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- Lessons learned from the current economic and financial crisis pose great challenges for the EU concerning the future development of the EMU.

- Through the recent changes the limits of a mere coordination of economic policies have been reached and a debate about turning the system into a true Economic and Monetary Union must be launched.

- A further strengthening of the EU's power in economic and fiscal policies would require a clearer move in the direction of fiscal federalism, that is, a more balanced relationship between the Union's budget and those of the member states. It would also require the finalization of the Union's democratic system along the lines of a federal political order.

- The divided character of the currency union presents significant difficulties for its further deepening and democratization.

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Frederik Reinfeldt and Jyrki Katainen signing the Fiscal Compact on 2 March 2012. Photo: The Council of the European Union

One of the main political conclusions drawn from the current economic and financial crisis has been that the Economic and Monetary Union (EMU) needs to be deepened. The need for 'more Europe' has been one of the slogans repeated over and over again in political speeches. What do these words mean in concrete terms? What do they mean in terms of new competences to be transferred to the EU in economic and fiscal policies? And how should they be interpreted in terms of the use of these competences, namely in terms of decision-making and democratic control?

To date, the management of the economic crisis has already led to a significant adjustment of the existing EU rules and their interpretation. This paper starts with an analysis of the measures adopted and agreements made, such as the six-pack, the Euro-plus pact and the Treaty on the Stability, Coordination and Governance of the EMU (Fiscal Compact). What is their relationship with the existing EU competences and how do they affect the EU's democratic system? An assessment of the stability mechanisms will complement the analysis. The next question will then centre on the new powers for the EU that are likely to see the light of day, and the challenges that will emerge if the Union's founding treaties are successfully opened during the next few years, as demanded by some member states at least. Does a blueprint for treaty change already exist and is it a blueprint that will keep the EU together?

Existing competences in economic and fiscal policy

The Economic and Monetary Union (EMU) forms the legal and political framework for the Union's competences in economic and fiscal policies. All the EU members take part in the EMU with, however, only seventeen of them participating in its final stage, which includes the common currency. Coordination of economic policies forms the common ground for all the EU members concerning the Union's role and competences. The controversial character of the Union's power in this policy field can be seen in the treaty provision according to which (Treaty on the Functioning of the European Union (TFEU), Art. 5) *the member states* shall coordinate their economic policies within the Union. To this end, the Council is, however, entitled to adopt measures, in particular to give broad guidelines for these policies. In the context of these powers the Council has, for instance, adopted recommendations in support of the previous Lisbon Strategy and the current Europe 2020 strategy. The Council is entitled to monitor the consistency of economic policies with the broad guidelines and may, on a proposition from the Commission, address the necessary recommendations to a member state whose policy deviates from them.

The Stability and Growth Pact forms the specific framework for the coordination of national fiscal policies in the EMU. The pact aims at safeguarding sound public finances by creating an excessive deficit procedure (TFEU, Art. 126) and a preventive system of monitoring and early warning to prevent excessive deficit. The Commission is entitled to monitor the budgetary situation and the stock of governmental debt in the member states with a view to identifying gross errors. The Council may then, in the final instance, impose fines on a member state that fails to put into practice the recommendations of the Council to correct its budgetary policy. The excessive deficit procedure has not functioned in accordance with the original expectations. First, the qualified majority needed in the Council in order to launch its final stage enabled France and Germany to prevent their own sanctioning. This, together with the amendments made to its rules which enhanced its flexibility, affected the credibility of the entire system.

When it comes to the group of member states that have joined the common currency, the treaty provisions have gradually developed to stress its legal and institutional role separate from the rest of the Union. In addition to the provisions of the common monetary policy—which is an exclusive competence of the EU and a prerogative of the European System of Central Banks—a couple of other important provisions exist for the members of the euro area separately. There is, first, a prohibition to use the lending facilities of the European Central Bank for any type of public funding in the EU (TFEU, Art. 123). And second, there is a prohibition for the EU and its member states to assume the commitments of other member states or other public authorities, namely the so-called no bail-out clause (TFEU, Art. 125). In the Lisbon Treaty, the role of the Council was furthermore strengthened in the coordination of the economic and budgetary policies of the members of the euro area in addition to the confirmation of the Eurogroup meetings, its system of presidency and its external representation.

Tightening the rules and control of the EMU

Since the financial and sovereign debt crisis hit the euro area in spring 2010, a number of legal and political measures have been taken in order to manage the crisis and safeguard European economies. Irrespective of differences in method and content, most of the measures adopted have strengthened the powers of the EU at the expense of the member states. Only in one context has a change in the EU's founding treaties been required for this. This treaty change, which was agreed upon by the European Council in March 2011, created a legal basis for the establishment of the permanent stability mechanism. The content of the new provision is as follows (TFEU, Art. 136):

> *"The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."*

While the amendment made to the TFEU has been undergoing a process of ratification in the member states, the details of the permanent stability mechanism have been prepared and an agreement on them was reached by the Eurogroup countries in February 2012. The treaty will enter into force along with the amendment to the TFEU in July 2012.

It has been argued that the treaty change neutralizes the effect of the bail-out prohibition of Art. 125 TFEU.[1] New interpretations about mutual responsibility and the conditions for this will thus emerge on the basis of the new treaty provision and its implementation. The reference made to the strict conditionality of the stability mechanism is, however, significant in this respect. With respect to the EU's competences, there is a difference between the legal and political roles of the European Stability Mechanism (ESM).[2] The ESM is, in legal terms, an intergovernmental institution established under public international law through an international treaty by the euro area countries. Politically, however, the setting is different as membership in the euro area *de facto* presupposes participation in the ESM.[3] Its internal logic is not intergovernmental as

1 See e.g. DE WITTE, B. *The European Treaty Amendment for the Creation of a Financial Stability Mechanism.* Sieps, Issue 2011:6; 6.

2 Its function is to mobilize funding and provide stability support under strict conditionality to its members which are experiencing severe financial problems. For this purpose, the ESM shall raise funds by issuing financial instruments or by entering into agreements or arrangements with its members, financial institutions or other third parties (Treaty establishing the European Stability Mechanism, Art. 3)

3 As a consequence of joining the euro area, a Member State of the EU should become an ESM member with full rights and obligations. Treaty, preamble (point 7).

the reputation and ratings of the most stable euro area countries are used to borrow from the market and to lend to those countries with financial problems.[4] Its decision-making combines intergovernmentalism with majority rule.

The other measures adopted haven't required a treaty change even if the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (The Fiscal Compact) originally had that goal. The fact that it had to be concluded in the form of an intergovernmental treaty separate from the EU treaties prevented it from creating new competences for the EU and its political institutions. Its role outside the EU's legal and institutional framework leads to ambiguities, taking into account, however, that it adds directly to the rules of the EMU. The Fiscal Compact shall in any case be read against its Art. 16, according to which its content shall be incorporated into the EU's legal framework within five years of its entry into force.

For the time being the Fiscal Compact thus extends the rules on economic coordination and national fiscal policy in an intergovernmental setting. The most significant new rules relate to the new demand for the member states to limit their structural deficit to 0.5 % of GDP, which is a more stringent demand than those of the Stability and Growth Pact, and the establishment of a correction mechanism which shall be triggered automatically in case the state deviates from the medium-term objective. The member states are obliged to bring the new rules into force through national legislation. The EU Court of Justice has been tasked with assessing the sufficiency of national implementation and, under certain conditions, imposing a penalty.

The six-pack legislative package which came into force in December 2011 has the character of secondary law binding all member states (five EU regulations and one directive) and as such doesn't extend the Union's explicit competences. It does, however, strengthen the use of the current competences. First, a new macroeconomic imbalances procedure was established on the basis of TFEU Art. 121.6 which allows the EP and the Council to adopt rules for the surveillance of the member states' economic policies. This system is meant to prevent and correct macroeconomic imbalances on the basis of ten indicators and alert thresholds established for each of them. The powers of surveillance granted to the Commission and Council are in line with those already exerted in the framework of the coordination of economic policies, but the scope of surveillance is more extensive.

Second, the details of the regulations and directive forming the Stability and Growth Pact were amended (TFEU, Art. 136) to correct the excessive deficit procedure. First, a more stringent application of the early-warning procedure was adopted by bringing in more detailed criteria for what a significant deviation from the medium-term budgetary objectives (MTO) or the adjustment path to it means. Moreover, the debt criterion was operationalized so that, in addition to the deficit above 3 % of GDP, a debt ratio above 60 % will also trigger the excessive deficit procedure. And finally, the system of sanctioning for a failure to correct an excessive deficit was made more efficient by making it gradual and launchable by reverse qualified majority voting. With a view to strengthening both macroeconomic surveillance and coordination and more stringent fiscal coordination, the so-called European semester was established as a new tool for this. It consists of a cycle of economic policy coordination that lasts for about six months and is repeated every year. Timing is the new element brought in by the European Semester as the member states are now required to submit their annual stability or convergence programmes to the Commission before they are discussed in the national parliaments and translated into national law. The same applies to the national reform programmes related to the promotion of growth and jobs and based upon a combination of broad economic policy guidelines (TFEU, Art. 121) and employment guidelines (TFEU, Art. 148). It has been argued that by bringing together both legislative and non-legislative procedures the European Semester might, in fact, change the role of the latter towards a binding one.[5]

Simultaneously with the above-mentioned measures of a legally binding nature, a political pact was adopted under the title "Euro-plus Pact" by the euro-area countries and six other EU members.

4 See LANNOO, K. *EU Federalism in Crisis*, CEPS Policy Brief 259; 2011, 3.

5 See e.g. *How Effective and Legitimate is the European Semester?* Briefing Paper, EP Econ 2011.

Jean-Claude Juncker, also dubbed *Mr. Euro*, addressing the press after a Eurozone Summit in October 2011. Photo: European Council

The pact aims to increase the competitiveness of European economies by engaging the participants in a set of reforms such as wage and productivity development, employment, sustainability of pensions, healthcare and social development. The pact is of an entirely political character, it operates in the field of national competences and is based upon a system of political surveillance and peer pressure. The policy objectives will be jointly set by the member states; each participant will then choose its own policy-mix among these for making commitments. Furthermore, the implementation of commitments and progress towards the common objectives will be monitored by the heads of state or government on the basis of a report by the Commission.

Economic governance and its challenges

Even without a transfer of any explicit new competences to the EU in economic and fiscal policies, the Union's actual power has increased through more detailed targets of macroeconomic coordination, more supranational systems of surveillance and sanctioning of both macroeconomic developments and national fiscal policies, including the obligation to adopt new limits to structural deficit in national law. It is obvious that with this new increase in power at hand and many new instruments still likely to emerge—such as the issuance of Eurobonds or an increase in the Union's own funds through taxes—the question of economic governance has attracted a lot of attention.

As in any other field of the EU's competence, its economic governance is exerted through a legislative and an executive arm. As the Union's executive body, the Commission has had its position strengthened by the extended policy coordination and reinforced surveillance mechanisms. The Council takes the final decisions on issues of a legislative character such as the macroeconomic imbalances procedure or the excessive deficit procedure, even if the new reverse qualified majority voting enhances the Commission's role also in this context. In parallel with a strengthened Commission, a strengthening of the intergovernmental leadership of the Eurogroup has taken place. During the economic crisis the Eurogroup, acting under the permanent presidency of Jean-Claude Juncker, took the lead in managing the crisis and finding new innovative and non-treaty-based solutions for the EU's action. Agreements on the financial stability mechanisms as well as the Euro Plus Pact and on the Fiscal Compact took place in the context of the Eurogroup. All of these were negotiated and agreed upon by the euro-area countries, even if they were opened for participation by non-euro members as well. The role of the Eurogroup has also been strengthened by the practice launched in 2008 to arrange a part of its meetings at the level of heads of state and government. This practice was formalized in the Fiscal Compact, which establishes the concept of a Euro Summit, and defines it as an informal summit to be arranged at least twice a year at the heads of state and government level by those countries that share the common currency. The treaty furthermore requires that a president will be appointed for the summits for the same term of office as that held by the President of the European Council.

The transfer of major new competences to the EU in economic and fiscal policies is of a principled character with respect to the division of power between the EU and its member states. The asymmetric character of the EMU has implied that an entirely federal monetary policy has been combined with the coordination of national economic policies only. The Stability and Growth Pact has imposed limits on public spending, but in other respects the powers over public finances have remained in the hands of the member states.

New powers and their challenges

In the context of the economic crisis, the need for the EU to exert a more binding power in economic and fiscal policy instead of a mere coordinating one has been raised.[6] It has been justified by the weak outcome of a merely coordinative approach as well as by the continuous differences in economic performance and competitiveness among the euro-area members. References have been made to the need to create a real economic and monetary union which would, however, entail at least three major challenges.

First, giving the EU binding powers of economic policy would require a funding element which would pave the way towards a true fiscal federalism. The EU has the necessary structures for such a system with the exception that the federal budget—that is, the EU budget—is very small in relation to the overall public financing. This budget is for the most part funded by the member states and not through the EU-level taxation. In a true economic and monetary union, economic and fiscal competences would be more equally divided between the two levels, the federal and member state level, which would be reflected in the size and structure of the federal budget. Existing federations differ considerably when it comes to the content of federal vs. state-level budgets but as a rule social security is typically a state and local responsibility, whereas the federal budget includes instruments for macroeconomic balancing.[7] A clear division of competences over economic policy would consequently need to be defined for the EU and its member states in the treaties and the budgetary powers to be changed accordingly. Even if this needn't imply a comprehensive change with respect to the current situation, it would still require a remarkable increase in the EU budget and amended structures in terms of both sources of income and expenditure. Whilst diminishing the scope of national budgets, a move towards fiscal federalism would not necessarily put further constraints on them as the EU has already currently been seen to constrain national budgets, including borrowing more than many federations do. Development in this direction would undoubtedly trigger the introduction of EU-level funding instruments such as Eurobonds and a reconsideration of the role of the European Central Bank as the lender of last resort.

Second, the move towards a real Economic and Monetary Union is challenged by its current institutional setting where this deepened union would only apply to a major part of the EU countries—those that belong to the common currency—but not all of them. It would be natural that the new economic and financial powers would be exerted following the normal division of labour between the Union's political bodies. The composition and logic of functioning of both the Commission as well as the European Parliament are, however, based on their roles as governing bodies of the whole EU and not just a part of it. During the crisis, many member states have proposed that a special commissioner should be appointed to monitor whether the Stability and Growth Pact is being followed. But it is unlikely that such an arrangement could be legitimate when it comes to the use of more far-reaching powers. Even if the intergovernmental bodies, the Council and the European Council, are both developing in a direction where they have two formats—one for the Eurogroup and the other for the whole EU—in the case of the Commission and the EP a similar solu-

6 Many European leaders have demanded new powers for the EU. In August 2011 Angela Merkel and Nicholas Sarkozy used the term 'True European Economic Government', and in November Angela Merkel referred to the strengthened fiscal powers of the EU (e.g. EurActiv).

7 See MCKAY, D. *Designing Europe; Comparative Lessons from the Federal Experience*. Oxford: Oxford University Press, 2001, 141.

A demonstration in Brussels on 11 February 2012 against the Anti-Counterfeiting Trade Agreement (ACTA). Two weeks later, the EP received a petition signed by 2.4 million internet users opposing the agreement. Photo: Agnes Hermapix

tion would, in practice, be impossible. There are no easy solutions to this question where the divisive character of the EMU constrains its deepening. Any decisive increases in the EU's powers over economic and fiscal policies would need to take place in the context of the Union's democratic machinery and would presuppose a further deepening of this machinery. In these conditions, pressures would increase against the divided character of the EMU, which would prompt those EU members that are outside the common currency to fulfill the conditions and join it. The other option would be much worse as it would imply the development of different memberships where a full membership—and access to the institutional system—would be limited to the members of the common currency only, while the non-members would have the role of associate members of the EU.

The third challenge involves the way of arranging the democratic control of the EU-level bodies responsible for economic and fiscal policies. Power over macroeconomic policy in the euro area combined with the ever-strengthening control over the member states' budgets has already triggered a debate about democratic control. Arranging the democratic control of the Union's economic policy primarily through its member states has thus far been justified as this has been the main context for public spending, and the EU's common budget has played only a minor role in this respect. Any steps towards an enhanced role of the EU need to engage its democratic machinery. A further development of the EU-level democracy is the critical condition for an increase in the common budget and steps taken towards a more accentuated fiscal federalism.

The main challenge in this respect doesn't reside in the EU's formal, institutional structures which for decades have been transforming along the lines of a federal political order. The European Parliament corresponds, both in terms of its powers and its internal functioning, to federal parliaments and the Commission fulfills the corresponding conditions of an EU executive. Several proposals have been made recently about the further development of this machinery, such as a clearer move into a bicameral European parliament as well as the election of the president of the Commission through direct election.[8] The first change would turn the Council even more towards a second chamber of the EP, which would then consist of one chamber representing European peoples and another representing the member states. The latter change would confirm the development of the EU's governance towards a presidential regime rather than a parliamentary one, which would create a slight conflict towards the existing treaty provision on the parliamentary accountability of the Commission (TEU, Art. 17).

8 These proposals are included in the programme of the German Christian Democrats (CDU) adopted in Leipzig in November 2011 (*Beschluss des 24. Parteitages der CDU Deutschlands—Starkes Europa—Gute Zukunft für Deutschland*).

The main challenge of the EU's democracy lies, however, in the problems of constructing a European civil society essential for the legitimacy and proper functioning of the democratic institutions. Through its political organization this civil society would create the very necessary link between the democratic institutions and the citizenry, as it would reflect the political divisions of any particular time. The empowerment of the European Parliament has essentially nurtured the construction of at least an embryonic civil society with European political parties which, however, still seem to reflect national political divisions rather than European ones. The question now remains to what extent an increase in the Union-level budget would speed up a Europeanization of civil society and its political movements.

Conclusions

When the acute economic and financial crisis subsides, the more serious political challenges of a true Economic and Monetary Union should be reflected upon. During the crisis the EU has taken advantage of its existing competences in order to respond to the problems and safeguard European economic stability, including the common currency. The measures adopted make the long-term challenges visible in the Economic and Monetary Union. The sufficiency of economic coordination remains doubtful even in the future and that's why the voices demanding a true Economic and Monetary Union are getting louder.

The establishment of a true Economic and Monetary Union would not only face the challenge of increasing euro-scepticism in many EU countries, it would also have to overcome resistance to fiscal federalism and an increase in the Union budget. The other major problem relates to the divisive character of parts of the EMU, namely the common currency. One would need to find out how to deepen the democratic governance of the EU's economic and fiscal policies in an institutional setting where not every member state participates in the common currency and doesn't plan to do so either.

Finally, a true economic and monetary union requires full democratic legitimacy and therefore attention should not only be paid to the structures of democratic governance in the EU. Of equal importance are the conditions of political organization and mobilization which contribute to the construction of a European polity and political identities. As a consequence of the economic crisis, the EU currently faces perhaps the most decisive turning-point in its entire history. The limits of a mere Monetary Union have been tested and the road to an Economic Union won't be easy.

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