to demand a higher interest rate from those countries that did not have solid public finances and did not respect the stability criteria. The no bail out clause finds a balance in the solidarity clause, which allows Member States and the European Union to provide financial support under strict conditionality to Member States experiencing certain difficulties.<sup>11</sup>

The asymmetry between the economic and the monetary union represents the “original sin” of the project and a structural weakness of the Union, which has produced important consequences. The drafters of the Maastricht Treaty were aware of the risk of creating a currency not provided with a real economic government. Nevertheless, faced with the opposition of Member States in accepting substantial loss of economic sovereignty, they preferred to initiate the project convinced that the development of the integration process would have adjusted the genetic deficits of the EMU. The outcome of the current crisis will reveal if they were right.

The negative consequences of this imbalance between the economic and the monetary union are better understood when looking at the first ten years of EMU, whose results have been contradictory. While the ECB has generally complied with the objective of price stability as provided by the treaty, economic coordination has been instead inefficient. European procedures have been characterised by a set of weaknesses such as the wide political discretion of the Council in the decision making process, the little credibility of sanctions and the flexible interpretation of the rules. Moreover, coordination only focused on budgetary consolidation, rather than on a wider prospective considering also economic imbalances within the Eurozone.<sup>12</sup> Financial markets also have proved quite ineffective in pressing Member States to respect the stability criteria. In fact, despite the no bail out clause, all countries have enjoyed low interest rate on their public debt, even those with a higher deficit. This occurred because markets have generally considered the Eurozone as a single entity, doubting that one Member State would be left alone in case of serious financial difficulties. The interdependence of the system would in fact oblige all countries to support each other in order to preserve the stability

<sup>11</sup> Art. 122.2 TFEU states that *if a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned.*

<sup>12</sup> The weakness of economic coordination has been proven few years after the adoption of the SGP, when the Commission opened in 2003 an excessive deficit procedure against France and Germany, which had passed the 3% ratio public deficit/GDP. Due to the unwillingness of the Council to implement the procedure, the Commission reported the Council to the Court of Justice for the violation of art. 126 of the TFEU. In its Judgment of July 2004, the Court of Luxembourg recognised the full discretion of the Council to decide if a Member State presented an excessive deficit and to proceed with sanctions. See Judgment of the ECJ of 13 July 2004 on the affair C-27/04, *Commission v. Council*, ECR I-6649. After this Judgment of the European Court of Justice, several governments insisted on emending the Stability and Growth Pact in order to make its application more flexible and proportionate to the specific situation of each member state. The reform of the SGP in 2005 has introduced longer deadlines for the correction of the excessive deficits and has included new factors in the monitoring of the stability criteria.

of the monetary union. In conclusion, because of weak European coordination, most countries have not been able to contain their public expense and reduce their level of debt. The financial situation of several members has gradually deteriorated without any substantial opposition from European institutions and other EU members.

The structural weaknesses of the Economic and Monetary Union have definitely left Europe unable to deal with the financial crisis that started in the United States in 2007. The collapse of the housing bubble in America produced a wider banking and financial crisis, which soon spread to the rest of the world also affecting the productive system. In order to prevent economic collapse, national governments decided to intervene to support the private sector by nationalising banks and bailing out firms in crisis. Europe, however, found itself in the peculiar situation of having one integrated financial and productive market with a single currency, but different governments responsible for the economic and budgetary policy. As a consequence, even if banks and companies had already reached a continental dimension, their bail out has often exceeded the forces of national authorities. In this difficult situation, the only EU institution provided with substantial powers to deal with the global financial crisis was the ECB, which in concert with other main central banks of the world has provided important liquidity injection in order to avoid a credit crunch and prevent a deflationary spiral.

Because of the mutual intervention of the ECB and Member States, the economic and financial crisis slowly decelerated in 2009. However, the efforts made to support the private sector definitely undermined the stability of public finances in several European countries. This was in particular the case of Greece, whose budgetary policy has been characterised by a chronic excessive deficit and public debt.<sup>13</sup> In October 2009, the new socialist government led by George Papandreou was obliged to reveal the disastrous reality of Greece's public finances, with a current public deficit of 12,7% and a public debt above 125%. As a consequence, international rating agencies immediately cut the rate of its sovereign debt, once financial markets realised Greece was been unable to repay its public debt. The inexorable rise of interest rates on national bonds further undermined public finances, making a Greek default possible. Because of the strong interdependence within the Eurozone, the financial collapse of Greece started a domino effect, undermining the stability of the EMU as a whole. Financial speculation spread to other countries with a weak financial situation, in Portugal and Ireland in 2010, Spain and Italy in 2011 and Cyprus in 2012.<sup>14</sup> The sovereign debt crisis had started.

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<sup>13</sup> At the launch of the last stage of the EMU the Hellenic Republic did not present the economic condition to adopt the single currency. After a couple of years, however, the European Council and the Commission considered sufficient the efforts made by the government to complete the process of convergence and accepted Greece into the Euro from 2001. In the following years, Greece, as many other members, was not able to contain its public expense and reform its public administration and welfare state. On the contrary, the low interest rate on its public debt encouraged the government to adopt an even more lax budgetary policy, constantly increasing the level of deficit. The economic data submitted to the European Commission have been constantly misreported.

<sup>14</sup> The increase of public deficit was due in Spain and Ireland because of the high debt of the private sector, while in Portugal because of the loss of competitiveness and the high external deficit.

## THE REFORMS OF THE ECONOMIC AND MONETARY UNION

The severity of the crisis prompted Member States to reform the Economic and Monetary Union in several ways. This has initiated an important and complex process of transformation, which is changing the nature and the functioning of the European Union.

The first important reform was the creation of the rescue mechanisms for Member States at risk of national default. With this purpose and faced with the likely collapse of Greece in May 2010, the European Council and the Commission created the European Financial Stability Facility (ESFS) and the European Stability Financial Mechanism (ESFM). These temporary rescue mechanisms acted in collaboration with the ECB and the International Monetary Fund (IMF) and intervened to support Greece, Portugal and Ireland.<sup>15</sup> Both the ESFS and the ESFM were replaced in 2012 by the European Stability Mechanism (ESM), which has been created by an intergovernmental treaty<sup>16</sup> between the governments of the Euro area on the basis of new art. 136.3 TFEU.<sup>17</sup> The ESM is a permanent international organisation based in Luxembourg, which has a total subscribed capital of € 700 billion. It is in charge of providing assistance to Member States in financial difficulty under strict conditions and in collaboration with the ECB and the IMF.<sup>18</sup> Since it became operational, the ESM has intervened to provide financial support to Spain<sup>19</sup> and Cyprus.<sup>20</sup>

A major role to prevent Member States from defaulting has also been played by the ECB. Due to the likelihood of Greece defaulting and the contagion to the rest of

<sup>15</sup> The European Financial Stability Facility (EFSF) is a special purpose vehicle (SPV) that can guarantee on a pro-rata basis lending up to €440 billion to Euro area Member States. The European Financial Stabilisation Mechanism (EFSM) is instead an emergency funding programme financed by borrowing secured against the EU Budget (up to €60 billions). Countries can get financial support at an interest premium. Both Funds have been created in May 2010 with a three years mandate.

<sup>16</sup> The Treaty has been signed on the 2<sup>nd</sup> of February 2012.

<sup>17</sup> European Council Decision of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the Euro (2011/199/EU).

<sup>18</sup> After the request for financial assistance the Board of Governors of the ESM entrusts the European Commission to negotiate in connection with the ECB and the IMF a Memorandum of Understanding. The Managing Director of the ESM prepares at the same time a proposal for a financial assistance facility agreement to be adopted by the Board of Governors. Afterwards the European Commission signs the Memorandum on behalf of the ESM. Finally, the Board of Directors approves the financial assistance facility agreement. A similar procedure applied in the case of the EFSF.

<sup>19</sup> On 20 July 2012, the Euro group granted financial assistance to Spain's banking sector following an official request made by the Spanish government. The ESM has decided to provide financial assistance for the recapitalisation of the Spanish banking sector up to €100 billion.

<sup>20</sup> On 25 June 2012, the Cypriot Government submitted a request for stability support to the President of the Euro group. A macroeconomic adjustment programme was agreed on 25 March 2013. The package of financial assistance is up to €10 billion. The ESM will provide up to €9 billion and the IMF around €1 billion.

the Eurozone, in May 2010 the ECB launched the Securities Market Program (SMP) consisting of the injection of liquidity in the banking system of the Euro area and the purchase of national bonds of Member States under pressure from financial markets. After the signing of the European Stability Mechanism (ESM), the ECB launched, in September 2012, the Outright Monetary Transactions (OMT) programme, aimed at supporting Member States under financial supervision of the ESM, through the potentially unlimited purchase of short-term national bonds on the secondary market.<sup>21</sup> Even if the OMT had not yet been applied, it marked an important emancipation of the ECB from the rigid conception of the central bank as exclusive guardian of price stability. By adopting non-standard measures of monetary policy to prevent the progressive aggravation of the crisis, the ECB has proved that its real primary objective is the survival of the single currency and that it is ready to do whatever it takes to save it.<sup>22</sup> Also recently, by adopting the Quantitative Easing (QE)<sup>23</sup> programme to deal with the persistent deflation and recession in the Eurozone, the ECB has demonstrated to be the only institution in the EU, which is able to address the consequences of the crisis.

The second important process of reform was the strengthening of the economic governance of the Eurozone. On the 25<sup>th</sup> March 2011, 23 Member States signed the Euro Plus Pact, which is a non-binding agreement setting the commitment of Member States to strictly coordinate their economic policies and to implement structural reforms. The Stability Pact was then reformed through the adoption of the Six Packs<sup>24</sup> in November 2011 and the Two Pack<sup>25</sup> in May 2013. They consist of a set of regulations and one directive, which have significantly strengthened economic coordination within the Eurozone. First, the reform has created a new Macroeconomic Imbalances Procedure

<sup>21</sup> Art. 123 TFEU prevents the direct purchase of government bonds.

<sup>22</sup> In his speech at the Global Investment Conference in London on the 26th of July 2012, the newly elected President of the ECB Mario Draghi reaffirmed the irreversibility of the single currency and declared that within its mandate the ECB would have done everything to stabilise the Euro. *Within our mandate, the ECB is ready to do whatever it takes to preserve the euro, and believe me, it will be enough* – Mario Draghi, Global Investment Conference in London on the 26 July 2012.

<sup>23</sup> The programme consists of expanding purchases of bonds issued by Euro area central governments, agencies and European institutions up to €60 billion each month. Purchases intended to be carried out until at least September 2016 and the programme is designed to fulfil the price stability mandate.

<sup>24</sup> The Six Pack includes: Reg. (EU) No 1173/2011 “on the effective enforcement of budgetary surveillance in the euro area”; Reg. (EU) No 1174/2011 “on enforcement action to correct excessive macroeconomic imbalances in the euro area”; Reg. (EU) No 1175/2011 “amending Reg. (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies”; Reg. (EU) No 1176/2011 “on the prevention and correction of macroeconomic imbalances”; Reg. (EU) No 1177/2011 “amending Reg. (EU) No 1467/1997 on speeding up and clarifying the implementation of the excessive deficit procedure”; Directive 2011/85/EU “on requirements for budgetary frameworks of the Member States”.

<sup>25</sup> The Two Pack includes: Reg. (EU) No 472/2013 “on the strengthening of economic and budgetary surveillance of Member States in the Euro area experiencing or threatened with serious difficulties with respect to their financial stability”; Reg. (EU) No 473/2013 “on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area”.



(MIP) aiming to address macroeconomic imbalances within Member States that have an impact on national public finances, including divergences in current accounts and competitiveness. Second, coordination has become more effective by introducing semi-automatic sanctions in the multilateral surveillance and excessive deficit procedures: according to the new reverse majority rule, sanctions proposed by the Commission are automatically adopted unless the Council decides, by qualified majority, to reject them within 10 days.<sup>26</sup> At the same time, the application of the convergence criteria has been better specified in regards to the public debt reduction,<sup>27</sup> while statistic surveillance on national public finances has been strengthened. Finally, the reform has synchronised all existing procedures of economic coordination in one legal framework assisting Member States in the approval of their national budgetary law. This has been accomplished by introducing the European Semester and the common budgetary timeline, which together coordinate the national budgetary cycle of Member States during the entire year, from January to December. Another important reform has been the signing of the Treaty on Stability, Coordination and Governance (the so-called Fiscal Compact). This is a separate intergovernmental agreement signed by 25 Member States on the 2<sup>nd</sup> of March 2012, with the exclusion of the United Kingdom and Czech Republic. The treaty introduces a balanced-budget amendment in supra-legislative source of law, fixes binding obligations to reduce public debt and creates a Summit of the Heads of State or government of the Euro area to discuss the most important political issues regarding the crisis (Euro summit). The Fiscal Compact has determined an important loss of national sovereignty because it prevents Member States from developing, in the future, economic policies based on debt. In order to ensure the application of the golden rule in Member States, the ECJ shall supervise its implementation within the domestic legal order and an automatic correction mechanism shall be set up with the purpose of correcting deviations from the stability criteria. Both the reform of the SGP and the ratification of the Fiscal Compact have obliged Member States to adopt austerity measures to reduce the level of deficit and consolidate their public finances.

The third important development of the EMU consisted of the strengthening of banking integration. In 2010, the European Commission and the Council endorsed a reform of prudential supervision creating on the basis of art. 127.6 of the TFEU the European Systemic Risk Board (ESRB), composed of an authority in charge of macro-prudential supervision, the European System of Financial Supervisors (ESFS), and three authorities in charge of micro-prudential: the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA). These authorities aim to play an important role in the coordination of prudential supervision at national level and

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<sup>26</sup> Concerns have been raised in relation to the compliance of semi-automatic sanctions with EU primary law. Several authors, particularly in Germany, have denied their legitimacy on the basis of a literal interpretation of Treaty rules on economic coordination.

<sup>27</sup> The public debt reduction is now considered "sufficient", as requested by art. 126.2 TFEU, if it declines by 1/20<sup>th</sup> of the differential between the 60% debt ceiling and the actual level of debt, averaged over a three-year period.

developing legal standards in order to consolidate the European banking and financial system. Later in 2012, faced with the deepening of the crisis and the necessity to break the vicious cycle between the banking crisis and the sovereign debt crisis, the European Council agreed to deepen integration even further by creating a banking union in the Eurozone. Between 2013 and 2014, the European Parliament and the Council have agreed the adoption of regulations establishing the banking union, which is composed of three elements. First, a Single Supervisory Mechanism (SSM) has been created within the ECB in order to supervise the major European financial institutions and their compliance with EU banking rules. The SSM will work in strict cooperation with national prudential authorities, which exercise their supervision on the smaller financial institutions. Second, the Single Resolution Mechanism (SRM) aims to intervene in the case a European bank fails despite the SSM supervision. Resolutions will be financed by a common fund financed by the banking sector in order to minimise the costs for taxpayers and real economy. Finally, common rules for the European banking sector have been introduced in order to harmonise national disciplines, in particular in relation to the capital requirements and the recovery and resolution of failing banks.

At this stage of the integration process, the natural evolution of the economic union would evidently be the establishment of a fiscal union in order to provide the EU with the instrument to develop a genuine economic policy at continental level and balance asymmetric shocks affecting its economy. This would mean balancing the asymmetry within the EMU by creating a European authority for economic and budgetary policy. Even if this project has always been opposed by national governments, the shock of the sovereign debt crisis, which has jeopardised the survival of the single currency, may have in part persuaded European leaders to transfer some fiscal competence to the EU. The perspective of fiscal union is also supported by the European Commission in the Blueprint for a Deep and Genuine EMU published in November 2012.<sup>28</sup> In this document the Commission envisaged the creation of a “fully-fledged fiscal union”, implying the development of a stronger capacity at European level capable of managing economic interdependences, and ultimately the development of a fiscal body for the Eurozone.

## THE DIFFICULTIES OF THE ONGOING PROCESS OF ECONOMIC CONSOLIDATION

The sovereign debt crisis has been the driver of important reforms, which until few years ago would have been unimaginable. Member States and citizens have realised how interdependent their future is and have accepted to proceed towards a stronger integration in the economic, fiscal and banking field. As we mentioned in the introduction, the crisis, however, has also marked the difficulties of the functionalist approach to

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<sup>28</sup> Communication from the Commission, *A blueprint for a deep and genuine economic and monetary union Launching a European Debate*, Brussels, 30 November 2012, COM(2012) 777 final/2, at <[http://ec.europa.eu/commission\\_2010-2014/president/news/archives/2012/11/pdf/blueprint\\_en.pdf](http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/pdf/blueprint_en.pdf)>.

dealing with current emergencies. Functionalism has pushed European integration for more than fifty years on the basis of the gradual expansion of European competences through the spill-over effect, the participation of both supranational and intergovernmental bodies to the decision making process, the research for consensus among all members and the development of the *acquis communautaire*.

*The sovereign debt crisis, however, has undermined this traditional model of integration. Instead of an organic and automatic development of the integration process, the crisis has shown the difficulties of the functionalist method to provide unitary and effective answers to the citizens in the framework of the Lisbon Treaty. There are several symptoms of the difficulty of functionalism to deal with the crisis.*

First, reforms have not pursued an organic and balanced development of the existing institutional framework, but have rather created new procedures or new bodies to deal with specific aspects of the crisis. As a result, the structure of the economic union has become extremely complex. Procedures are specified in different legal texts, under both EU, international and national law with the risk of overlaps and contradictions. The decision making process lacks transparency and efficiency, especially because important decisions are still taken by informal intergovernmental bodies, like the Euro summit, or technical authorities, like the Eurostat. The crisis has not reinforced the community system, but rather intergovernmental institutions, notably the Council and the European Council, which have gained relevant powers of supervision and have increasingly assumed the role of legislative initiator.<sup>29</sup> *This development of the EU institutional balance shows how the crisis management is not the result of a genuine European policy, but rather of the compromise among different national views.*

Second, several reforms adopted up until now are not consistent with the letter of EU primary law. Because of the necessity to prevent the collapse of the monetary union, Member States have already moved beyond the legal framework set out by the Treaty. This happened for example with the progressive transformation of the Economic and Monetary Union in a “conditional transfer union”, characterised by horizontal transfers of resources between Member States. Vertical transfers of money within the Union in fact already existed in small quantities in the framework of the cohesion policy financed by the European budget. However, the creation of the European Stability Mechanism represented a turning point in this perspective, because it counts on much more resources, which can be provided to Member States in certain emergency situations and under strict conditionality. Also the role of the ECB has changed. Art. 127 TFEU clearly states that the monetary policy of the ECB must pursue the objective of price stability. Nevertheless, the massive intervention of the ECB to buy government bonds of Member States under speculative pressure has been considered as potentially in contrast with art. 123 TFEU on the prohibition of monetary facility. In particular, the launch of the Outright Monetary Transaction programme based on the potentially

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<sup>29</sup> The role of legislative initiator is mainly played by the European Council by adopting conclusions at the end of its meetings. Such a process has determined evidently an erosion of the initiator power of the Commission. M. Dawson, F. de Witte, ‘Constitutional Balance in the EU after the Euro-Crisis’, *The Modern Law Review*, Vol. 76, No. 5 (2013), p. 830, at <<http://dx.doi.org/10.1111/1468-2230.12037>>.

unlimited purchase of government bonds may represent an indirect monetary financings to Member States. The fact is, the ECB has started acting as a “conditional lender of last resort” for those states in financial difficulties, which have accepted a process of fiscal consolidation under the European supervision. In reality, the objective pursued by the ECB is still monetary stability, as requested by the Treaty, but in a wider context. Even if certain decisions might not be strictly consistent with the genuine pursuit of price stability in the short term, they served the major scope to prevent the collapse of the single currency and therefore ensure the stability of the monetary union. Finally, economic coordination has been characterised by an important transformation, which does not find a clear support in EU primary law. Indeed, the application of the reverse majority rule in the decision making process has substantially changed the institutional balance of the Economic union making the Council subject to the decisions of the Council in contrast with the principle of conferral and the procedures outlined in the Treaty.

Third, the current process of integration has shown how divergent the vision on the future of the EU is among Member States. While the Eurozone countries share the necessity to strengthen integration in order to secure the single currency and their financial stability, other governments clearly refuse any new transfer of competences to Brussels. We are witnessing an acceleration of multispeed integration, with the Eurozone representing the most integrated core, around which some member states have accepted progressive limitation of national sovereignty, in view of joining the monetary union, while others, starting with the United Kingdom, have substantially remained apart from the current process of integration. The process has produced a significant fragmentation of the EU legal framework. This occurred in particular with the signing of the Fiscal Compact as a separate agreement beyond the EU legal framework, which may now become a standard procedure for treaty change, when it is not possible to reach unanimity. This reasoning based on the *realpolitik* represents, however, a danger for the unity and the coherence of the European economic governance.

In the light of this analysis, we should wonder whether functionalism may be able to deal with the current challenges of the integration process, in particularly the establishment of a fiscal union within the Eurozone. In other words, we should consider whether the reform of the current economic governance or even a Treaty amendment may be sufficient to provide the Eurozone with a limited, but real power to collect and redistribute resources by adopting a single economic policy. In our opinion this perspective would meet at least a twofold limit.

The first opposition would come from the guardians of national legal orders, notably constitutional courts. Indeed the partial transferal of economic and fiscal authority at European level would deeply change the constitutional identity of member states, limiting *de facto* their autonomy to shape national policies. It is not a case that the current process of integration, including the reform of the SGP and the adoption of the Fiscal Compact, has already got the attention of national constitutional judges. The German Constitutional Court (*Bundesverfassungsgericht*) has already expressed its opposition to a possible shift of budgetary sovereignty from the *Bundestag* to the EU. In

the famous judgement on the ratification of the Lisbon treaty<sup>30</sup>, the Court of Karlsruhe had already stated that the process of European integration cannot impinge on core elements of national sovereignty such as budgetary policy. Despite the German constitution (*Grundgesetz*, GG) states in art. 23<sup>31</sup> the principle of openness to EU law (*Europarechtsfreundlichkeit*), Germany has to maintain its constitutional identity of sovereign state.<sup>32</sup> The integration process can therefore continue only without depriving the German Parliament of its core competence, included budgetary policy. In the light of its previous case law, the Court has considered the ESFS and the ESM consistent with the *Grundgesetz*,<sup>33</sup> as long as these mechanisms do not create an unlimited responsibility of Germany towards the other Member States and the Bundestag agrees on any transfer of national resources to the European funds in the future. Besides from their resistance to the transferal of further core sovereignty to EU level, National Constitutional Courts have also raised concerns on the consistency of current processes of reform with European treaties. Preliminary rulings of the European Court of Justice have been requested by the Irish Supreme Court on the compatibility of the ESM with EU Treaties (Pringle case)<sup>34</sup> and by the *Bundesverfassungsgericht* on the consistency of the OMT programme with the prohibition of monetary financings.<sup>35</sup> Even if the ECJ has been able for the moment to argue the consistency of reforms with EU law, it may be difficult in the future to prove the legitimacy of a further process of fiscal and economic integration in the light of the principle of conferral and the other limits set by the EU

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<sup>30</sup> Federal Constitutional Court, Judgement, 30<sup>th</sup> June 2009.

<sup>31</sup> The principle of "openness to Europe" at art. 23.1 of the Constitution commits Germany to participate in the development of the European Union *that is committed to democratic, social, and federal principles, to the rule of law, and to the principle of subsidiarity, and that guarantees a level of protection of basic rights essentially comparable to that afforded by this Basic Law.*

<sup>32</sup> Federal Constitutional Court, Judgement, 30<sup>th</sup> June 2009, para. 249: *Essential areas of democratic formative action comprise, inter alia, citizenship, the civil and the military monopoly on the use of force, revenue and expenditure including external financing and all elements of encroachment that are decisive for the realisation of fundamental rights, above all as regards intensive encroachments on fundamental rights such as the deprivation of liberty in the administration of criminal law or the placement in an institution. These important areas also include cultural issues such as the disposition of language, the shaping of circumstances concerning the family and education, the ordering of the freedom of opinion, of the press and of association and the dealing with the profession of faith or ideology.*

<sup>33</sup> German Constitutional Court, Judgement 12<sup>th</sup> September 2012. Para. 248: *With a view to the binding limitation of the burdens on the budget to EUR 190.024.800,000, which is to be ensured by a reservation to this effect, the safeguarding of the Bundestag's overall budgetary responsibility does not require providing a special right of resignation or termination in the Treaty. The limitation of liability sufficiently ensures that the entry into force of the Treaty alone does not establish an automatic and irreversible procedure regarding payment obligations or commitments to accept liability. Instead, every new payment obligation or commitment to accept liability requires a new mandatory decision by the German Bundestag. In other respects, the general provisions apply in this context.*

<sup>34</sup> ECJ Judgment of 27 November 2012, Case C-370/12, Thomas Pringle v Government of Ireland, (2012) ECR I-413.

<sup>35</sup> The Advocate General in his opinion of 14 January 2015 has declared the OMT programme compatible with EU Treaties. See Advocate General's Opinion in Case C-62/14, 14 January 2015.

Treaties. Even if the ECJ supported a progressive shift of sovereignty to the EU level, national constitutional courts could still intervene to stop such process.

Second, the process of economic and fiscal integration through a functionalist approach would be democratically unsustainable in the current EU legal framework. Indeed, because of the reluctance of national governments to lose their sovereignty, reforms have strengthened intergovernmental institutions, notably the Council and the European Council. Even if the European Parliament has participated in the negotiation of the Six Pack and Two Pack, it does not play any active role in shaping economic coordination. The Treaty only foresees the obligation for the Presidents of the Council, the Commission and the Euro Group to report to the European Parliament the results of economic coordination in the framework of the economic dialogue. Similar provisions are contained in the Fiscal Compact, which also recalls the possibility of inter-parliamentary cooperation without, however, conferring specific responsibilities to the European and national parliaments. The Economic Union is therefore characterised by a weak democratic legitimation, which is not able to compensate the limitation of parliamentary prerogatives of Member States imposed by European coordination.<sup>36</sup> This has produced an unsustainable situation, where citizens are bound to important decisions on fiscal and budgetary policies taken by subjects, they do not directly elect. This is a clear violation of the rule of no taxation without representation, which is the fundamental principle of modern democracies. The inability of Member States and EU institutions to develop a proper European democracy, through the strengthening of the European Parliament, represents a handicap for the process of integration. The intergovernmental management of the economic union does not only raise problems of legitimacy, but has also produced a laceration of the European public debate. Lacking an institutional space to develop and share ideas at European level, the debate has been split among national communities, privileging a short-sighted approach to the crisis. It is not a case that citizens from southern countries have reduced their confidence in the EU and other Member States, considering them responsible for the austerity policy, which has been introduced to consolidate public finances in accordance with the new European rules. At the same time, citizens from northern countries started wondering why they should pay for the mistakes of other governments and people by providing a large quantity of money to the European rescue funds. Lacking constructive public discussion on the crisis and real democratic institutions at European level to participate in the decisions, many citizens have preferred to vote for Eurosceptic parties to protest against a system where they have no voice.

## CONCLUSION

The outbreak of the sovereign debt crisis has accelerated the process of economic, banking and fiscal integration in the Eurozone, which is still in process. The consolidation

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<sup>36</sup> N. De Sadeleer, 'The New Architecture of the European Economic Governance: a Leviathan or a Flat-footed Colossus?', *Maastricht Journal of Comparative and EU Law*, Vol. 19, No. 3 (2012), p. 378.

of Economic governance has avoided, for the moment, the collapse of the monetary union, but has not secured its survival and stability in the future. Indeed, further steps towards the establishment of a genuine fiscal union are required, as already suggested by the European Commission in its Bluebook of November 2014. This vision cannot be reasonably pursued following the traditional functionalist approach to integration. Functionalism has indeed run out of its positive contribution to the integration process, having consumed as much national sovereignty as it could. The current challenges the EU is dealing with require a progressive transfer of sovereignty, as well as a substantial democratisation of the EU institutional framework, which shall be granted only by a re-launch of the constitutional project. In our opinion, a public debate on the adoption of a new constitution for Europe should be based on few considerations.

First, it may be opportune to clarify a final aim for the integration process. Beyond ambiguities and vague declarations on the necessity of the political union, it should be discussed with honesty whether the Union should develop into a proper federation or finally accept its status of international organisations reducing then its ambitions and competences.

Second, it is necessary to accept that not all Member States will integrate together at the same time. As there are different necessities and expectations about the destiny of the EU, it is not possible to provide any member with a veto right preventing others to proceed. Treaty reforms should be endorsed then by majority rule. At the same time, countries that have not accepted reforms may join later.

Third, the process should proceed through gradual sovereignisation of the EU Parliament, which is the only institution able to provide legitimacy to the policies endorsed at European level and more in general to the project of European unification. This may require a reform of several national constitutions.

In conclusion, despite the uncertainty of the future, one thing is sure: the *status quo* cannot stay. As Jacques Delors said, *the process of European integration is like riding a bike: you stop pedalling and you fall off*. We are witnessing a process of reforms that is changing the nature of the European Union. If it succeeds, it will probably lead to the transformation of Europe into a political union, likely on a federal basis. If it fails because of the decisions of the political class and the scepticism of public opinion, the European Union will probably refold on the common market, renouncing for a long time, a more ambitious perspective of unification and leaving each member state to deal with globalisation on its own.

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