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EDITORIAL

ESSAYS

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Guidelines for a Constitutional Reform of the European Union

by

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Abstract

On several occasions over the last few years, the prospect of a reform of the treaties, which seemed to have been put on the back burner after the laborious gestation of the Lisbon Treaty, has regained topicality and has also been called for by several EU governments, including that of Germany, ever since the economic crisis has begun to threaten the very survival of the Euro. The aim of this paper is to lay down guidelines for a future reform that could ensure the stable efficiency and democratic legitimacy both of the Union as a whole and of the core Eurozone countries, as well as that of any additional EU Member-State aggregation, which may be larger or smaller than the Eurozone but does not include all the members of the Union itself.

Key-words:

European Union, constitutional reform, crisis in the Eurozone

1. Premise

On several occasions over the last few years, the prospect of a reform of the treaties, which seemed to have been put on the back burner after the laborious gestation of the Lisbon Treaty, has regained topicality and has also been called for by several EU governments, including that of Germany, ever since the economic crisis has begun to threaten the very survival of the Euro, resulting in a dramatic decline in growth and employment, unknown since the 1930s.

The aim of this paper is to lay down guidelines for a future reform that could ensure the stable efficiency and democratic legitimacy both of the Union as a whole and of the core Eurozone countries, as well as that of any additional EU Member-State aggregation, which may be larger or smaller than the Eurozone but does not include all the members of the Union itself.

The reforms proposed here can be carried out following different procedures, depending on issues and functions. Some of them do not even require the treaties in force to be amended and can be achieved on the basis of existing rules, in particular through enhanced cooperation or disciplines related to implied powers (Art. 352 TFEU) or the Euro (Art. 136 TFEU): A significant set of reforms to make the EU (or, rather, a group of Member States willing to advance) both more effective and democratic – in terms of the EU's economic policies, by introducing a European fiscal power at least inside the Eurozone and launching a large-scale investment plan for growth and employment; in extending the qualified majority vote; in security and defense; in terms of codecision etc. – could thus be achieved without changing the existing treaties. Others require regulatory changes that can be achieved using the procedures provided for in Art. 48 of the Treaty on European Union (TEU). Finally, another way to reform consists in one or more new treaties involving only some EU Member States, as was the case with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) and the European Stability Mechanism (ESM).

Each of these proposals has a different implementation timeframe. While activating possible reforms within the treaties only formally requires the political will of a large number of Member States to implement them, amending the treaties involves ratification

by all members, hence an implementation period of several years can be expected, as experience has proven. Even the adoption of one or more new treaties only by some EU Members would take rather long, as this is likely to be undertaken only once there is evidence that amendment to the treaties on the basis of Art. 48 TEU are not agreed upon by all Member States.

One additional point must also be emphasized *in limine*. The EU's constitutional reforms envisaged here are based on the assumption that certain, still widespread ideological concepts regarding sovereignty as the exclusive prerogative of nation-states will be recognised to be simply wrong, in principle, as well as to be already disproved by the political reality both at national and European level. EU Member States already are no longer sovereign in a series of functions and important competences. Therefore, these lines of reform aim at completing a trend already underway at Union level, imposed in turn by the inescapable reality of the globalisation of the planet, while at the same time protecting to the fullest extent possible – on the basis of the principle of subsidiarity included in the treaties – national and local identities as well as the autonomy of nation-states (as required by Art. 4 TEU).

2. A Two-Tier Regulatory System of the Union

The still unattained objective of the reform of the EU treaties should be twofold: ensuring that the EU possesses a stable constitution while, at the same time, enabling minor future regulatory adjustments under procedures which are sufficiently smooth.

To this end, a two-tier EU legal and institutional system should be created, as foreseen in the 2003 Convention and in part also included in the current combination of the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU).

The top tier should be constitutional and include: a) the principles on which the EU is founded, the basic profiles of its institutions, and rules for future institutional reforms; and b) the EU Charter of Rights. The lower tier, which regulates the functioning of the Union, should include the current TFEU and the reforms the EU requires at this and later stages.

Regarding future amendments, on both tiers the new treaty should: a) charge the European Council (EC), the Commission and the European Parliament (EP) with making proposals; and b) give the EC and the EP codecision power in future treaty amendments.

Any future amendment to the first-tier Treaty (ECT: European Constitution Treaty) would require more complex procedures and higher qualified majorities than future amendments of the second-tier Treaty (TFEU).

Amendments to the ECT would presumably enter into force after being ratified by a super-qualified majority of Member States, calculated using the double parameter of number of States and overall population (e.g. two-thirds or three-fourths of one and the other). However, amendments to the TFEU (provided they are not in conflict with what is laid down in the ECT) could enter into force without the need for national ratification, by reaching a qualified majority within the EC that accounts for a similar majority of the EU population (e.g. an absolute majority or two-thirds of both the EC and the population).

From the perspective of a federal union, the new treaty should not allow for the withdrawal of one or more Member States (Art. 50 TEU); but the opportunity to shift from being a full Member State to becoming an Associate State could be considered.

Institutional configurations that allow for participation, and that are well-differentiated in terms of the coordination and integration level with respect to the new European Union, should also be provided for EU Member States that are not parties to a new treaty, for Eastern European countries, and for Mediterranean countries. There could be distinct institutional arrangements for the different Associate States.

Finally, forms of coordination including special procedures for decision-making and decision implementation should be laid down for cross-border regions sharing geographical and economic characteristics (alpine regions, sea-coasts etc.).

3. Principles

The institutional reforms outlined here are consistent with the fundamental principles enshrined in the EU Charter of Fundamental Rights and in the TEU: dignity, freedom, equality, solidarity, citizenship, and justice, to which the right to peace should be added. The reforms are based on the three fundamental pillars of the Union's legal system, all now laid down in the treaties:

- *subsidiarity* (as a principle of competence allocation to jointly achieve the objectives of minimum governance, finding the appropriate level of governance for the problem to be solved, and governance that is as close as possible to the citizen);

- *efficiency* (only possible if there are rules ensuring real decision-making opportunities, hence by generally adopting the majority principle, which centuries of experience have proven to be the only way for a body to take decisions within its powers when its members take divergent positions); and

- *democracy and rule of law* based on popular sovereignty (which, at the European level, is only possible by granting the European Parliament, elected by universal suffrage, full legislative codecision, budgetary powers, as well as control over the government of the Union). Also, the channels of direct democracy established by Art. 11 TEU must remain open.

4. EU Institutions

The European Parliament

In addition to the functions provided for in the existing treaties, the European Parliament should be granted:

a) *Codecision power in all EU legislative decisions*, including proposals for the reform of the European Constitution and the TFEU;

b) *The power to introduce taxes at the European level, in codecision with the European Council;*

c) *The power to approve a share of the debt (borrowing capacity) within predetermined limits established by the treaties to be allocated for investments in European common goods on the basis of the principle of subsidiarity;*

d) *Budgetary power relating to the amount and allocation of the EU's own resources, in codecision with the Council* and (for the multi-annual planning of resources transferred from national budgets) with the cooperation of national parliaments;

e) *The power of legislative initiative* in cases in which the Commission has not responded to the invitation to prepare a draft law;

f) *The ability to define common foreign and security policy guidelines* and allocate the corresponding financial resources; and

g) *The ability to appoint the President of the Commission and issue a vote of confidence in the Commission in codecision with the European Council.*

Decision-making requiring an absolute majority of EP members for legislative codecision and for appointments should be limited to a few matters of particular constitutional importance.

The parliamentary procedures as well as the forms and limitations of the powers of the EP Committees should be established through regulation by the EP itself, approved by a qualified majority.

A deadline should be set for adopting a uniform electoral procedure (Art. 223 TFEU), which should also be approved by a qualified majority in codecision between the EP and the Council.

The new treaty would be able to review the distribution of EP seats to the Member States, reducing (but not necessarily completely eliminating) the over-representation of the smallest States with respect to the largest ones (in fact, a strict proportionality of representative bodies is often missing at the national level, too).

For decisions regarding the Eurozone and in the enhanced cooperation framework adopted for a group of countries, which may be larger or smaller than the Eurozone, the European Parliament must be involved at the legislative level (which is already possible: cf. Art. 333 TEU). In this case, the debate could take place in plenary composition, both in the Committees and in the House, but the *voting power should be limited to those MEPs from countries participating in the initiative* that has only been adopted by them and not by the entire Union[I].

The European Council

The European Council must retain its role as the highest body with political driving force, a sort of collegiate presidency of the Union. It must also continue to exercise the direct function of government, especially in foreign and security policy, in synergy with the Commission and without creating another bureaucratic apparatus within the Union.

The majority principle must apply *to all the decisions of the European Council* – proposals for and decisions on new laws, actions, appointments, future reforms of the treaties –, with the double calculation of the number of states and their population sizes: a simple, qualified, or super-qualified majority, depending on the matter at hand.

The President of the Commission may be appointed by a qualified majority as President of the EC, already possible under the current TEU. This option would have the dual benefit of ensuring both the unity and personalisation of leadership that are typical of present-day democracies while maintaining a regime in which the Head of the Executive is chosen via second-order elections by the two "Chambers" of the Member States and the citizens, in line with the outcome of the EP election, again as already established by the treaties[II].

The Council of Ministers

The majority principle must apply to all the decisions of the Council of Ministers, with a simple or qualified majority, depending on the matter at hand.

Regarding the legislative procedure to adopt for the Council of Ministers, the options are the following: to make its sessions public, to make the meeting minutes public (within a specified period of time), or to maintain the current system. The second of the three proposed solutions may be preferable to ensure both greater transparency and freedom of discussion, also protecting against the risks of forcing through any issues for internal political use.

Furthermore, a future reform could be envisaged which emphasises the configuration of the Council of Ministers as the second Chamber of the Union by adding one representative from each Member State's national parliament, elected by the latter and belonging to the opposition or, in any case, to a different political grouping with respect to the Minister from that country.

The Commission

The Commission should become the true government of the EU acting, as already mentioned, in synergy with the European Council, which would retain its role as the main political driving force of the Union: a synergy that would be greatly enhanced if the two presidencies were conferred upon one and the same person.

The Commission's control and its role as "guardian of the Treaties" could be partly entrusted to special agencies, accountable to the Commission itself. The latter, despite frequent claims, has always exercised *an inherently political function* as well, in that it has the exclusive right of legislative initiative, which is a political function par excellence.

This *legislative initiative* function could be maintained by the Commission, while granting both the European Parliament and the two Councils the power to put forward draft legislation when an invitation of the Commission to that effect has remained unanswered.

The principle enshrined in the treaties, according to which *the President of the Commission* must obtain the affirmative vote of both the European Council and the European Parliament, must be maintained. The need for such double consent is based on the dual legitimacy of the Union, i.e. a political system of peoples *and* nation-states.

However, the current procedure for the appointment of the President gives priority to the European Council's role over that of the European Parliament, although it is true that the Lisbon Treaty requires EP election results to be taken into account. Looking ahead, a better balance between the two bodies seems however necessary. The Council could choose from a list of names provided by the EP, or *the European Parliament could choose the President of the Commission from a list of names indicated by the Council*, certainly deciding by a majority and also taking into account the election outcome. This second option would be preferable, especially if the previously suggested criterion of making the President of the European Commission also the President of the European Council was adopted.

The Commission should obtain a vote of confidence in the European Parliament. While the individual Commissioners are chosen by the appointed President, putting forth a motion of censure with, if carried, the obligation to resign should be possible both as regards the President (in which case the entire Commission has to resign) and each individual Commissioner, who would then be replaced if he earlier obtained confirmation by the European Parliament.

The number of Commissioners could be reduced, with a reasonable rotating mechanism between larger and smaller Member States, without prejudice to the principle that each Commissioner would act as a Union Minister and not as a member of his/her nation-state.

The Commissioners for a) the economy, taxation and the European treasury; b) foreign policy; and for c) defence as well as the internal and external security of the Union would have to be appointed upon mutual agreement between the European Council and the President of the Commission.

The Court of Justice

The Court of Justice would maintain its current functions in this two-tier structure. Its functions as the Constitutional Court of the Union would be exercised only at the higher tier and could (or indeed should) include the power to declare ineffective national laws if the Court regards them as conflicting with the Constitutional Treaty of the Union (TEU or ECT or Fundamental Law) and/or the Treaty on the Functioning of the European Union (TFEU).

National Parliaments

National Parliaments – either all of them or only those of the Member States participating in an Enhanced Cooperation – are called upon to cooperate with the European Parliament in the multi-annual planning of EU budgetary resources as regards the transfer of funds and tax revenues from national budgets to the Union budget.

5. The Budget, EU Taxation and the European Central Bank

In line with the above stated, codecision between the European Parliament and the Council by a qualified or super-qualified majority should be the cornerstone of the reform insofar as Union resources are concerned (Art. 311.3 TFEU).

The multi-annual financial framework (Art. 312.2 TFEU) should also be prepared in codecision of the Council with the EP, involving national parliaments in the form of a convention-assembly, or via a special mandate given by each parliament to its own government, which would then take decisions in the Council in accordance with said mandate.

The transfer of shares of taxes (e.g. VAT) or certain budget shares (e.g. regarding defence spending) from the national to the European level should take place using the same procedure: codecision between the Council and the EP, plus the involvement of national parliaments in one of the two above-mentioned forms.

In both cases, decisions would be taken at the European level and would be binding upon all Member States if a codecisional agreement between the Council and the EP – by qualified or super-qualified majority – is achieved.

The EU's annual budget (Art. 314 TFEU) may continue to follow the current procedure.

The Union must be able to establish its own taxation (e.g. carbon tax, Financial Transaction Tax) using the codecision procedure between the EP and the Council by a qualified or super-qualified majority. Similarly, the Union must be able to have its own Treasury.

The European Central Bank must fulfill its role as a last-resort lender, which is also essential for stability.

The same codecision procedure between the Council and the EP must be respected in order to coordinate Member States' internal tax regimes at European level.

It is essential that some budget sections and items be subject to a restricted configuration (e.g. with regard to European taxes, defence spending by means of funds transferred from national budgets, the ESM and so on), with the decision-making and voting powers of the European Council and the European Parliament limited to the governments and (as mentioned above) the parliamentarians of the countries participating in the initiatives concerned. This applies not only to the Euro Group but also to other aggregations (e.g. in the area of a Financial Transaction Tax).

Both the TSCG and the ESM must be integrated into the Community method with appropriate roles for the EP, the Commission, and the Court of Justice.

The obligation of a balanced Union budget should be imposed, freed from cycle shifts, to ensure a level of primary surplus that enables interest expenditures related to investments at the European level to be included while maintaining a balanced budget.

The possibility of establishing *a maximum ceiling for the EU budget* should be considered, for example 5% of the combined European GDP, including defence expenditures, after the transfer of the current and corresponding national allocations for this item.

6. Enhanced Cooperation and Dual Institutional Configuration

A key issue is whether or not it would be appropriate to maintain enhanced and structured cooperation procedures (EC, SC) in the institutional framework of a new treaty. On the one hand, it may be argued, with undoubted consistency, that adopting codecision and the majority principle across the board implies that decisions regularly taken within the

EU are always binding, even upon dissenting States. On the other hand, it may be assumed that proceeding with further reforms with an advance guard of Member States – so far constantly followed by the EU (e.g. regarding social policy, Schengen, or the Euro) – does not deserve to be removed.

This second assumption seems preferable, but only under three conditions: a) that the restricted configuration be applied in a way that does not jeopardise the Single Market by structurally altering the rules of competition and international trade; b) that obligations and benefits resulting from decisions made by only a few governments in the Council (for example regarding their own resources or European taxation) are borne by or benefit only those Member States that have subscribed to them; and c) that in these cases the right to vote in the European Parliament be reserved to the MEPs from the Member States participating in the new initiative, similar to what is provided for in Art. 330 TFEU on Enhanced Cooperation.

A specific institutional dimension is already up and running in form of the Eurozone, and has been explicitly recognised in the current treaties and in the two Treaties on the TSCG and the EMS, which are now in force. Similar rules should also apply to common defence.

Since it is highly unlikely (if not impossible) that the United Kingdom will agree to bring the EU to the level of a federation by increasing its supranational dimension, generalising the principle of majority rule and accepting the greater involvement of the EP, a two-tier configuration of rules needs to be provided for in order to maintain a single institutional framework. This means that there will be rules that are valid for all 28 Member States – maybe even accepting a reduction in their supra-nationality, as the British would prefer – and rules valid only for those countries which have accepted the reforms, first of all the Eurozone countries, but also others which will agree with them.

This is in part already possible by adopting the Lisbon rules on enhanced cooperation, including Art. 333 TFUE, allowing for the passage to the ordinary legislative procedure, hence assigning a potentially greater role also to the EP. However, the new treaty will have to go further and impose general legislative codecision, the majority principle, the fiscal capacity of the EP, common defence, and the other above-mentioned changes.

These rules (the majority principle and the double legitimacy of the EP as well as the Council of Ministers and the European Council, formed only by representatives of

participating countries) should also apply to the group adopting enhanced cooperation, i.e. at the federal core of the Union: the two Councils in restricted formation and the European Parliament with the right to vote reserved to MEPs from participating countries.

7. Common Defence

The principle of structured cooperation, already included in the treaties (Art. 42.6 TEU), should become the basis for future common defence, if not all the Member States show their willingness to establish it from the outset for everyone. The States that agree to it would have to transfer a greater part (if not all) of their current budgetary resources for national defence to the EU, possibly reducing the amount in proportion to the economies of scale made possible by the far greater efficiency of common management.

The use of these resources should be regulated according to codecision procedure between the EP and the Council, both taking decisions in restricted configuration (only ministers and parliamentarians of the structured cooperation may vote), according to that which has been stated regarding enhanced cooperation.

A Commissioner appointed jointly by the European Council and the EP would perform the functions of EU Minister of Defence.

8. Planetary Cosmopolitan Guidelines

So far the European Union has been leading the way in giving precedence to cosmopolitan and multilateral approaches to issues that (consistent with the principle of subsidiarity) do not have appropriate solutions outside a global framework.

This concerns peacekeeping, including peace enforcement and peacekeeping instruments; international trade; arms control, especially regarding nuclear weapons; climate control and policies to combat planetary global warming; investments in alternative sources of energy; the protection of biodiversity; reactions to and the prevention of genocide; and a world monetary system with its related institutions.

These objectives may be achieved through institutions and international agencies: from the UN to the WTO, from the International Criminal Court to the International Tribunal for the Law of the Sea, and from the IMF to the World Bank and other international agencies.

The new EU treaty should thus include: a) a general clause similar to Art. 11 of the Italian Constitution, containing a willingness to transfer parts of EU sovereignty to global institutions, starting with the UN, in accordance with the principle of subsidiarity; b) the obligation to start negotiations (by a date to be agreed upon) for attaining a unified EU representation within the UN Security Council and the IMF Board; or, alternatively and/or as an interim agreement, at least France's commitment to bring the positions adopted by qualified majority inside the European Council into the UN Security Council; c) a UN reform aimed at modifying the Assembly system, promoting the implementation, even under a restricted configuration, of Art. 43 of the UN Charter as well as at reforming the Security Council by introducing representatives at the continental level and removing the veto power; and d) the definition of transitional measures and timeframes towards the achievement of these objectives.

9. To Amend the Treaties or Draft a New Treaty?

There are two conceivable ways to carry out EU reforms along the lines of the aforementioned suggestions with respect to the rules not contained in the current legislation that therefore cannot be adopted without changing the legislation, taking recourse to enhanced cooperation.

A new treaty may be adopted following the procedure requested by art. 48 TUE for amending the existing treatises, or instead (once ascertained that unanimity on the proposed reforms is unattainable) choosing to forego such a procedure in order to establish a new treaty entering in force only among Member States who sign up to it.

The first way is clearly indicated in Art. 48 TEU: the European Parliament, the Commission or one or more of the EU governments may submit a proposal; the European Council shall act by a majority in favour of examining the proposed amendments and convene a Convention to draft the proposal; an Intergovernmental Conference (IGC) shall approve, amend or reject the proposal; and then all EU Member States shall ratify it according to their respective constitutional rules. While relatively easy in the first two stages, the rules of Art. 48 become very strict in later stages: the Convention must decide in accordance with the principle of consent, which implies unanimity; the IGC shall act by unanimity; and ratification must take place in all the Member States.

Within the Convention, the principle of consent may be interpreted as the consent of all four of its components, which does not mean that unanimity is required within each of them and hence in the final decision. Within the IGC and during the ratification process, however, unanimity is an insurmountable constraint, despite the fact that the saving clause in Article 48.5 establishes that the matter shall be referred to the European Council in the event of ratification by at least four-fifths of EU Member States.

Since the scope of Art. 48, with the double unanimity of governments and national parliaments, implies with almost absolute certainty that at least the United Kingdom, and perhaps a few other Member States, will not agree to such institutional reforms, at this point there might be three possible ways to achieve a genuine reform treaty of the EU:

a) Adopting the treaty with an opting-out clause for dissenting countries; this procedure, which is already being followed for the Euro in Maastricht, might be more easily adopted by Great Britain if the new treaty ensured the same country the return of some competences which do not hinder the Single Market, or at least some new opting-out clauses*;*

b) Launching the treaty within a treaty on the basis of the Vienna Convention on International Treaties, by means of the "rebus sic stantibus" clause; or

c) Launching a new treaty agreed upon by the consenting Member States, in which the previous treaties are deemed inadequate (due to the bottlenecks of Art. 48) to meet the objectives set out by the very same treaties in force related to the improvement of the EU and are replaced by a new treaty. This can be achieved by envisaging the withdrawal of States in favour of the new treaty, or the withdrawal of dissenting States (for example, following the negative outcome of a British referendum on staying in the EU), in both cases through the negotiation of the relations after the approval of the new treaty in order to maintain the Single Market.

After national ratification, the new treaty would be submitted to a European referendum and enter into force if approved by a qualified majority of both States and the European people.

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[*] These pages are a revised version of my 2012 paper published as a Policy Paper on the Turin Centre for Studies on Federalism website (www.csfederalismo.it) and in the review "Il Mulino", 61 (2012), pp. 497-506. This revision has benefited greatly from the results of a workshop organised by the Turin Centre for Studies on Federalism and the Scuola Superiore S. Anna, Pisa, held on 27 September 2013 in Pisa, which was attended with original contributions by Giuseppe Martinico, Carlo Maria Cantore, Roberto Castaldi, Giacono

Delledonne, Federico Fabbrini, Cristina Fasone, Nicola Lupo, Leonardo Pierdominici, and Paolo Ponzano, to all of whom I would like to express my thanks. Other valuable suggestions have come from Giuseppe Bianco, Katarzyna Granat, Mario Kölling, and Nikos Skoutaris. The views expressed here are entirely my own.

[I] This solution seems far more preferable than the other possibilities. In fact, it should be noted that: a) assigning the function of legislative codecision in these cases to national parliaments or to another assembly composed of representatives elected in the first or second grade at the national level (except for cases that will be discussed below) distorts the necessary European level of popular, i.e. representative legitimacy that is the proprium of the European Parliament elected by universal suffrage, thus seriously delegitimising its democratic representativeness; b) the extension of the voting power to the entire EP would be unjustified in decisions regarding resources or actions concerning only the Eurozone or a larger or smaller group of Member States (e.g. for the Financial Transactions Tax); and that c) the participation of the entire EP in the debate would, however, still take into account the needs of the EU as a whole.

[II] This solution – which is consistent with a constitutional structure typical of a federation of states in the form of a parliamentary republic based on the dual legitimacy of people (EP) and States (European Council of Ministers) – certainly seems preferable to that of electing the President of the Commission by direct universal suffrage, which poses several problems, starting with the language barrier not yet removed, nor likely to be removed in the near future.

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EU Citizenship before the CJEU: On the importance of the application of the proportionality principle

by

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Abstract

Courts use the proportionality principle to ensure the legitimacy of their decisions. According to Harbo (2010), the CJEU is interpreting the principle in different ways, determined by the different areas of law in which it is applied and the substance of the conflicting interest at stake. Starting from this premise, the first aim of this paper is to throw light on the rationale of the CJEU when applying the principle in a concrete 'area of law': citizenship. In order to do so, this work compares recent cases that share similar conflicting interests: cases where Member States' derogation from Art. 21 TFEU is related to public policy issues are particularly sensitive due to their constitutional identity concerns. The approach for the comparison in this paper consists in finding and measuring 'pathologies' (a concept introduced by Endicott, 2012), in the application of the principle by the CJEU. Through this approach, I will evaluate, as a second aim, the legitimacy of the final result achieved by the Court when applying the principle.

Key-words

Principle of proportionality, citizenship, pathologies, substantial legitimacy, formal legitimacy, substance of conflicting interests, national sensitive policy, constitutional identity

1. Introduction

According to Harbo, the CJEU is interpreting the proportionality principle in different ways, and these different interpretations 'are determined by the different areas of law in which it is applied, and the substance of the conflicting interests at stake' (Harbo 2010: 180). Starting from this premise, this paper will focus on one specific area, that of citizenship, in which particularly strong and conflicting interests are at stake: it is a sensitive area of individual rights in which the exclusive competence of the Member States to grant and withdraw the status of citizen (derived from its power to award nationality) converges with the 'fundamental status' that the CJEU has constantly proclaimed it would tend to achieve for European citizenship[I].

Within the more general purpose of determining if there is a unique interpretation of the principle of proportionality in the citizenship's case law of the CJEU, this paper also has a more specific aim: to throw light upon the rationale (or rationales: either a single or multiple ones) followed by the CJEU when applying the proportionality principle in cases concerning citizenship and sharing a particular 'substance of the conflicting interests at stake' (Harbo 2010). More particularly, I will analyze cases where Member States' derogation from Art. 21 TFEU is related to public policy issues that are particularly sensitive due to their constitutional identity concerns. Additionally, through the analysis of the use of the proportionality principle by the CJEU, I will be able to evaluate the legitimacy of the final result of this use.

In order to attain that aim, a selective but in-depth comparison of how the Court applies the principle of proportionality in two recent cases corresponds to the chosen methodology. The approach that I am going to use for that comparison is based on searching for 'pathologies'[II] (a concept introduced and used by Endicott 2012), in the application of the proportionality principle by the CJEU, and a comparison of their significance in the respective cases. Through this approach, I will also be able to evaluate the legitimacy of the final result of the ruling.

The two selected cases are *Sayn-Wittgenstein*[III] and *Runevič-Vardyn*[IV]. In both *Sayn-Wittgenstein* and in *Runevič-Vardyn* the CJEU is faced with national measures concerning 'national sensitive policies' that aim to protect fundamental constitutional principles related

to the constitutional identity of the respective State: concretely, in the case of *Sayn-Wittgenstein* the national measure pursues to protect the principle of equality; in *Runevič-Vardyn*, the national measure protects the official national language which is at the same time a safeguard for national unity and social cohesion.

In order to clarify the discussion of this paper, I do not distinguish between justifications anchored in national fundamental rights concerns (such as the principle of equality in *Sayn-Wittgenstein*) and other justifications based on the constitutional identity, because all of them fall within the concept of 'national sensitive policy' that concerns the constitutional identity. Nevertheless, it is important to point out that fundamental rights can be separated from justifications based on 'public provisions', but this separation is hardly problematic because sometimes 'the state simply couches its (possibly legitimate) "public interest" in terms of fundamental rights' (Reich 2011)[V]. In any case the CJEU considered the justification in *Sayn-Wittgenstein* as a matter of public policy. It is therefore the purpose of this article to enter into this discussion.

Before comparing the application of the proportionality principle by the CJEU in the selected cases, this paper will first provide a review of the origins and significance of the principle of proportionality in general terms, of its attractions and failures. Secondly, I will briefly analyze the application of the proportionality principle in the European Union legal system in particular. In a third part, the analysis of the application of the proportionality principle by the CJEU is focused on case law pertaining to citizenship, and more particularly on two cases in which a particular substance, 'national sensitive policies', is at stake: *Sayn-Wittgenstein* and *Runevič-Vardyn*. The application of the proportionality principle by the Court to these two cases will be the main object of comparison, but before that, a brief overview of the facts and the reasoning followed by the Court in each of these cases will be provided. Finally, I summarize the conclusions.

2. The proportionality principle – its strengths and weaknesses

The proportionality principle, broadly perceived, is a technique for managing conflicts between two legal claims: a 'right provision' or private interest, on the one hand, and a state or public interest, on the other. The origins of the principle of proportionality are to be found in the German legal tradition that developed a formal test of proportionality

consisting in a three step analysis: suitability, necessity, and proportionality in a narrower sense (or proportionality *stricto sensu)*. The suitability test measures the adequacy of the public interest to attain its aim. A measure is found necessary if no less restrictive measure is capable of achieving the same aim. Finally, in the third stage of the proportionality test, even if a measure is found both suitable and necessary, it still should not place an excessive burden upon an individual. The essence of the proportionality principle is that it makes it possible to combine a liberal rights-based constitutional rationality with a strong commitment to a welfare state (Harbo 2010: 158).

Courts use principles of law, in general, and the proportionality principle, in particular, to ensure the legitimacy of their decisions: principles of law rationalise the decision making; they make decisions more objective and predictable, so they are capable to increase legal certainty. These advantages of the proportionality principle have been proclaimed in different ways by the main theorists on the subject. For Alexy, 'balancing turns out to be an argument form of rational legal discourse' (Alexy 2010: 32). For Beatty, 'proportionality offers judges a clear and objective test to distinguish coercive action by the state that is legitimate from that which is not' (Beatty 2004: 166). Barak considers that it structures the mind of the balancer (Barak 2010: 1). Craig thinks that 'the proportionality test provides a structured form of inquiry. The three-part inquiry focuses the attention of both the agency being reviewed, and the court undertaking the review' (Craig 2008: 637).

Nevertheless, the certainty of the result cannot be guaranteed automatically through the application of the proportionality principle, that is through the mere application of this 'structured form of inquiry', using Craig's words (2008: 637). The reality is more complicated, as law is not a natural science and rights cannot be measured, at least not without difficulties. The results of the application of the proportionality principle to similar factual circumstances may differ. Is this an inconsistency? Is the application of the proportionality principle still legitimate when it leads to diverging results?

In a recent article, Harbo distinguishes the formal structure of the proportionality principle from its substance. Within the substantial understanding of the principle of proportionality, Harbo makes a theoretical distinction between a 'strong' and a 'weak rights regime'. According to the strong rights regime, based on a liberal understanding of rights represented by the works of Dworkin (1977) and Habermas (1998: 259-260), 'there is not room for weighting mechanisms like the one laid down in the proportionality principle'

(Harbo 2010: 168). Rights should always trump public interests. In strong rights regimes the structure of the Court's reasoning as provided within the frame of the proportionality principle is not its main vehicle of legitimacy; rather, the reference to rights is in itself sufficient to legitimise its decisions (Harbo 2010: 168). By contrast, in a weak rights regime, based on the work of Alexy (2002), rights are perceived as principles which imply that they can be balanced against other principles, i.e. other individual rights but also collective interests or public policies. Therefore, the proportionality principle is, according to a weak rights regime, a 'tool in which a balance between individual and group interests, on the one hand, and public interest, on the other hand, can be struck in the best possible way' (Harbo 2010: 166). Both theoretical distinctions would in practice appear in different and combined forms.

According to Harbo, the proportionality principle may be interpreted in different ways, depending on the substantial understanding of the principle – so the use of the principle can lead to different results according to the substantial meaning accorded to it by different legal orders. Different results are possible and do not undermine the legitimacy of a decision as long as the competent court, in its interpretation, does not deviate too much from the understanding of the principle that it has itself proposed (Harbo 2010: 169 f).

One of the main arguments against the usage of the proportionality principle is the problem of the incommensurability of the interests subjected to the balancing exercise. Despite the ability of the competent judge to define the substantial understanding of the different interests, judges can still face difficulties when measuring the impact of the respective interest against each other. This difficulty would be exacerbated in a pure weak rights regime, where no standards exist and in which all the interests can be balanced against each other without any hierarchy guiding the weighting. Habermas argues that, if it is to be considered rational, weighting has to be conducted with a clear advantage given to individual rights, according to customary standards and hierarchies (Habermas 1998: 259, as interpreted by Harbo 2010: 161). In my opinion, the existence of these customary standards and hierarchies makes incommensurability difficult: if there are customary standards and hierarchies to guide the weighting, there are also units of measurement in the balancing that make the problem of incommensurability disappear.

This problem may lead one to consider the proportionality principle as useless, since it would not bring any objectivity and transparency to the judge's reasoning. Still, scholars

that consider this problem as the main failure of the principle nevertheless find arguments in support of it. Endicott identifies an argument for saving the proportionality principle, based on its necessity: 'it is necessary, in light of the institutional premise (that is that the respect that all public authorities must have for certain human interests can be best secured by a power in an independent tribunal (Endicott 2012: 17)), even though it does not bring objectivity and transparency to governance' (Endicott 2012: 20). He continues that 'the incommensurabilities in human rights cases … do not necessarily lead to arbitrary decision making … So the proportionality reasoning is not generally pathological. If the institutional premise holds, then there is good reason for a justiciable bill of rights. And then, the pathologies of proportionality that might affect the system are particular, and depend on particular mistakes'.

I find it useful to put the theories of Harbo and Endicott together in order to infer from them premises that help to evaluate the legitimacy of the result of the application of the proportionality principle. According to those authors, the legitimacy of the result depends on how the Court adapts its decision to two premises that I qualify as substantial and procedural respectively. Firstly, according to Harbo, legitimacy depends on how the Court adapts its decision to the substantial meaning accorded to it in that particular legal order (substantial legitimacy); and secondly, in Endicott's view – and due to the impossibility to perfectly measure the concrete impact on rights while making the final balance, even if the substantial meaning is perfectly defined –, legitimacy also depends on how the Court adapt its decision to its particular power in the concrete legal order or particular institutional context, with more or less deference vis-à-vis the concrete powers at stake (procedural legitimacy).

I find especially Endicott's identification and definition of certain potential 'pathologies' of the proportionality principle interesting. I only partly agree with his view on the impossibility of avoiding pathologies completely. But this disagreement does not preclude the employment of his concept as a useful tool. I think that the Endicott's 'pathologies' may be used as a good approach to measure the level of legitimacy of decisions on proportionality. I am going to use them in this way in this paper.

According to Endicott, the seriousness of pathologies depends on the degree of creativity that a judge applies. Applying this consideration to the two sources of legitimacy mentioned above, substantial and procedural, it is possible to infer that creativity would

nevertheless be reduced (and consequently the legitimacy reinforced) if a judge does not deviate too much from substantial and procedural premises.

The pathologies come in pairs because distortions may be in favour of the individual or in favour of the public authority. The first of the pathologies identified by Endicott is 'proportionality spillover', consisting in 'balancing' things that should not be balanced. This is due to the generalisation of proportionality into a legal technique. The worst would be to 'balance' public interests against private interests, although public interests do not belong to these so-called scales (Endicott 2012: 21). A lesser risk would be the unwarranted weighting of private interests in the balance.

The second pathology is 'uncertainty'. A judge's policy choice in human rights litigation will suffer from this pathology if she favours the public interest by 1) exaggerating the capacity of the choice in question to achieve the prospective public benefit, or by 2) underestimating the risks posed for private interests at stake because these are uncertain. On the other hand, she will suffer from the same pathology when favouring the individual interest by 1) exaggerating the risks posed to private interests, or by 2) underestimating the capacity of the choice in question to achieve the prospective public benefit, because this is uncertain. These pathologies involve a dilemma that the author calls the 'dilemma of uncertainty': 'on the one hand, it would be a fallacy to think that only proven gains can legitimately be pursued, when there is a proven detriment to … (an individual right). On the other hand, some speculative measures to pursue uncertain gains are bad mistakes' (Endicott 2012: 29). One way of solving this dilemma, even if not fully satisfactory, would be to leave it to the initial decision maker, supposed to possess a more technical sense of the realities.

The last potential risk for the application of the proportionality principle is the 'pathology of deference'. It relates to the challenge that courts face in any review of executive or legislative action: the challenge of taking an appropriate attitude towards the judgments of the authorities whose decisions they are reviewing (Endicott 2012: 30). If the courts defer excessively to the initial decision maker, then the protection of human rights will be lost. If courts do not defer to the judgement of other institutions where there is good reason to, the system suffers from the same pathology but in reverse. The relevant question to be posed by the judge in this case is if there is ever a good reason for deference (Endicott 2012: 30).

In this paper I use these 'pathologies' as a tool for analysing the proportionality review of the CJEU in a selection of cases. But before that, in order to set the context for the discussion, the next section briefly analyses the particular application of the proportionality principle in the European Union legal system.

3. The proportionality principle in the case law of the CJEU

The proportionality principle has been used by different international and supranational judges, such as those sitting in the European Court of Human Rights or, what is relevant for this article, also in the European Court of Justice.

There are some peculiarities of the application of the principle of proportionality into the case law of the CJEU that are due to the *sui generis* nature of the European legal order. One of these peculiarities of the proportionality test in EU law is its 'changing nature' (Fontanelli and Martinico, forthcoming: 15), or the ambiguity of the approach in the CJEU's use of proportionality. A second characteristic is the 'cooperation dynamic' (Fontanelli and Martinico, forthcoming: 15) that takes place between judges in the EU.

Firstly, concerning the ambiguity of the approach in the CJEU's use of proportionality, in terms of procedure the CJEU very rarely follows the formal test elaborated by the German legal tradition[VI]. Only in theory is it possible to perceive a paradigm of proportionality in the EU that follows the German model. According to Gerards, '*Although these three sub-tests are also widely used and recognised in European law, the CJEU appears to be rather ambiguous as regards their application. In fact there is no single formula the Court systematically and consistently uses in its proportionality review. Rather, the Court disposes of a variety of different formulas, seemingly rather arbitrarily choosing one or the other depending on the circumstances of the case. Sometimes the Court focuses on just one or two of the three distinct tests; in other cases it applies a general test of arbitrariness or reasonableness; and it even sometimes uses a completely different formula, for instance stating that a decision should not impair the very substance of the right at hand*' (Gerards 2009).

Also, substantially, it has been strongly supported that the CJEU takes two different approaches to the proportionality principle (de Búrca 1993: 105; Tridimas 2006). On the one hand, when the Court assesses whether a Community regulation is in accordance with the four freedoms and proportional, it adopts a very lenient approach. By contrast, when the court assesses national measures, it adopts a much stricter approach. The reason for

these two different approaches is that the Court is not neutral – quite the contrary: its reasoning is guided by a strong substantial bias of promoting European integration (Tridimas 2006: 193).

Harbo, in assessing the proportionality principle in EU law from a legal theoretical and constitutional perspective in order to discover the function of the principle, came to the conclusion that it is 'plausible to suggest that there are enough cases to underpin an assumption that the court is interpreting the proportionality principle in a variety of different ways, i.e. that the different results in cases where the proportionality principle is applied are not merely due to the cases' different facts. The diverging interpretations of the proportionality principle are determined by the different areas of law in which it is applied and the substance of the conflicting interests at stake' (Harbo 2010: 180).

Reich (2011) has reaffirmed this difficulty, further identifying four different versions of the proportionality test as applied by the CJEU: an 'autonomous balancing' approach, a 'margin of discretion' approach, a 'fundamental rights' approach and a 'quasi-legislative' approach.

These different approaches in EU law can better be understood considering the complexities of the EU legal order, especially two main features: that in EU law the interests that call for legal protection are different from those that emerge in national legal orders; and, secondly, that they emerge from three main actors and not only two (the individual and the state), as it is the case in nation-states.

In EU case law the main interest has basically been to prevent national public measures that impede free trade and the free movement across borders within the Single Market. Therefore, traditionally the proportionality principle has been used to balance fundamental freedoms vis-à-vis national legislation or, less often, EU legislation. The proportionality principle has been used therefore in a *sui generis* way, balancing fundamental freedoms against EU or national legislation. Craig has defend this use of the proportionality principle, arguing that 'proportionality should be a general principle of judicial review that can be used both in cases concerned with rights and in non-rights based cases' (Craig 2010: 265), basing his argument on EU reality.

Secondly, the European legal order is based on a complex 'triangular relationship' (Reich 2011: 11) between individuals, Member States imposing certain limits to these individuals that may impede their fundamental freedoms, and the role of the CJEU to

monitor the respect of the 'fundamental freedoms'. This relationship makes the application of the proportionality principle a particularly complex one.

Nevertheless, the respect of fundamental freedoms is in some occasions very closely related to the respect of fundamental rights, and this is especially true in cases concerning EU citizenship or free movement of persons. As a consequence, the boundary between fundamental freedoms and fundamental rights has become very much blurred. In these cases the CJEU, while monitoring the protection of the fundamental freedoms, is also enrolled in the monitoring of the protection of the fundamental rights that are intrinsically connected to freedom[VII]. These cases approximate the proportionality principle as understood in EU context to its general understanding: fundamental freedoms/fundamental rights are balanced against Member States/public interests.

There is an increasing tendency for Member States to invoke human rights (in some cases as recognised singularly by their own national constitutions due to the guarantee of national identity enshrined in the recently added Art. 4 (2) TUE[VIII]) as a defence for justifying restrictions to fundamental freedoms. This tendency can be included in a more general movement – which started with the proclamation of the Charter and continued with its integration into the Constitutional Treaty[IX] – aimed at proclaiming a 'fundamental rights discourse' in the EU legal order (Biondi 2004: 52). As a consequence, the normative hierarchy between national constitutional rights, international and European conventions on human rights, and the economic freedoms that form the backbone of the EU has become mixed up (Hepple 1995: 46). These developments have reopened the debate on the necessity of reconciling the fundamental freedoms with the protection of the fundamental rights as recognised in national constitutions. They have also complicated the application of the proportionality principle by the CJEU: the balancing between these interests is complicated, especially because of the primacy of EU law over national constitutions and also because of the complex division of competences between the national and the EU legal orders. The application of the proportionality principle in the EU context opens up the question for the CJEU about the degree of deference to be paid to the national legislator – which differs depending on the degree of EU competence in the area of law at stake.

The CJEU usually takes the necessity to respect national prerogatives into account. As determined by de Búrca in her seminal article on proportionality, where a state's measure

'is seen to be primarily within the competence of the state, the Court is likely to be reluctant, unless a very important Community interest is adversely affected, to examine the proportionality of the national measure too closely' (de Búrca 1993: 112). In these cases the CJEU applies a very vague test of proportionality, implying a very deferential approach vis-à-vis national judges.

That is why scholars talk about a second peculiarity of the proportionality test in EU law: the 'cooperation dynamic' (Fontanelli and Martinico, forthcoming: 15) that takes place between judges in the EU, notably in respect of the use of the preliminary ruling machinery (Art. 267 TFEU). The attention of scholars has normally been focused on the 'upward phase' of the mechanism, when national judges pose a question to the CJEU on the interpretation or validity of EU law. However, as pointed out by Fontanelli and Martinico, 'proportionality, instead, offers a quite interesting example of "downward" cooperation between the CJEU […] and the referring judge (which receives from Luxemburg the applicable instruction to resolve the main proceedings). In many cases, indeed, the CJEU, after "constructing" the test of proportionality, hands it over to the ordinary judge. This is because, in the logic of judicial subsidiarity, the referring judge is the real master of the proceedings, he knows the factual background of the dispute, as well as the national context and sensitivity in which the allegedly discriminatory measure operates' (Fontanelli and Martinico, forthcoming: 15). This practice of the CJEU is more often used when the proportionality principle is applied to fundamental rights cases[X].

After having provided a review of the origins and significance of the principle of proportionality in general terms, its strengths and weaknesses, and its application in the European Union legal system in particular, I now analyse the application of the proportionality principle by the CJEU in a concrete area of law, that of citizenship, through a comparative analysis of the principle's application by the Court in two particular cases.

4. The peculiarities of the proportionality review made by the CJEU in a concrete area of law: Citizenship cases where Member States' derogation from Art. 21 TFEU is related to public policy issues that are particularly sensitive due to constitutional identity concerns

Considering the peculiarities and complexities regarding the application of the principle of proportionality in the EU context, I have decided to focus, in this study, on a concrete

area of law, citizenship, taking as a premise the hypothesis stipulated by Harbo (2010: 180)[XI].

As already mentioned above, Reich has identified four different versions of the proportionality test as applied by the CJEU: an autonomous balancing approach, a margin of discretion approach, a fundamental rights approach and a quasi-legislative approach. These different versions of the proportionality test have been found when analysing case law pertaining to the internal market. Nevertheless, citizenship is a hybrid area in which the reasoning of the CJEU may differ from the one followed in market cases because of, amongst other reasons, the inherent personality element that may come close to fundamental rights protection (Reich 2011: 2) (Reich 2011: 2; see in this regard Art. 21(2) of the EU Charter of Fundamental Rights).

As inferred in the previous section from the works of Harbo (2010) and Endicott (2012), legitimacy has to be both substantial (depending on how the Court adapts its decision to the substantial meaning accorded to it in that particular legal order) and procedural (based on how the Court adapts its decision to its power in the legal order, i.e. taking a more or less deferential stance vis-à-vis other public authorities).

Firstly, in EU law the substantial legitimacy strongly depends on the effective protection of human rights. The substantial meaning given to fundamental rights protection is particularly strong in the EU legal order. This is not the ambit for providing an overview over the protection of human rights in the history of EU integration. The history of the incorporation of the fundamental rights as general principles of EU law to the case law of the CJEU, through which the Court has been able to guarantee the respect for human rights, even before the first codification of the rights in the EU Charter, is well known. Today, after the entry into force of the Treaty of Lisbon, the Charter is part of primary EU law sources[XII], legally binding for Member States. The CJEU has proclaimed that the 'European Economic Community is a Community based on the rule of law, inasmuch as neither its Member States nor its institutions can avoid a review of the question whether the measures adopted by them are in conformity with the basic constitutional charter, the Treaty'[XIII]. Moreover, 'measures which are incompatible with observance of the human rights thus recognised are not acceptable in the Community'[XIV], including international obligations[XV]. In the Court's own words, the obligation of the Union to give effect to its international obligations 'may in no circumstances permit any

challenge to the principles that form part of the very foundations of the Community legal order, one of which is the protection of fundamental rights'[XVI].

The Member States and the EU share the same interest for protecting fundamental rights. Outside the limits of EU law, Member State's constitutions equally ensure the protection of fundamental rights. Member States are additionally signatories to the Convention for the Protection of Human Rights and Fundamental Freedoms. Moreover, fundamental rights as guaranteed by the European Convention and as they result from the constitutional tradition common to all Member States, constitute general principles of the Union's legal framework (art. 6.2 TUE).

But an especially problematic case arises when a Member State stands to derogate from a fundamental freedom, a fundamental constitutional value or a sensitive national policy. The constitutional tradition may be additionally funded on a fundamental right that is particular to that national legal order. The Court in these cases only engages in a marginal review. The reason is that in these cases the CJEU is faced with a norm that in principle is exogenous to the EU legal order, a matter of sensitive national policy (Craig 2006: 516; De Búrca 1993: 127-128 and 147), so it takes a very lenient approach vis-à-vis the national court to preserve the legitimacy of its decision.

But the deference due by the CJEU to national courts in citizenship cases is especially complex to determine because of the fact that the protection of the fundamental freedom comes very close to fundamental rights protection. The effective protection of fundamental rights is what is at stake in these cases. Arguably, in these cases a marginal review of proportionality is more appropriate, even if sensitive national policies are involved (the protection of fundamental rights is also a main interest for the Member States to accomplish). If the Court concentrates its efforts on achieving procedural legitimacy for its decision in these cases, accordingly showing more deference to national judges, it might risk loosing out on the substantial legitimacy of the result by failing to properly protect the special meaning accorded to human rights in the EU legal order.

Considering this risk, this paper in particular aims at shedding light upon the rationale (or rationales: either a single or multiple ones) followed by the CJEU when applying the proportionality principle in the area of citizenship. In order to attain this purpose, I will compare two recent cases regarding citizenship, *Sayn-Wittgenstein*[XVII] and *Runevič-Vardyn*[XVIII], where the interests that have to be balanced are very similar. On the one hand, a Member

State's derogation from Art. 21 TFEU is related to public policy issues that are particularly sensitive due to constitutional identity concerns. On the other hand, the fundamental freedoms contained in Art. 21 TFEU are in both cases intrinsically related to a fundamental right: Art. 7 of the Charter of Fundamental Rights of the European Union (protection of identity and private life).

Before comparing the application of the proportionality principle by the CJEU in the two selected cases, I briefly mention the facts of the cases and then provide an overview over the reasoning followed by the Court in each case.

4.1. *Sayn-Wittgenstein*

4.1.1. The facts of the case

This case deals with whether a constitutional tradition specific to Austria (the Austrian law on the abolition of nobility that prohibits Austrian nationals from holding any title of nobility[XIX]) was contrary to Treaty provisions on citizenship. The facts of the case are the following: the applicant, Illonka Sayn Wittgenstein (thereinafter Mrs. Sayn Wittgenstein) is an Austrian national born in 1944. In 1991 she was adopted by a German national, Lothar Fürst von Sayn-Wittgenstein. The adoption did not have any effect on her nationality. However, it had an effect on her surname: by supplementary order of 24 January 1992, the competent German administrative authority stated that, following the adoption, the applicant in the main proceedings acquired the surname of her adoptive father in the form 'Fürstin von Sayn-Wittgenstein', which would be the name she would use[XX]. Thereafter, following the acquisition of her new identity, the Austrian authorities registered that surname in the Austrian civil registry[XXI]. This means that they issued Mrs Sayn Wittgenstein with a birth certificate in the name of Ilonka Fürstin von Sayn-Wittgenstein.

On 27 November 2003, the *Verfassungsgerichtshof* (the Austrian Constitutional Court) delivered a judgment in which it held that the Law on the abolition of nobility, which is of constitutional status and implements the principle of equal treatment in this field, precluded any Austrian citizen from acquiring a surname which would include a former title of nobility, including one of foreign origin[XXII].

Sometime after the judgment, the Austrian administrative authorities adopted the view that the birth certificate of the applicant was incorrect and notified her of their intention to correct her surname in the civil registry to 'Sayn-Wittgenstein'. Despite the objections of

the appellant, on 24 August 2007 they issued a decision in which they confirmed that her family name had henceforth to be registered as 'Sayn-Wittgenstein'. Mrs. Sayn-Wittgenstein appealed that course of action.

The appellation was dismissed, so the applicant sought to have the decision overturned by the *Verwaltungsgerichtshof*, the referring Court in the case. She claimed that her rights to freedom of movement were hindered by the non-recognition of the effects of her adoption with regards to the law governing surnames[XXIII]. She also claimed the existence of an interference with the right to respect for family life, guaranteed by Art. 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms signed in Rome on 4 November 1950.

The national court referred the case to the CJEU for a preliminary ruling, posing the following question: 'Does Art. 21 TFEU preclude legislation pursuant to which the competent authorities of a Member State refuse to recognise the surname of an (adult) adoptee, determined in another Member State, in so far as it contains a title of nobility which is not permissible under the (constitutional) law of the former Member State?'[XXIV]

4.1.2. The answer of the Court and the review of proportionality

The CJEU firstly pronounced, by way of a preliminary point, that 'a person's name is a constituent element of his identity and of his private life, the protection of which is enshrined in Article 7 of the Charter of Fundamental Rights of the European Union'.

The Court continued by holding that the refusal, by the authorities of a Member State, to recognise all the elements of the surname of a national of that State as determined in another Member State, where that national resides, and as having been recorded during 15 years in the civil registry of the first Member State, is a restriction on the freedoms conferred by Article 21 TFEU upon every citizen of the Union[XXV].

After having determined the existence of a restriction, the CJEU then analysed if a valid justification for the obstacle existed, i.e. if the Law on the abolition of nobility of constitutional status is an objective justification for the restriction on the freedom of movement and residence enjoyed by citizens and, if so, if this obstacle is proportionate with its aim.

Firstly, regarding the objectivity of the justification, the Court considered that, within the context of Austrian constitutional history, the Law on the abolition of nobility, as an

element of national identity, could be regarded as a valid justification.[XXVI] The CJEU considered it a public policy justification and recalled that the concept of public policy had to be interpreted strictly and that it had to be relied on only if there was a genuine and sufficiently serious threat to a fundamental interest of society. Nevertheless, as the concept of public policy may vary from one Member State to another and from one era to another, the competent national authorities could therefore be allowed a margin of discretion within the limits imposed by the Treaty[XXVII].

The Austrian Government argued that the Law on the abolition of nobility constituted the implementation of the more general principle of the equality before the law for all Austrian citizens. The CJEU held that the principle of equal treatment was also a general principle of EU law, enshrined in Article 20 of the Charter of Fundamental Rights[XXVIII].

Once it had determined the adequacy and objectivity of the defence adcovated by Austria, the CJEU started to analyse the proportionality of the justification in question – the most interesting part of the judgement for the purpose of this paper.

As a preliminary point, the CJEU held that 'the need for, and proportionality of, the provisions adopted are not excluded merely because one Member State has chosen a system of protection different from that adopted by another State'[XXIX]. The CJEU then mentioned Art. 4(2) TEU which defines the obligation of the European Union to respect the national identities of its Member States.

The CJEU, in applying a very vague test of proportionality – in scarcely one paragraph –, subsequently suggested that the measure was indeed proportionate: *'In the present case, it does not appear disproportionate for a Member State to seek to attain the objective of protecting the principle of equal treatment by prohibiting any acquisition, possession or use, by its nationals, of titles of nobility or noble elements which may create the impression that the bearer of the name is holder of such a rank. By refusing to recognise the noble elements of a name such as that of the applicant in the main proceedings, the Austrian authorities responsible for civil status matters do not appear to have gone further than is necessary in order to ensure the attainment of the fundamental constitutional objective pursued by them'.*[XXX]

4.2. *Runevič-Vardyn*

4.2.1. The facts of the case

The first applicant in this case was Ms. Runevič-Vardyn, a Lithuanian national belonging to the Polish minority in the Republic of Lithuania but not possessing the Polish nationality. She was born as 'Malgožata Runevič', so her forename and surname were accordingly registered in her birth certificate in their Lithuanian form as Malgožata Runevič, on 17 June 1977.

After having lived and worked in Poland for some time, the first applicant married the second applicant in 2007 in Lithuania. On the marriage certificate issued by the Vilnius Civil Registry, the name of the second applicant, a Polish national, 'Łukasz Paweł Wardyn', was transcribed as 'Lukasz Pawel Wardyn' (using the characters of the Roman alphabet but without its diacritical modifications), whilst his wife's name appeared, unlike his own, in Lithuanian characters as 'Malgožata Runevič-Vardyn' – Lithuanian characters do not include the letter 'W', so the addition of her husband's Polish surname to her own surname[XXXI] appeared with 'V'. The applicants were at that time living in Belgium, together with their son.

The first applicant subsequently requested that the Vilnius Civil Registry Division would change her birth and marriage certificates into the Polish spelling form, that is to say to Roman characters including diacritical modifications. The refusal of the request by the Lithuanian administrative authorities led the applicant to bring an action before the competent national court.

The second applicant stated that the refusal of the Lithuanian authorities to transcribe his forenames on the marriage certificate into a form which complied with the rules governing Polish spelling constituted discrimination against a citizen of the European Union who had married in a State other than his State of origin[XXXII].

According to settled case law of the Lithuanian Constitutional Court, a person's forename and surname have to be entered on a passport in accordance with the rules governing the spelling of the official national language in order not to undermine the constitutional status of that language.

The First District Court of the City of Vilnius took the view that it was not possible to solve the dispute without further clarification of Articles 18 and 21 TFEU and of Article 2(2)(b) of Directive 2000/43, so it decided to refer four questions to the CJEU for

preliminary ruling, later reformulated by the CJEU. The first and second questions concerned the application to the case of Directive 2000/43 that implements the principle of equal treatment between persons irrespective of racial or ethnic origin. The CJEU held that the situation referred to did not fall within the scope of this Directive.

Through the third and fourth questions – the interesting ones for the purpose of this paper – the national court asked, in essence, whether Articles 18 and 21 TFEU precluded the competent authorities of a Member State from refusing to change the form in which a person's surname and forename are registered, pursuant to national rules that would oblige them to issue certificates of civil status in the official national language, with the result that those names must be entered using only the characters of the national language, without diacritical marks, ligatures or any other modifications to the characters of the Roman alphabet which are used in other languages.

4.2.2. The answer of the Court and the review of proportionality

Concerning the third and fourth questions – the interesting ones for the purpose of this paper – the CJEU proceeded first to review its competence for this case. Mr. and Mrs. Vardyn were both nationals of Member States of the Union so derivatively citizens of the EU that had exercised their fundamental freedoms to move and reside in a different Member State. The situation was therefore within the scope of Article 21 TFEU.

Once the competence of the Court determined, the CJEU started to analyse, as in *Sayn-Wittgenstein*, if there was a restriction on the freedom of movement. To do so, the Court divided the different requests into three[XXXIII]:

- the request by the first applicant in the main proceedings for her maiden name and her forename to be entered on her birth and marriage certificates in a form that complied with the rules governing Polish spelling, involving the use of diacritical marks common for that language;
- the request of the applicants in the main proceedings that the surname of the second applicant in the main proceedings, joined to the maiden name of the first applicant in the main proceedings and appearing on the marriage certificate, should be entered in a form that complied with the rules governing Polish spelling; and

- the request of the second applicant in the main proceedings for his forenames to be entered on that certificate in a form that complied with the rules governing Polish spelling.

As in *Sayn-Wittgenstein*, the CJEU started its argumentation concerning the analysis of the existence of a restriction on the freedom of movement, mentioning, by way of a preliminary point, the importance of the protection of the fundamental rights as enshrined in the Charter and also in the European Convention. More specifically, it held that a person's forename and surname were a constituent element of his identity and of his private life, the protection of which is enshrined in Article 7 of the Charter of Fundamental Rights of the European Union and in Article 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms.

With regard to the first and third requests, the CJEU found that there were no restrictions of Art. 21 TFEU. The facts were estimated by the Court not to cause inconveniences to those concerned.

By contrast, with regard to the second request, the Court thought the existence of a restriction to be likely. However, the Court recalled that in order to constitute an obstacle to Art. 21 TFEU, national rules at hand had to be liable to cause 'serious inconvenience' to those concerned at administrative, professional and private levels[XXXIV]. Weak restrictions of fundamental freedoms would not override the power of the Member State to refuse to amend the joint surname of the applicants recorded by the civil registries according to its national rules.

Differently than in its ruling in *Sayn-Wittgenstein*, in which the Court itself determined the existence of a 'serious inconvenience' by taking into account the facts provided by the national judge, in this case the Court, surprisingly, handed the decision back to the referring judge. It would be up to the national judge to consider whether the 'refusal involves the possibility that the truthfulness of the information contained in those documents will be called into question and the identity of that family and the relationship which exists between its members placed in doubt'[XXXV],which in turnwould have significant consequences as regards, among other things, the exercise for the right of residence conferred by Article 21 TFEU[XXXVI]. But the CJEU, although delegating the final decision on the existence of a serious inconvenience (and therefore on the existence of restrictions to the freedoms contained in Art. 21 TFEU) to the referring judge, nonetheless issued the

guidelines as to how to qualify a restriction as a 'serious inconvenience at administrative, professional and private levels'.

Despite this delegation, the Court still hypothetically considered the existence of a restriction. In this way it was capable to express its view on the evaluation of the justification and its proportionality[XXXVII]. The Court found that, firstly, it was legitimate for a Member State to ensure that the official national language is protected in order to safeguard national unity and preserve social cohesion[XXXVIII]. This cements Art. 3(3) TEU and Art. 22 of the Charter of Fundamental Rights of the European Union (that provide for the obligation to respect the cultural and linguistic diversity of the Union). Additionally, according to the Court the obligation to respect the national identity of a Member State (Art. 4(2) TEU) would include the protection of a State's official national language.

Thereafter, in paragraphs 87 to 93, the CJEU reviewed the necessity and proportionality of the justification. Interestingly enough, and also differently from *Sayn-Wittgenstein*, at this point the Court highlighted, by way of a preliminary observation, the importance of the protection of Art.7 of the Charter of Fundamental Rights of the European Union and Art. 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms (protection of private and family life)[XXXIX]. It expressly mentioned the link between fundamental freedoms and fundamental rights, stating that 'the importance of ensuring the protection of the family life of citizens of the Union in order to eliminate obstacles to the exercise of the fundamental freedoms guaranteed by the Treaty has been recognised under European Union law'[XL]. Therefore, the balance to be struck in the present case, once it had been determined that a restriction of Art. 21 existed, was one between, on the one hand, the right of the applicants in the main proceeding to respect for their private and family life and, on the other, the legitimate protection of its official national language and its traditions through the Member State concerned[XLI].

The CJEU suggested a solution for the proportionality test: 'With regard to the alteration, on the marriage certificate, of the Polish surname "Wardyn" to "Vardyn", the disproportionate nature of the refusal…may possibly appear from the fact that the Vilnius Civil Registry Division entered that name, in respect of the second applicant in the main proceedings, on the same certificate in compliance with the Polish spelling rules at issue'[XLII]. This solution is nevertheless conditional on a prior finding of a 'serious

inconvenience' by the referring judge that would confirm the competence of the CJEU in the case.

4.3. Comparing the application of the proportionality principle by the CJEU in *Sayn-Wittgenstein* and *Runevič-Vardyn*

4.3.1. Why comparing Sayn-Wittgenstein *and* Runevič-Vardyn*? Similarities between the cases*

In the cases summarized above, the CJEU does not examine the proportionality too closely. It applies a very vague test in both cases but with some differences. The respective results of the application of the principle diverge: in *Sayn-Wittgenstein* the Court finds that 'the Austrian authorities […] do not appear to have gone further than is necessary in order to ensure the attainment of the fundamental constitutional objective pursued by them'[XLIII], while in *Runevič-Vardyn* the Court establishes the 'disproportionate nature' of the 'refusal by the Vilnius Civil Registry Division to accede to requests for change made by the applicants'[XLIV].

According to Harbo's premise (2010: 180)[XLV], the 'differences' in the application and results of the proportionality principle by the Court in *Sayn-Wittgenstein* and *Runevič-Vardyn,* could find an explanation in the fact that the two cases belong to two different areas of law and/or because of the different substance of the conflicting interests at stake in each of the cases.

Regarding, firstly, the area of law, both cases concern the same area: citizenship. In both cases the analysis of proportionality concerns the application of Art. 21 TFEU. This article contains the right to move and reside and a prohibition of discrimination[XLVI]. Discrimination is only claimed in *Runevič-Vardyn*, not in *Sayn-Wittgenstein*, but as Art. 21 TFEU also contains the prohibition of discrimination, at the stage of the analysis of the justification for the restriction and its proportionality (the object of this analysis), it is only Art. 21 TFEU (and not 18 TFEU) that is taken into account here. Therefore, this difference is not relevant for the purpose of comparing the proportionality principle.

Secondly, concerning the 'substance' of the conflicting interests at stake, in my opinion the two cases are equally similar. Even if there are differences of facts, I think that the substance of the interests subjected to the balancing exercise is close enough to compare the application of the proportionality test by the Court. Below I will provide further arguments in support of this conclusion.

Firstly, in both *Sayn-Wittgenstein* and *Runevič-Vardyn* the CJEU is faced with a 'national sensitive policy' with the the aim of protecting fundamental constitutional values related to constitutional identity. Concretely, in the case of *Sayn-Wittgenstein* the latter relates to the principle of equality; in *Runevič-Vardyn*, to the official national language that it is at the same time the safeguard of national unity and social cohesion. Both interests are protected by Art. 4(2) TEU: according to the Court, the obligation to respect the national identity of a Member State (Art. 4(2) TEU) includes both the protection of a State's official national language[XLVII] and also the peculiar system for the protection of equality used by Austria[XLVIII]. The principle of equality and a Member State's official national language are also values protected by EU primary law, as the CJEU has recalled in both cases. The principle of equality is enshrined in Article 20 of the Charter of Fundamental Rights[XLIX], while the protection of a State's national language is guaranteed by Art. 3(3) TEU and Art. 22 of the Charter that ensure respect for the cultural and linguistic diversity of the Union[L].

It is true that the public policy justification in *Sayn-Wittgenstein*, differently from *Runevič-Vardyn*, has a closer relation with a fundamental right concern. This could be the origin of a different reasoning by the Court. Still, the separation between public policy and human right is hardly problematic because sometimes 'the state simply couches its (possibly legitimate) "public interest" in terms of fundamental rights' (Reich 2011: 24)[LI]. But in *Sayn-Wittgenstein* the CJEU considered the justification as a matter of public policy, which entails that 'it must be interpreted strictly, so that its scope cannot be determined unilaterally by each Member State without any control by the European Union institutions'[LII]. Additionally, the CJEU stated that a 'public policy may be relied on only if there is a genuine and sufficiently serious threat to a fundamental interest of society'[LIII]. This finding of the Court lies outside the remit of this article.

Secondly, in both cases national measures based on fundamental constitutional values have brought about a partial change to the surnames of claimants. In both cases the changes were applied by the State to the surnames of its own nationals that, similarly, have received those surnames from non-nationals: by adoption and by marriage, respectively. Due to the change, the surnames of the claimants have become slightly different from the one of their relatives with different nationality. Consequently, the changes may lead the claimants to the same inconveniences: the family ties and respective identities of the claimants may be put into question. The change may thus create inconveniences at private

and public levels which may consequently create interferences on the freedoms guaranteed by Art. 21 TFEU.

The changes to the surnames are nevertheless formally different, which could in principle explain the different result of the Court concerning the proportionality of the changes. In *Sayn-Wittgenstein,* the change consists in removing from the surname the title of nobility (from 'Fürstin von Sayn-Wittgenstein' to 'Sayn-Wittgenstein') because those noble elements are not authorised by national legislation based on a fundamental constitutional value, the principle of equality. In *Runevič-Vardyn*, the change to the surname consists on placing a 'V' instead of a 'W' in the surname (from 'Wardyn' to 'Vardyn'), because this last letter does not exist in Lithuanian, the national language, which is also a fundamental constitutional value that should be protected.

In *Runevič-Vardyn* the claimant received the 'foreign surname' from a non-national, therefore originally written in a foreign language according to its own rules. The change in the spelling of a foreign name means a change in a constituent element (one of the letters) of the surname. By contrast, in *Sayn-Wittgenstein*, the claimant had received, also from a non-national, a 'German surname', written nevertheless in the national language of Austria. The removal of a title of nobility from a 'national' name could therefore be understood as a non-substantial change. Nevertheless, while Germany and Austria share the same language, they do not share the same understanding of noble elements included in surnames. As affirmed by the Court in its ruling, 'under German law, the words 'Fürstin von' are regarded not as a title of nobility but as a constituent element of the name lawfully acquired in the State of residence'[LIV]. Consequently, the names 'Fürstin von Sayn-Wittgenstein' and 'Sayn-Wittgenstein' are considered as not being identical[LV].

In conclusion, even if there is a formal difference in the changes, substantially the transformations are similar: in both cases they make the surname 'not identical' to the one of their respective relative in a place where the claimants reside and develop their respective family lives. Therefore, the alterations of the surnames are able to lead the claimants into the same inconveniences concerning their respective identities and family lives, and also their freedoms under Art. 21 TFEU.

To sum up, at the stage of the analysis of proportionality, the Court is faced in both cases with a similar interest to be subjected to the test. I only find a difference between the justifications in *Sayn-Wittgenstein* and *Runevič-Vardyn* concerning the substance of the

interests. In *Sayn-Wittgenstein,* the CJEU is confronted with a constitutional principle which is 'specific' to the national legal system (the system for the protection of equality used by Austria), while in *Runevič-Vardyn* the constitutional tradition is 'common' to several Member States (the protection of the official national language). I will discuss later on if this single divergence may justify the difference in the application of the proportionality principle by the CJEU and also the different results. Despite this difference, the similarities between the two cases enable a comparison of the application of the proportionality principle by the Court.

4.3.2. Comparison of the application of the proportionality principle by the CJEU in the selected cases

As affirmed by de Búrca, where a state's measure 'is seen to be primarily within the competence of the state, the Court is likely to be reluctant, unless a very important Community interest is adversely affected, to examine the proportionality of the national measure too closely' (De Búrca 1993: 112). The jurisdiction over national sensitive polices based on constitutional values should lie primarily with a national judge, who better knows the national sensitivities. This is even more so the case when those national policies are 'specific' to that national legal order. In this type of cases, the CJEU cannot strike a balance between two norms that are exogenous with respect to each other (the principle of EU law and the norm deriving from the national legal order) (Fontanelli and Martinico, forthcoming: 19). Additionally, if the area of law concerns citizenship – a transverse area of competence in which Member States still retain the main competence[LVI] – the deference due to the national court and the national legislator is stronger than it would be in other areas of EU law.

Sayn-Wittgenstein is a case in which all those facts may justify a vague examination of proportionality by the Court: it is a citizenship case where the measure disputed is a national act based on a constitutional identity concern that constitutes a singular value to that State. All these facts would explain the reasoning of the Court which, in merely one paragraph, suggests that the national measure is proportionate without further analysis and justification.

As argued previously, the legitimacy of the result of the review of proportionality, using the works of Harbo and Endicott and putting them together, depends on two premises: firstly, on how the Court adapts its decision to the substantial meaning accorded to it in the

particular legal order (substantial legitimacy) and, secondly, on how the Court adapts its decision to the particular institutional context (procedural legitimacy). In *Sayn-Wittgenstein* the CJEU seems to be adapting its decision on proportionality to its particular power in the concrete case, assuring the legitimacy of its decision according to the second premise.

The judgement in *Sayn-Wittgenstein* seems to follow the path of the case law established by *Omega*[LVII] and *Dynamic Medien*[LVIII], even if these two cases concern a different area of law, namely the internal market (Öberg 2012: 72-76; and Fontanelli and Martinico, forthcoming: 18-19). Scholars also add to this list the case of *Schmidberger,* even if this last case is slightly different from the rest (Öberg 2012: 72-76; and, only concerning the cases on internal market, Reich 2011: 18-19). In this case the CJEU was facing a constitutional tradition that was 'common' to several Member States (the freedom of assembly), while in the other cases the measure in question was 'specific' to a single legal system: in *Omega* the derogation was related to human dignity, while in *Dynamic Medien* the protection of child/human dignity was at stake. As Martinico affirms: *'Arguably, only in the first scenario* – the one in which a 'common' constitutional tradition is involved – *is the Court required to do some balancing proper. In these cases, indeed, the Court needs to balance two principles or sources belonging to the same legal order (the idea behind that is that national and supranational law share a zone where they overlap, in which the two terms of the balancing are situated). This is not the case in the second group of cases* –concerning 'singular' constitutional tradition – *because the CJEU cannot strike a balance between two norms that are exogenous with respect to each other (the principle of EU law and the norm deriving from the national legal order)'*(Fontanelli and Martinico, forthcoming: 19).

But in all these cases (*Schmidberger* included), the Court applied the proportionality test in the same way and arrived to the same result. It applied a vague review of proportionality and was reluctant to undertake a proper balancing, therefore adopting a deferent approach vis-à-vis the national legislator. The result in all these cases was that, for the Court, constitutionally sensitive measures based on fundamental rights arguments (being either common to all or specific to a single legal system) trump fundamental freedoms. This result respects the especial substantial meaning accorded to human rights in the EU legal order[LIX] (substantial legitimacy), while respecting also the deference due to the national legislator that stems from the constitutional sensitivity of the measure (procedural legitimacy).

In principle, *Sayn-Wittgenstein* seems to be an example of the same approach taken by the Court. The Court would be applying a test similar to that used in *Omega*, *Schmidberger*,

Dynamic Medien and *Sayn Wittgenstein* because (using Harbo's premise) 'the substance of the conflicting interests at stake are the same', or at least similar enough. But I do not think that in this last case the 'substance' is completely the same because of to 'the different areas of law' involved in the respective cases.

Sayn-Wittgenstein regards citizenship, an area where the personality element brings fundamental freedoms closer to fundamental rights. In *Sayn-Wittgenstein*, the freedom to move and reside is intrinsically linked to the fundamental right to respect for the private and family life, while in the other cases the fundamental freedoms concerned merely economical aims. An application of the proportionality principle as used in *Omega*, *Schmidberger* and *Dynamic Medien* would entail a different result for *Sayn-Wittgenstein*. The result of *Sayn-Wittgenstein* was that constitutionally sensitive measures based on fundamental rights arguments (even if 'specific' to a single legal system) trump not only fundamental freedoms, but also fundamental rights that are 'common' to the constitutional tradition of Member States, and that is not only of interest for the EU but also for the Member States to effectively protect them. I think that, in this type of cases, at the very least a deeper analysis of proportionality is required in order to duly ascertain the substantial legitimacy of the result.

According to de Búrca, in applying a lenient test of proportionality the CJEU is not striking a proper balance (De Búrca 1993). Nevertheless, I think that the reasoning of the Court involves a balance in which prominence is given to the national measure. The Court is suggesting 'a result on proportionality', and the absence of a proper balance only indicates a strong bias in favour of the constitutionally based national measure, which renders an exhaustive balancing unnecessary. This bias is the result of the lack of competence of the CJEU in an ambit of national sensitive policy (which is, additionally, 'singular' to the Austrian legal system in the case of *Sayn-Wittgenstein*). This makes the constitutionally based national measure to stand as the main interest to be protected. But regarding a formal application of the principle of proportionality, this bias provokes some 'pathologies' (Endicott 2012) in the principle of proportionality that erode the very function of it: to secure the legitimacy of judicial decisions (Harbo 2010).

This problem did not emerge in *Omega*, *Schmidberger* or *Dynamic Medien*, cases in which the legitimacy was nevertheless assured: the final decision of the CJEU made fundamental rights prevail over fundamental freedoms while at the same time respecting the

constitutional character of the national measure. Nevertheless, in *Sayn-Wittgenstein* the implications of applying the same test to a different area of law have been underestimated. As a consequence, the proportionality principle suffers from two of the 'pathologies' identified by Endicott (2012): the pathology of 'uncertainty' and the pathology of 'deference'.

Concerning, firstly, the pathology of uncertainty, I think that in *Sayn-Wittgenstein* the CJEU, while applying the proportionality principle, is favouring the public interest and underestimating the risks to the private interest at stake. The Court, in the ruling in *Sayn-Wittgenstein,* only mentions, as a preliminary point before assessing the existence of a restriction to the free movement, that the importance of protecting 'a person's name is a constituent element of his identity and of his private life, the protection of which is enshrined in Article 7 of the Charter of Fundamental Rights of the European Union'[LX]. Consequently, it affirms the link between the fundamental freedoms involved in the dispute and the fundamental rights recognised by the Court. Nevertheless, when the answer of the Court arrives to the stage of analysing proportionality, the Court upholds the proportionality of the national measure without any further mention of that fundamental right just proclaimed.

This lack of reference to the human rights involved in the case could be explained by the lack of binding force by the EU Charter when the request for a preliminary ruling was received by the CJEU[LXI]. But human rights were already then one of the main interests to be protected by the CJEU. The legitimacy of the application of the proportionality principle is undermined if human rights are underestimated and I think this was the case in *Sayn-Wittgenstein*. While confirming the proportionality of the national measure without any further consideration of the private interest at stake, the CJEU was implicitly giving priority to public policy provision.

This conclusion is supported by the fact that, already at the stage of the judgement when the Court was considering whether or not a restriction existed, it determined that the divergence between the most recent Austrian identity documents of Mrs Sayn-Wittgenstein and the name which she had used for 15 year in her daily life was causing her 'serious inconvenience' at private and public levels. According to the Court's own case law a restriction on the freedoms recognised by Art. 21 TFEU must be liable to cause 'serious inconvenience' to those concerned at administrative, professional and private levels[LXII] in

order to be qualified as such. The liability to dispel doubts as to the person's identity that is capable to cause a serious inconvenience at private level constitutes also an interference (that is qualified by the Court as 'serious') on the right to private and family life. I think that the Court is already measuring, implicitly, the proportionality of the national measure when considering it a 'serious' inconvenience for Mrs. Sayn-Wittgenstein's private rights.

The test of proportionality is linked to and conditioned upon the previous finding of a restriction of Art. 21 TFEU. If the Court finds a restriction, the application of the proportionality principle is conditioned upon two premises, in my opinion: the strict understanding of the public policy provision that the CJEU has reiterated[LXIII] and also the fact that a restriction that has been qualified as a 'serious inconvenience' for the private interests of Mrs. Sayn-Wittgenstein has already been found and affirmed.

It seems inconsistent to me to sustain, firstly, that there exists a restriction of Art. 21 TFEU and, consequently, a restriction of the right to private and family life, qualified as a 'serious inconvenience' for Mrs. Sayn-Wittgenstein, while later on the judgement, when examining the proportionality, does not make any reference to the private right involved. Consequently I think that this fact proves the existence of the pathology of uncertainty: when determining the proportionality of the public interest, the Court is favouring this interest and underestimating the risks to the private interest at stake. A more prominent role of the likely risks for the private interest is required, at least in the examination of proportionality, in order to elude or minimize this pathology.

A national constitutional sensitivity by the CJEU is also the reason of a second pathology in the application of the proportionality principle in *Sayn-Wittgenstein*: the pathology of deference. I consider that the Court, for the same reasons as enshrined above, is deferring excessively to the initial decision maker, so the protection of human rights is lost. It gives priority to the national measure without weighting this interest vis-á-vis the private interest involved in the case.

In conclusion, the interpretation of the principle of proportionality as it is used in cases concerning the area of the internal market may lead to pathologies if it is applied in the same way in cases concerning citizenship, a different area of law. As a consequence of these pathologies, the legitimacy of the result is undermined. The result in *Sayn-Wittgenstein*, as I have previously advanced, is that for the CJEU, a constitutionally sensitive measure based on a fundamental rights concern (even if 'specific' to a single legal system) trumps

not only fundamental freedoms, but also fundamental rights that are 'common' to the constitutional traditions of the Member States. The legitimacy of this result is at least more questionable than in the cases of *Omega*, *Schmidberger* or *Dynamic Medien*.

But the Court is trapped by its obligation of deference. Therefore, a dilemma arises: how to effectively protect the special substantial meaning accorded to human rights in the EU while respecting, at the same time, the deference due to the national judge because of the constitutional character of the national measure (and additionally in some cases its singularity) and the area of law at stake?

Runevič-Vardyn is a judgement of the CJEU where the problems of the proportionality principle as applied by the CJEU in *Sayn-Wittgenstein* decrease (even if they are not completely erased). Differently than in *Sayn-Wittgenstein,* the CJEU in *Runevič-Vardyn*, at the stage of the analysis of proportionality, highlights the importance of the protection of Art. 7 of the Charter of Fundamental Rights of the European Union and Art. 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms (protection of private and family life)[LXIV]. The Court expressly mentions the link between fundamental freedoms and fundamental rights: 'the importance of ensuring the protection of the family life of citizens of the Union in order to eliminate obstacles to the exercise of the fundamental freedoms guaranteed by the Treaty has been recognised under European Union law'[LXV]. By mentioning the importance of the fundamental right at stake at this stage of the reasoning, the CJEU contributes to alleviate the pathology of 'uncertainty' with respect to *Sayn-Wittgenstein*, a case where the Court made no express reference to the private interest at stake. Already this sole mention renders more justice to the special substantial meaning given to human rights in the EU legal order.

Still, the test is very lenient, but the fact of giving a more important role in the reasoning about proportionality to the human rights involved in the case contributes to alleviate the pathologies found in *Sayn-Wittgenstein*. It entails also less deference to the national legislator (consequently, it alleviates the pathology of deference) because the CJEU highlights the importance of not undermining the protection of human rights, despite the constitutionally sensitive national interest. The results on proportionality are different in *Sayn-Wittgenstein* and *Runevič-Vardyn.* This can be seen as a proof of the lack of deferential constrains of the Court. In this last case, differently from *Sayn-Wittgenstein,* the CJEU suggests the 'disproportionate nature'[LXVI] of the national measure.

4.3.3. Why the differences between Sayn-Wittgenstein *and* Runevič-Vardyn *in the application of the proportionality principle?*

The question that arises from the comparison above is why the reasoning of the Court in *Runevič-Vardyn*, and the ensuing result, differs from *Sayn-Wittgenstein*. Why does the Court highlight, at the stage of the analysis of proportionality in *Runevič-Vardyn* but not in *Sayn-Wittgenstein*, the protection of the human right involved? *Sayn-Wittgenstein* and *Runevič-Vardyn* are both cases where references for a preliminary ruling were received by the Court before the entry into force of the Treaty of Lisbon, when the Charter of Fundamental Rights of the EU had not acquired its binding force[LXVII]. Additionally, both cases were resolved by the Court after the entry into force of the Treaty of Lisbon. Therefore, there are no differences between the two cases concerning the binding force of the Charter that could explain the mentioning of the human right involved in one but not in the other.

Can the difference be explained by the fact that in *Sayn-Wittgenstein* the constitutional principle is 'specific', while it is not so in *Runevič-Vardyn*? Arguably, only in this second case is the Court required to making a proper balance because the two interests belong to the same legal order (Fontanelli and Martinico, forthcoming: 19). This could explain the reduction of pathologies in *Runevič-Vardyn,* where the origin of the bias is lessened: in *Runevič-Vardyn* the CJEU is less constrained than in *Sayn-Wittgenstein* to show deference to the national legislator because the constitutional tradition is 'common' to several Members. In *Sayn-Wittgenstein*, where the constitutional value is 'specific', the CJEU theoretically cannot strike a balance between two norms that are exogenous with respect to each other. The problem is that, in spite of its lack of competence, the CJEU still proposes a solution in *Sayn-Wittgenstein* (even if only as a suggestion), thus incurring in pathologies due to a vague analysis made because of its constrains.

Still, I do not think that this explanation is fully convincing because the main difference between the reasoning of the Court in both cases does not arise at the stage of the analysis of proportionality but already before, at the stage of the decision about the existence of restriction on Art. 21 TFEU. I think that this main difference is the cause of the subsequent divergence between *Sayn-Wittgenstein* and *Runevič-Vardyn* in the application of the proportionality principle. The CJEU in *Runevič-Vardyn*, differently than in *Sayn-Wittgenstein*, delegates the decision about the existence of a restriction of Art. 21 TFEU to

the national judge. More specifically, the CJEU delegates the decision about the existence of 'serious inconvenience', which involves a restriction of Art. 21 TFEU.

It is true that, in both cases that are the object of this analysis, the CJEU suggests a decision base on proportionality, and also that in both cases the last decision about proportionality rests with the national judge. But the delegation made in *Runevič-Vardyn* has consequences for the application of the principle of proportionality by the CJEU. When the CJEU applies the proportionality principle, its competence to do so has not yet been ascertained because the affirmation of the existence of a restriction of Art. 21 TFEU is still pending. The Court only assumes, hypothetically, that it is competent, in order to issue guidelines to the national judge about proportionality. As a consequence, the national judge might not feel compelled so strongly to follow the guidelines by the CJEU on proportionality; while, in parallel, the CJEU on its part can assume in this case, more comfortably than in *Sayn-Wittgenstein,* the place of the national judge when suggesting a solution on proportionality. Therefore, its suggestion is removed more clearly from the origin of its bias – the obligation of deference towards to the national judge – and thus the pathologies decrease.

One of the main arguments for this conclusion is the fact that the CJEU does not hesitate to affirm that the balance to be made in *Runevič-Vardyn* is one between, on the one hand, the right of the applicants in the main proceeding to respect for their private and family life and, on the other, the legitimate protection of the official national language and traditions by the Member State concerned[LXVIII]. Art. 21 TFEU and the freedom to move and reside disappear from this balance, absorbed by the human right involved in the case. This is astonishing, considering that the CJEU has still not clarified in its case law whether the right to private and family life may be seen as part of the content of Art. 21 TFEU (Kochenov 2013), even if it is intrinsically linked to it.

The explanation of this attitude is that the Court is assuming, without prejudice, the place of the national judge when suggesting its own view on proportionality. The national judge is the one that has the competence and who is not constrained to balance the human right to private and family life. So the CJEU would be assuming the position of the national judge, who does not owe deference in the same way that the CJEU does, and who may also take into account in the balancing the human right involved without problems of competence.

Still, the possibility for the national judge to fall into any of the pathologies while examining the proportionality is not precluded, but the result of the application of the principle of proportionality as suggested by the CJEU is liberated from the bias: the referring Court, unlike the CJEU, does not owe any deference to an exogenous Court in order to balance a public policy based on a constitutional concern with a fundamental right also protected not only by its own constitution, but by the EU Charter and the European Convention.

But even if this delegation might constitute a way to minimize the pathologies of the proportionality principle, as it has been argued above, I think that it stops short of being truly convincing because of the high price to pay by the CJEU when ceding the decision on the existence of restriction of Art. 21 TFEU. The delegation may lead to undermining the coherence and consistency of EU law, as well as the essence of EU citizenship (Kochenov 2013: 17-18). But it is beyond the purpose of this paper to analyse the effects of the delegation, which that are different from the effects on the application of the principle of proportionality in particular. This will have to be the object of further research.

5. Conclusions

In this paper I have tried to shed light on the rationale of the CJEU when applying the principle of proportionality in a concrete area of law: that of citizenship. In order to do so, this article has compared recent cases that share similar conflicting interests. The approach for the comparison has consisted in finding and measuring 'pathologies' (Endicott 2012) in the application of the principle by the CJEU. Through this approach it was possible to evaluate the legitimacy of the final result achieved by the Court. The main findings of this article may be summarized as follows:

- In the two cases analysed that concern the same area of law and where the interests to be weighted are close enough, the reasoning of the Court in the application of the proportionality principle is nevertheless different. Consequently, I can conclude that there is no unique reasoning in the interpretation of the principle of proportionality by the CJEU in the selected cases, despite the fact that they regard the same area of law, citizenship, with similar interests subjected to balance.

- Owing to this divergence in the reasoning, also the pathologies in the application of the proportionality principle differ. In *Sayn-Wittgenstein* the pathologies are more important because the reasoning of the Court on proportionality is biased in favour of the public interest, which in turn is due to the deferential constrains of the Court when balancing a national measure related to a national sensitive policy that is additionally specific to the Austrian legal order. The Court favours the public interest when it suggests its solution on proportionality, not making special reference to the private interest involved. By contrast, in *Runevič-Vardyn* the private interest (and, more specifically, the fundamental right involved in the balance that is intrinsically linked to the fundamental freedom) is mentioned and considered by the Court.

- However, despite of the less pathological application of the proportionality principle in *Runevič-Vardyn*, the vague application of the proportionality test does not render justice to the special substantial meaning given to human rights in the EU legal order. Additionally, the delegation to the national Court to decide about the restriction of Art. 21 TFEU (which has been argued in Section 4.3.3. of this paper to be the cause of the different reasoning on proportionality in *Runevič-Vardyn*) stops short of being truly convincing. This delegation may lead to undermining the coherence and consistency of EU law, as well as the essence of EU citizenship (Kochenov 2013: 17-18).

- In conclusion, a more coherent interpretation of the proportionality principle by the CJEU is urgently required in order to effectively protect the special substantial meaning given to fundamental rights in the EU legal order. This is especially true for citizenship cases where fundamental rights are intrinsically connected to fundamental freedoms. In order to achieve legitimacy, it is crucial to explore alternative ways to eliminate or at least diminish the pathologies of the principle of proportionality in the application of it by the CJEU. This will be the object of personal future research.

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[I] The 'fundamental status' has been established by the Court (Case C-184/99 *Grzelczyk* [2001] ECR I-06193) and it is gathered in Directive 2004/38/EC of the European Parliament and of the Council of 29 April 2004 on the right of citizens of the Union and their family members to move and reside freely within the territory of the Member States, [2004] OJ L158/77.

[II] A further explanation of this concept is provided is Section 2 of this paper.

[III] Case C-208/09 *Sayn-Wittgenstein* [2010] ECR I-13693.

[IV] Case C-391/09 *Runevič-Vardyn* [2011] ECR I-03787.
[V] Cf. Case C-36/02 *Omega* [2004] ECR I-9609; Case C-244/06 *Dynamic Medien* [2008] ECR I-505.
[VI] Joined cases C-96/03 and C-97/03, *A. Tempelman and Coniugi T.H.J.M. van Schaijk v. Directeur van de Rijksdienst voor de keuring van Vee en Vlees* [2005] ECR I-1895.
[VII] It is well-known the history of the incorporation of the fundamental rights as general principles of EU law to the case law of the CJEU (at that time CJEU), through which the Court has been able to guarantee the respect of human rights, before the first codification of the rights in the EU Charter.
[VIII] See for example *Omega* (n V); *Dynamic Medien* (n V); *Sayn-Wittgenstein* (n III).
[IX] Treaty establishing a Constitution for Europe, Official Journal of the European Union, notice number 2004/C 310/01 Volume 47, 16 December 2004.
[X] See Case C-122/00 *Schmidberger* [2003] ECR I-05659; Case C-341/05 *Laval* [2007] ECR I-11767; Case C-438/05 *Viking* [2007] ECR I-10779.
[XI] The hypothesis was already mentioned in the Introduction of this paper. According to Harbo, the CJEU is interpreting the proportionality principle in different ways, and these different interpretations are determined by the different areas of law in which it is applied as well as by the substance of the conflicting interests at stake.
[XII] Art. 6, para. 1, TUE: 1. "1. The Union recognises the rights, freedoms and principles set out in the Charter of Fundamental Rights of the European Union of 7 December 2000, as adapted at Strasbourg, on 12 December 2007, which shall have the same legal value as the Treaties"
[XIII] Case C-294/83, *Parti écologiste "Les Verts" v European Parliament* [1986] ECR 1986 Page 01339, para. 23.
[XIV] *Schmidberger* (n X), para. 73. See, *inter alia*, Case C-260/89 *ERT* [1991] ECR I-02925, para. 41; and Case C-299/95 *Kremzow* [1997] ECR I-2629, para. 14.
[XV] Joined Cases C-402/05 P and C-415/05 P, *Yassin Abdullah Kadi and Al Barakaat International Foundation v Council and Commission* [2008] ECR I-06351, para. 307.
[XVI] *Ibid.*
[XVII] *Sayn-Wittgenstein* (n III).
[XVIII] *Runevič-Vardyn* (n IV).
[XIX] (Gesetz über die Aufhebung des Adels, der weltlichen Ritter- und Damenorden und gewisser Titel und Würden) of 3 April 1919 (StGBl. 211/1919), in the version applicable to the main proceedings (StGBl. 1/1920; 'the Law on the abolition of the nobility'). It has constitutional status under Article 149(1) of the Federal Constitutional Law (Bundes-Verfassungsgesetz).
[XX] *Sayn-Wittgenstein* (n III), para. 22.
[XXI] *Sayn-Wittgenstein* (n III), para. 23.
[XXII] *Sayn-Wittgenstein* (n III), para. 24.
[XXIII] *Sayn-Wittgenstein* (n III), para. 27-30.
[XXIV] *Sayn-Wittgenstein* (n III), para. 35.
[XXV] *Sayn-Wittgenstein* (n III), para. 71.
[XXVI] *Sayn-Wittgenstein* (n III), para. 83.
[XXVII] *Sayn-Wittgenstein* (n III), para. 87; *Omega* (n V), para. 30; Case C-33/07 *Jipa* [2008] ECR I-5157, para. 23.
[XXVIII] *Sayn-Wittgenstein* (n III), para. 89.
[XXIX] *Sayn-Wittgenstein* (n III), para. 91; *Omega* (n V), para. 37-38.
[XXX] *Sayn-Wittgenstein* (n III), para. 93.
[XXXI] *Runevič-Vardyn* (n IV), para. 20.
[XXXII] *Runevič-Vardyn* (n IV), para. 25.
[XXXIII] *Runevič-Vardyn* (n IV), para. 50.
[XXXIV] *Runevič-Vardyn* (n IV), para. 76. See to that effect, Case C-148/02 *Garcia Avello* [2003] ERC I-11613, para 36; Case C-353/06 *Grunkin and Paul* [2008] ERC I-07639 paras 23-28; and *Sayn-Wittgenstein* (n VI), paras 67, 69 and 70.
[XXXV] *Runevič-Vardyn* (n IV), para- 77.
[XXXVI] See, also to that effect, *Garcia Avello* (n XXXIV), para. 36, and *Sayn-Wittgenstein* (n III), paras 55 and 66-70.
[XXXVII] *Runevič-Vardyn* (n IV), para. 83.
[XXXVIII] *Runevič-Vardyn* (n IV), para. 84.
[XXXIX] *Runevič-Vardyn* (n IV), para. 89 and 90.
[XL] *Runevič-Vardyn* (n IV), para. 90. See Joined Cases C-482/01 and C-493/01 *Orfanopoulos and Oliveri* [2004] ECR I-5257, para. 98.

[XLI] *Runevič-Vardyn* (n IV), para. 91.
[XLII] *Runevič-Vardyn* (n IV), para. 92.
[XLIII] *Sayn-Wittgenstein* (n III), para. 93.
[XLIV] *Runevič-Vardyn* (n IV), para. 92.
[XLV]Harbo´s premise was already mentioned in the Introduction of this paper. He affirms that the CJEU is interpreting the proportionality principle in different ways, and these different interpretations 'are determined by the different areas of law in which it is applied and the substance of the conflicting interests at stake'.
[XLVI] *Runevič-Vardyn* (n IV), para. 65.
[XLVII] *Runevič-Vardyn* (n IV), para. 86.
[XLVIII] *Sayn-Wittgenstein* (n III), para. 92. Concretely the CJEU says in this paragraph: 'It must also be noted that, in accordance with Article 4(2) TEU, the European Union is to respect the national identities of its Member States, which include the status of the State as a Republic'.
[XLIX] Article 20 of the Charter of Fundamental Rights of the European Union enshrines: 'Everyone is equal before the law'.
[L]Art. 3(3) TEU says: 'It (the Union) shall respect its rich cultural and linguistic diversity, and shall ensure that Europe's cultural heritage is safeguarded and enhanced'. Article 22 of the Charter of Fundamental Rights of the European Union enshrines: 'The Union shall respect cultural, religious and linguistic diversity'.
[LI] See *Omega* (n V); *Dynamic Medien* (n V).
[LII] See *Sayn-Wittgenstein* (n III), para. 86; *Omega* (n V), para. 30; and *Jipa* (n XXVII), para. 23.
[LIII] *Sayn-Wittgenstein* (n III), para. 86.
[LIV] *Sayn-Wittgenstein* (n III), para. 64.
[LV] *Sayn-Wittgenstein* (n III), para. 65.
[LVI] Case C-135/08 *Rottman* [2010] ECR I-01449.
[LVII] *Omega* (n V).
[LVIII] *Dynamic Medien* (n V).
[LIX] Reference to it has already been mentioned in section 4 of this article.
[LX] *Sayn-Wittgenstein* (n III), para. 52.
[LXI] The reference for preliminary ruling was received on 10 June 2009. The EU Charter acquired binding force with the entry into force of the Lisbon Treaty on 1 December 2009.
[LXII] See Case *Runevič-Vardyn* (n IV), para. 76; *Garcia Avello* (n XXXIV), para. 36; *Grunkin and Paul* (n XXXIV), para. 23-28; and *Sayn-Wittgenstein* (n III), paras. 67, 69 and 70.
[LXIII] *Sayn-Wittgenstein* (n III), para. 86; *Omega* (n V), para. 30; and *Jipa* (n XXVII), para. 23.
[LXIV] *Runevič-Vardyn* (n IV), para 89-90.
[LXV] *Runevič-Vardyn* (n IV), para. 90. See also *Orfanopoulos and Oliveri* (n XL), para. 98.
[LXVI] *Runevič-Vardyn* (n IV), para. 92.
[LXVII] 10 June 2009 and 2 October 2009 respectively.
[LXVIII] *Runevič-Vardyn* (n IV), para. 91.

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Indirect Taxation and the role of the European Court of Justice within the preliminary reference procedure

by

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Abstract

This article examines the interpretation of indirect taxes by the Court of Justice of the European Union (hereinafter, "CJEU" or "the Court") by means of the preliminary reference procedure. It is argued that the nature of the relationship between the national courts that send requests for preliminary rulings and the CJEU has undergone profound changes. By analysing the case law in the field of indirect taxation, the aim is to identify the new elements that frame this jurisdictional dialogue, as well as to explain how this framework affects the hermeneutic criteria employed by the Court. Finally, in this particular field, it will be stressed that the CJEU adopts a hierarchical role, rather than the traditional cooperative one as set out in the Treaty.

Key-words

Preliminary reference procedure, CJEU, indirect taxation, reformulation, formula, hypothetical questions, artificial dispute, effet utile, constructive cooperation, hermeneutic criteria, hierarchical model of justice

1. Introduction

The aim of this article is to contrast the classical axioms of the preliminary reference system with the current case law in the field of indirect taxation. These axioms can be defined as the structural elements – the bricks, in a metaphorical sense – of the interplay between the national courts which pose questions for preliminary rulings and the CJEU. In this complex and unsteady procedural framework, these axioms enable the Court to pinpoint exactly which are the specific functions and goals of the national courts within the preliminary reference procedure. How do we recognise these axioms in the case law? The answer is very easy: those axioms emerge as "*formulas*" employed by the Court in its legal reasoning. Therefore, my idea with this article is to challenge these axioms represented in the *"formulas*" used in the case law in this particular field on indirect taxation (Azoulai 2009: 165).

For the purpose of this article, I will focus on the analysis of the following indirect taxes: (i) Taxes on the raising of capital regulated by Council Directive 2008/7/EC of 12 February 2008 concerning indirect taxes (hereinafter, "Capital Duty Directive");[I] and (ii) the Value Added Tax regulated by the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (hereinafter, "VAT Directive").

According to cases selected in relation to these two types of taxes, I emphasize that the interpretation of EU indirect tax law by the CJEU suggests that the preliminary reference scheme may not be generally applicable. Indeed, the necessity for the CJEU to look into the factual context of each case, in addition to solving the matter in dispute, is an element which, among others, clearly shows the breach of the axioms of the preliminary reference.

Insofar as the axioms of the preliminary reference procedure are challenged whenever the Court considers cases related to indirect taxation, the new procedural framework influences the hermeneutic criteria used by the Court in making decisions. Finally, this article claims that the case law in the field of indirect taxation is a good example of the change of policy that the CJEU is adopting towards a hierarchical model of justice, rather than a cooperative one, in the field of indirect taxation. In other words, the traditional functions of the CJEU within the preliminary reference system are being replaced by those which belong to a national Supreme Court.

2. The breach of the axioms of the preliminary reference procedure in the field of indirect taxation

Article 267 TFEU (ex article 177 TCE) sets out a clear distribution of roles between the national courts and the Court of Justice of the EU. According to this provision, the CJEU has the right to interpret EU law at the request of national courts which apply that law – as interpreted by the Court – to the cases they are dealing with. In other words, under this model of cooperation, whereas national courts have exclusive jurisdiction to raise questions for preliminary reference by means of assessing the relevance and content of the questions to be addressed, the CJEU is confined to giving an abstract interpretation of EU law that should be useful for the former. The idea behind this cooperation between national courts and the CJEU is thus a dialogue in *"equality of arms"*.

As long as the tasks are clearly assigned, the preliminary reference procedure provides a rigid framework for safeguarding the above-mentioned distribution of roles between the national courts and the CJEU. Taking into account the drafting of preliminary rulings by the Court, the following three axioms, which constantly emerge as "formulas" in the case law, can be extracted to characterize this relationship:

i. The national court is the only body competent for providing the CJEU with the facts and the applicable national law. The CJEU is therefore confined to interpreting EU law within the fixed parameters provided by the national court.
ii. The national court is the only body competent for resolving the case at stake, using the interpretation of EU law given by the CJEU.
iii. The Court is precluded from answering either references raised in artificial claims or hypothetical questions.

Our task in the following section is precisely to challenge the above mentioned three axioms with the case law of the CJEU within the field of indirect taxation.

2.1. The growing importance of the facts and national law settings

One of the main axioms of the preliminary reference procedure, put forth in *Salgoil,*[II] was the preclusion of the CJEU to appraise the facts of the case: *"Article 177 is based on a distinct separation of functions between national courts and tribunals on the one hand and the Court of*

Justice on the other, and it does not give the Court jurisdiction to take cognizance of the facts of the case, or to criticize the reasons for the reference." This means that the Court was not entitled to examine the facts of the case, nor to rule on the compatibility of the domestic provisions with EU law. The Court has, however, progressively widened its room for manoeuvre in order to examine the facts provided by a national court and the national law background applicable to the case at stake (Lenaerts 1994: 356).The breach of this *Salgoil* axiom came about in two stages.

First, as LENAERTS points out, the Court introduced a duty on the national court to provide an adequate and proper explanation of both the facts and the applicable national law. In the event that this requirement was not fulfilled, the CJEU would be forced to reject the reference for a preliminary ruling (Lenaerts 1994: 359; Barnard and Sharpston 1997: 1145). In its landmark decision, *Telemarsicabruzzo,*[III] the Court concluded that the information contained in the order of reference was fragmentary and inadequate for the Court to give a ruling, taking into account the importance of the facts in the field of competition law. Thus, in the words of KOVAR, *Telemarzicabruzzo* envisages the new framework of the preliminary reference procedure as a cooperation *"disciplinée"* between the national court and the CJEU (Kovar 2010 : 275).

The obligation to provide the CJEU with adequate factual context prevents the Court from giving an abstract judgment on the interpretation of EU law that would not be useful to the national court for solving the case in question.

The entrenchment of this cooperation *"disciplinée"* is also visible in terms of the reformulation of the references requested by the national court. According to the *Salgoil* reasoning, which strived at a radical separation between interpretation and application, some scholars conceptualised the reformulation of the preliminary references as a mechanism for phrasing new concepts of EU law (Bergerès 1985 : 158). To this effect, the reformulation was deemed to be an abstract task, a purely interpretative attempt to develop new categories of EU law that should be applied on a general basis in all cases. To put it another way, the idea was that the reformulation of preliminary references needed to be separated from the factual context provided by the national court.[IV] The CJEU has, however, begun to oversee the way in which the questions for preliminary references are drafted and submitted by national courts with the aim of giving a precise interpretation of the relevant EU law that is useful for the national courts to decide the case.[V] In other

words, for the purposes of reformulating or reframing the references for preliminary ruling, the Court will specify and flesh out the questions in light of the particular facts set out in the order for reference and the national case-file. For instance, in the recent case of *Nilaş and others,*[VI] the Court notes that: *"the fact that a national court has, formally speaking, worded a question by referring to certain provisions of European Union law does not preclude the Court from providing to the national court all the elements of interpretation which may be of assistance in adjudicating on the case pending before it, whether or not that court has referred to them in its questions. It is, in this context, for the Court to extract from all the information provided by the national court, in particular from the grounds of the decision referring the questions, the points of European Union law which require interpretation, regard being had to the subject-matter of the dispute".*

Second, not only is it necessary to provide an adequate description of the facts and the national law but, as the case law on indirect taxation reveals, this factual context also forms part of the final judgment. The interpretation of the relevant EU law provided by the CJEU depends on the description of these national settings.[VII] In *Schriever,*[VIII] the referring court asked whether or not a transaction, whereby a trader transferred the stock and fittings of his retail outlet to a purchaser and merely leased the premises which he owned to the purchaser for an indefinite period but terminable at short notice by either party, amounted to a *"transfer of a totality of assets within the meaning of the Sixth Directive"*. This specific narrative required the Court to take into account the relevant facts:[IX] *"It follows from the foregoing considerations that an overall assessment must be made of the factual circumstances of the transaction at issue in order to determine whether it is covered by the concept of the transfer of a totality of assets for the purposes of the Sixth Directive. In that context, particular importance must be attached to the nature of the economic activity which it is sought to continue."* Likewise, with regard to the taxes on an increase in shared capital, the recent case of *Speranza*[X] reveals how the Court considers the facts contained in the order of reference: *"it is also apparent from that file that it subsequently emerged, before the duty had been paid, that, as result of fraud, the contribution of assets had not in fact taken place at the time of registration and it was clear that it would not take place. In such circumstances and in the light of the considerations set out at paragraphs 32, 34 and 36 above, there could therefore be no demand for payment of capital duty."*

The level of detail of the indirect taxation regulations within the relevant EU law requires the Court to carefully examine the file of the case provided by the national court in order to reply properly to the national court. The indirect taxation case law demonstrates

that the task assigned to the CJEU cannot be confined to giving an abstract interpretation of EU law.

2.2. The solution to the dispute: does the CJEU rule on the compatibility of national provisions with EU law?

The crucial role of the facts and national legal settings for the interpretation of indirect taxation directives creates a new role for the Court by means of the preliminary reference procedure. According to one classical axiom mentioned above, article 267 TFEU precludes the CJEU from actually resolving the case at stake. Whereas the interpretation of EU law belongs to the Court alone, the application of the judgment falls within the scope of national courts. Therefore, the Court cannot rule on the compatibility of national law with EU law:[XI]

"It should first of all be noted that, although in proceedings brought under Article 177 of the Treaty, it is not for the Court to rule on the compatibility of national rules with provisions of Community law, the Court is competent to give a ruling on the interpretation of Community law in order to enable the national court to assess the compatibility of those rules with the Community provisions."

This formula, strongly evident in the case law of the Court, forestalls abstract interpretations of EU law which are not useful for national courts (Lenaerts 2006: 190). It should be noted that only the national court is endowed with the exclusive competence to set aside national provisions in breach of EU law.

In relation to the case law on indirect taxation, however, inasmuch as the CJEU has an adequate knowledge of the facts and applicable national law, it really does solve the dispute in question. Hence, the national court is only required to implement the judgment of the CJEU which is *per se* directly applicable.[XII] What is omitted from this new procedural framework applicable to indirect taxation is the distinction between interpretation and application. This phenomenon can easily be identified in the preliminary rulings handed down by the CJEU concerning the classification of goods under the Common Custom Tariff Nomenclature. In cases like *Gmurzynska-Bscher*[XIII], the Court ruled that *"a work of art consisting of a steel plate with a fused coating of enamel-glaze colors constitutes a painting executed entirely by hand within the meaning of Heading 9701"*. Insofar as the CJEU solves the dispute at stake, the national court is only obliged to implement the judgment of the Court. The justification for this breach of the established division between interpretation and application is clear:

customs duties at EU countries" national borders were abolished and replaced by a harmonized and uniform system for taxing imports (the Common Customs Code). As long as a harmonized regulation is contained within the Common Customs Code and the national court provides an adequate description of the facts, a shift in the role of the CJEU can be observed. The Court cannot be confined to providing an abstract interpretation of EU law; it must decide upon the case at stake. The same circumstances arise when the Court deals with cases belonging to the field of indirect taxation: a widely applicable regulation contained within the Directives as well as an adequate knowledge of the facts and national law background. The final outcome overcomes transcends the rigid margins of a mere interpretation of EU law. In *Komen,*[XIV] the dispute was about the meaning, for VAT purposes, of the transfer of a building in which the vendor started refurbishment works before the sale of the property. To the extent that those works required to be continued by the purchaser of the building, the national court questioned whether or not this transfer was deemed to be VAT exempted. The answer of the Court was that the "*directive must be interpreted as meaning that the exemption from value added tax provided for in that first provision covers a supply of immovable property consisting of a plot of land and an old building undergoing transformation into a new building, such as that in issue in the main proceedings, where, at the time of that supply, the old building had only undergone partial demolition work and was, at least in part, still used as such".* In this case, the national court was forced to considering this transaction as VAT exempted. The same wording is used by the Court in the cases concerning the indirect taxes regarding the raising of capital, like the recent case of *Immobilien Linz GmbH:*[XV] *"Article 4(2)(b) of Council Directive 69/335/EEC of 17 July 1969 concerning indirect taxes on the raising of capital, as amended by Council Directive 85/303/EEC of 10 June 1985, must be interpreted as meaning that the absorption by a member of a company's losses pursuant to an undertaking given by the member before the losses were sustained, the sole purpose of which was to cover such losses, does not increase the assets of that company".*

Not only does the Court give a preliminary ruling on the interpretation of concepts that are directly applicable by the national court, it also takes a further step forward. Although, the Court cannot rule on the compatibility of EU law with national provisions, the terms employed in the preliminary rulings "*Articles ….. Treaty precludes national legislation.../doesn't come within the scope of EU law..."* go beyond a simple and abstract interpretation of EU law. In practice, the decision of the CJEU is therefore directly applicable, although formally the

national court is the only body with the competence to strike down the national provisions which are in breach of EU law. As in the case of *Peter David,*[XVI] national authorities are compelled to put a stop to an administrative practice. *"Articles 167, 168(a), 178(a), 220(1) and 226 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax must be interpreted as precluding a national practice...".*

The need for the CJEU to know the facts and the applicable national law, together with the detailed regulations within the field of indirect taxation, weaken the position of the national court which is confined to implementing the preliminary ruling that comes from Luxembourg. In order to give a useful and effective response to the questions posed by national courts, there has been a shift in the role of the CJEU with regard to indirect taxation. Rather than being limited to an abstract interpretation of EU law, the Court solves the pending case pending before the national court.

2.3. The preclusion of answering either hypothetical questions or questions raised in artificial disputes

Finally, the case law on indirect taxation reveals the weaknesses of the concepts of *"artificial dispute"* and *"hypothetical question"* which emerged for the first time in the *Foglia v. Novello*[XVII] cases. In a transaction between two private parties relating to the sale of liquor wine from Italy to France, a French custom duty that was charged on the transaction was challenged before an Italian court. The Court declined jurisdiction to give a ruling on the grounds that *"(I)t thus appears that the parties to the main action are concerned to obtain a ruling that the French tax system is invalid for liqueur wines by the expedient of proceedings before an Italian court between two private individuals who are in agreement as to the result to be attained and who have inserted a clause in their contract in order to induce the Italian court to give a ruling on the point."*[XVIII]

From this judgment, and with the aim of demonstrating the evolution of this axiom, I can draw a distinction between the prohibition from responding to hypothetical questions and the preclusion of answering questions raised in artificial disputes.

In relation to the first preclusion, the Court has declined jurisdiction to reply to questions addressed to it which were not linked with the dispute in question, such as in the cases of *Ritter-Coulais,*[XIX] *or Lourenço Dias.*[XX] In the latter case, the CJEU refused to reply to certain questions posed concerning the compatibility of the Portuguese motor-vehicle tax with EU law on the grounds that the questions raised were manifestly irrelevant for the

purposes of deciding the case. Although, in general terms, the questions addressed to the CJEU need to be connected with the facts of the case in order to prevent the Court from giving advisory and abstract opinions, some exceptions can be found in the case law in the field of taxation. The preliminary references requested by the Swedish advisory board, the *Skatterättsnämnden,* in which the Court deals with questions related to future, planned transactions that have not yet taken place, are an example of this. In cases like *X AB and Y AB* or in *X e Y,*[XXI] the Court actually gave a preliminary ruling despite the fact that the transactions in question had not yet been performed. Despite the hypothetical nature of the transaction, the Court justified its decision to respond on the grounds that the resolutions issued by the *Skatterättsnämnden* can be challenged before the *Regeringsrätten.* Therefore, a nuance is introduced into the abovementioned preclusion from answering "hypothetical questions": only those references which are *"sub judice"* allow the Court to give a preliminary ruling. In other words, the preclusion of answering hypothetical questions, does not apply to questions concerning future transactions raised by an advisory board such as the *Skatterättsnämnden* when the resolution can be challenged before an upper court.

With regard to the second preclusion, the CJEU declines jurisdiction to give a preliminary ruling whenever the dispute before the national court is not genuine. In order to assess whether or not the dispute in question is genuine, the Court is limited to carrying out a subjective analysis: what were the intentions of the parties when they raised the claim that enabled the national court to request a reference for a preliminary ruling? It should, however, be noted that this subjective approach has led to contradictory and unsatisfactory responses from the Court. For instance, in *Celestini*[XXII], an Italian Court referred to the CJEU questions for preliminary references related to a dispute between an Italian producer of wine and a German undertaking which was a buyer of this wine. The questions referred by the Italian Court focused on the compatibility of EU law with German provisions that established controls for testing the conformity of the imported wine introduced with Community regulations (oxygen 16/18 method). Although, the facts of *Celestini* and *Foglia v. Novello* are quite similar – both concerning the challenging of EU Member State legislation before a court or tribunal of another Member State in a transaction between two private parties – the Court admitted the references submitted in *Celestini,* without an adequate justification: *"Admittedly, neither Celestini nor Faber, both of which contest the legality of the*

oxygen 16/18 method, brought the matter before the German courts, which alone have jurisdiction to rule on the validity of the measure whereby the German authorities declared the wine in question unfit for human consumption. However, that finding is not in itself sufficient for the reference for a preliminary ruling to be regarded as inadmissible. There is nothing in the documents before the Court which clearly shows that the parties to the main proceedings had, as was the case in Foglia, jointly fabricated a dispute as a device for obtaining a preliminary ruling from the Court". Due to the lack of an explanation as to the criteria followed by the Court in assessing the genuineness of the dispute,[XXIII] the "subjective *test"* signifies a clear breach of the minimum standards of legal certainty. Likewise, this approach has provoked peculiar decisions such as the one in *Bertini*[XXIV], in which the Court replied to the questions submitted that: *"it is difficult to see how the answers which the Court is asked to give can influence the decision in the main proceedings. It should be added that there is nothing to suggest that those proceedings constitute in reality a procedural contrivance".* The wide criterion employed in *Bertini* could result in the removal of the notion of "artificial dispute" on the grounds that if the national court asks a question for preliminary ruling, there is a reason for that and the reference should be admitted.

The above criticisms and the uncertainty created by the Court with regard to the subjective *test* reveal the failure of the notion of "artificial claim". Moreover, as the case law in the field of taxation shows, to what extent do private parties *"fabricate"* a case with the ultimate goal of obtaining a judgment of the CJEU that asserts the breach of EU law by national provisions? Since article 258 TFEU does not entitle private parties to challenge national legislation which contravenes EU law by means of the infringement procedure, the preliminary reference procedure can be a suitable tool to remedy this lack of standing. Therefore, it should be noted how private parties or individuals can, in their pleadings, influence or convince a national court to pose a question for preliminary ruling on the basis that the national provisions are contrary to EU law. How can the Court draw a conclusion as to whether the dispute is artificial or genuine when it appears from the facts that the parties have "fabricated" the case in order to seek a preliminary ruling? For instance, in *Idéal Tourisme*[XXV], a dispute about the rate of the VAT to be charged in respect of the international transport of passengers, the undertaking in question considered the transaction to be exempt from the VAT, although the relevant Belgian legislation stipulated a VAT rate of 6% for these types of transactions. The decision not to apply the rate set out in the national legislation was justified by the undertaking on the basis of the existing

exemption in respect of international air transport which was considered as exempt. Although Belgium expressed its doubts about the artificial nature of the claim, the Court admitted the reference. Since the undertaking did not comply with the Belgian legislation, it could be deduced that the aim was to bring the case before the Court and, therefore, obtain a preliminary ruling on the compatibility of the Directive with the national provisions.

In conclusion, it can be noted that this two-part axiom, which has been described as the prohibiting the CJEU from answering either hypothetical questions or questions raised in artificial disputes, has been weakened: the mere existence of the proceedings before a national court would be enough for the admissibility of the claim. The nature of this preclusion has been blurred.

3. The interpretative criteria employed by the Court in indirect taxation

The breach of these three axioms suggests a sui generis position of the CJEU when dealing with indirect taxation issues. Due to the growing prominence of the case-specific facts and national legal settings provided by national courts, the role of the Court cannot be limited to providing an abstract interpretation of the VAT Directive or the Capital Duty Directive that enables the national court to solve the dispute at stake. Therefore, as observed, the Court goes beyond an abstract interpretation of the Directives in order to solve the dispute pending at the national level. How does this new jurisdictional interplay between the CJEU and the national courts influence the way in which the Court justifies its judgments?

This section is devoted to analyzing the interpretative criteria employed by the Court in reaching a solution in cases relating to indirect taxation. The reasoning of the Court comprises a chain of hermeneutic criteria[XXVI] that lead to the final solution. In other words, the idea is to assess the impact of the breach of the classical axioms on the reasoning of the Court in the indirect taxation field.

3.1. Interpretative criteria in VAT

In the case of VAT, as *Henriksen*[XXVII] or *Stoppelkamp*[XXVIII] clearly demonstrate, the Court usually reaches the final decision by using the following hermeneutic criteria in the following order:

i. Firstly, insofar because as the VAT Directive is drafted in multiple official languages, the task of the Court is to look up the concept to be interpreted by means of comparing the different official linguistic versions of it (semiotic criteria of interpretation).[XXIX] The comparison of the different linguistic versions of the VAT Directive entitles the Court to conclude that there is no univocal meaning of the terms employed among the different versions.[XXX] Consequently, with the aim of overcoming the contradictions encountered, the CJEU *"communitarizes"* the term. In other words, the term would have an autonomous meaning within the EU context. As in other areas of EU Law, the Court does not simply transpose the elements that shape a legal concept within the common legal traditions of Member States, but has rather sought to constructively and actively locate the legal concepts in the EU context. In the field of taxation, the communitarization of legal notions has acquired great importance, revealing the willingness of the CJEU to stimulate and achieve the common market goal, which is heralded in article 3.3 of the TFEU (ex- article 2 TEU). According to this article, any kind of hurdle that might impede the correct functioning of the common market must be removed. Inasmuch as substantial disparities between national tax laws could jeopardize the achievement of the common market objective, the Court has communitarized the notion. Whenever the CJEU defines a concept in its judgments, the idea is that the definition must fit well with the policies and objectives laid down in the Treaties.[XXXI] The terms included in EU law must be defined in the context of European integration.

ii. Secondly, the construction of this autonomous concept is built upon the two following hermeneutic criteria that can be stressed in *Stoppelkamp*:[XXXII]

- Systemic and contextual criteria. The VAT Directive must be interpreted in a coherent manner in order to ensure consistency (paragraphs 23 y 24).[XXXIII] All the concepts that are relevant to VAT – taxpayers, taxable base, taxable transactions, exemptions...- require a uniform and univocal interpretation.
- Dynamic criteria. Not only is it necessary to pinpoint the autonomous terms within the general scheme of the VAT Directive, but those terms also need to be shaped into the objectives, principles and aims defined in the Directive. According to BENGOETXEA (Bengoetxea 1993: 252) the dynamic hermeneutic criteria can be

classified into: functional (the norms are to be interpreted in such a way that they function effectively); teleological (the norms should be interpreted to achieve the pursued goals); and, finally, consequentialist (the interpretation of the norm should foresee the consequences of this interpretation). For instance, in *Stoppelkamp,* the ECJ adopts a consequentialist criterion.[XXXIV]

3.2. Interpretative criteria in the indirect taxation on the raising of capital

With regard to the indirect tax that is charged upon the raising of capital, *ESTAG*[XXXV] can be selected as a paradigmatic case in terms of the reasoning of the Court in this area. Unlike the cases commented upon in the VAT area, the ECJ takes a completely different approach, based on the understanding of the transaction in question. Recalling the words of the Court, "*the economic point of view*" guides the hermeneutic task of the Court in cases concerning the indirect taxation on the raising of capital: *"As is clear from paragraph 11 of the judgment in Case C-49/91 Weber Haus [1992] ECR I-5207, in order to decide whether or not a transaction falls within the scope of Article 4(2)(b) of Directive 69/335, it is necessary to adopt an economic approach, and not a formal one based solely on the source of the contributions".* The Court skips the semiotic/linguistic criteria[XXXVI] to adopt a hermeneutic approach that can be qualified as functional. To put it another way, rather than comparing the different linguistic versions of the Directive and, additionally, building an autonomous concept, the Court carefully examines the facts provided by the national court to determine if the transaction performed comes within the scope of the Capital Duty Directive.

In *ESTAG,* the national court asked, essentially, whether *"Article 4(1)(c) of Directive ICC is to be interpreted as meaning that the expression contribution of assets of any kind used therein covers additional payments when they are made to subsidiaries of the capital company which is increasing its capital by the issue of new shares".* To answer this question, the reasoning of the court follows these steps:

i. The Court rejects a systemic hermeneutic criterion advocated by ESTAG (the undertaking party to the dispute) that suggests that the terms of the Capital Duty Directive need to be interpreted consistently within all the norms. According to this criterion, article 5 of the Capital Duty Directive, related to the taxable base must be jointly interpreted with article 4, being the article that contains the description of the taxable transactions. In light of the above, *"ESTAG claims that,*

having regard to the terms of Article 5(1)(a) of Directive 69/335, only contributions made by direct members of the capital company which receives them are subject to capital duty. Since payments such as those in issue in the main proceedings do not satisfy that criterion, they do not come within the scope of Article 4(1)(c) of that directive (paragraph 35).” This approach can also be deemed to be *formal* due to the fact that it searches for a literal/abstract interpretation of the articles of the Capital Duty Directive without questioning the nature of the transaction performed.

ii. In this regard, the economic approach should prevail over a systemic interpretation of the Capital Duty Directive (paragraphs 37-39). The facts provided by the national court are decisive to solve the dispute: *“In a situation such as that in the main proceedings, which is characterized, first, by the fact that the company which has contracted to make certain payments in order to acquire a holding in another company is the subsidiary of the company which has actually made those payments and, secondly, by the fact that such payment has discharged the liability of that subsidiary, the payment is to be regarded as having been made by the subsidiary in its capacity as a member of the company which is increasing its capital.”* Therefore, and taking into account the particular circumstances of the case, the payment of ATS 5,083,332,000 made by the holding company on behalf of its subsidiary, described as a *non-refundable shareholder's contribution,* comes within the scope of Article 4(1) of the Capital Duty Directive as an increase of a capital company. The economic understanding of this complex transaction enables the Court to set aside a systemic interpretation of the Directive handled by the undertaking[XXXVII] (paragraph. 37).

iii. Finally, this economic hermeneutic approach is linked to a teleological-consequentialist argument. By admitting the interpretation advocated by ESTAG, the effectiveness of article 4 of the Directive would be undermined, *“since a company belonging to a group could carry out a transaction coming, theoretically, within the ambit of that directive without that transaction attracting capital duty (paragraph 40)”*. In other cases, the CJEU enhances its functional hermeneutic approach to through the aims or purposes contained in the Capital Duty Directive [XXXVIII] (teleological criterion).

3.3. A heterogeneous hermeneutic approach within the field of indirect taxation

What can be asserted throughout from the comparison between of the cases involving VAT and cases those related to the taxes on the increasing of capital is that the reasoning of the Court is completely different. Although, the facts and national law settings provided by the national courts are equally important in both types of cases in enabling the Court to resolve the dispute at stake, the chain of hermeneutic criteria employed to reach the final decisions are is diverse. In other words, the breach of the abovementioned axioms of the preliminary reference procedure is transformed into different interpretative approaches within the field of indirect taxation. For instance, in the case of VAT, as *Stoppelkamp* proves, the systemic hermeneutic criterion necessitates a coherent and consistent interpretation being applied to the whole Directive. By comparison, however, in the case of taxes on the raising of capital, as *ESTAG* shows, this systemic criterion is precluded in order to uphold an economic/functional interpretative criterion.

The lack of a homogenous interpretative approach can be clearly explained through the distinctive normative framework that the Court is required to deal with. While the VAT Directive contains a general and exhaustive regulation that considerably restricts the room for manoeuvre of the national legislator, the provisions contained in the Capital Duty Directive still require need to be implemented and detailed in the through national legislation. Thus, in the cases concerning the taxes on the raising of capital, the Court must interpret the questions posed by the national court within the context of the aims and purposes set out in the Capital Duty Directive. Because the Court needs to understand the transaction undertaken by the parties in the case of taxes on the raising of capital, a semiotic interpretative criterion of the Directive does not make sense. In VAT cases, however, the Court is required to take note of the nuances derived from the text of the VAT Directive drafted in the official languages and the final normative text implemented in the Member States. Therefore, it is only logical to start with the semiotic hermeneutic criterion, in the case of VAT-related disputes, to start with the semiotic hermeneutic criterion.

To sum up, the break breach of the axioms of the preliminary reference procedure has provoked a fragmentary approach to in the interpretative task of the Court.

4. Conclusion: towards a new, hierarchical model of cooperation

As commented in section two of this article, the preliminary reference procedure was built under a scheme of dialogue in "equality *of arms"*. The meaning of this jurisdictional cooperation between the Court and the national courts thus implied that each court performed its own task: whereas the CJEU interpreted EU Law, the monopoly of on the drafting of the questions for preliminary reference exclusively belonged exclusively to the national court. Indeed, pursuant to this rigid framework of dialogue, it transpired that whenever the Court perceived that the questions requested by the national court were drafted in an erroneous way or when the terms employed by the national court were imprecise or obscure, article 101.1 of the Rules of Procedure (ex. article 104.5 of the former Rules of Procedure) merely provided for a mechanism to request clarifications from the referring body.

Is this theoretical scheme still applicable to the case law concerning indirect taxation? The breach of the axioms of the preliminary reference procedure paved the way for a substantial shift in the meaning of cooperation. Rather than a rigid scheme of distribution of roles between the national courts and the CJEU, the preliminary reference system is moving towards a *"constructive cooperation model"*.[XXXIX] Such a constructive cooperation is rooted in the "*effet utile*" doctrine that pursues a useful answer to the questions posed by the national court and enables the Court to go beyond an abstract interpretation of EU law. Obviously, this new model of constructive cooperation entails a hierarchical element that strengthens the role of the CJEU as a court of last resort, thereby resembling the role of a Supreme Court at the national level. The role of the national courts, which poses the question for preliminary reference, is thus limited to implementing the judgement handed down by the Court.

The diverse hermeneutic interpretation criteria employed by the CJEU in the cases within the field of indirect taxation reveals that there is not a unique approach to the interpretation of the Directives. The substantial differences between the VAT Directive and the Capital Duty Directive demand a completely different hermeneutic approach, although in both cases, the Court takes into consideration the facts provided by the relevant national court and resolve the case at stake in both domains.

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I Capital duty is an indirect tax, which interferes with the free movement of capital. This Directive acknowledges that the best solution would be to abolish the duty, seeing it as harmful to business development within the European Union (EU). However, the loss of revenue which would result from the immediate application of such a measure is unacceptable for certain Member States. Accordingly, those Member States that charged the duty as of 1 January 2006 may continue to do so under strict conditions. See: http://europa.eu/legislation_summaries/taxation/l25098_en.htm.

II Case C-13/68, *Salgoil,* [1968] 661; Case C-100/64, *Van der Veen,* [1964] 1105; Case C-20/67*, Kunstmühle Tivoli*, [1968] 293; Case C 20/64, *Albatros,* [1965], 29, paragraphs 34-35.

III Joined Cases C-320/90 – C-322/90, *Telemarsicabruzzo,* [1993] I-393, paragraph 8.

IV *"Ce préliminaire parfois nécessaire étant acquis, il est possible pour la Cour de passer à l'abstraction communautaire. En d'autres termes, il s'agit de dégager de la gangue de la formulation les éléments théoriques qui sont susceptibles de se ranger dans les catégories ou les concepts du droit communautaire"* (Bergerès 1985: 158).

V It is necessary to underline this progressive process to intervene into the national court's sphere of competence. Firstly, the Court has started to reject references raised by national bodies (setting up a control of admissibility); and secondly, the Court tries to monitor the use by national supreme courts of the procedural exception called "*acte clair"* (i.e. the *Köbler* doctrine).

VI C-248/11, *Nilaş and Others*, [not yet reported], dated 22 March 2012, paragraph 31.

VII *"…la clarification du contexte juridique national, qui est determinant, devient un aspect substantiel de toute la procédure préjudicielle et même de l'arret de la Cour"* (Rodríguez Iglesias 1987: 596).

VIII Case C-444/10*, Schriever*, [not yet reported] dated 10 November 2010, paragraph 32; also, see the way the factual context determines the judgment of the Court in Case C-572/07, *RLRE Tellmer Property,*[2009] I-10333

IX *Schriever* (n VIII), paragraph 32.

X Case C-35/09, Speranza, [2010] I-06581, paragraphs 37-38.

XI Case C-130/93, *Lamaire*, [1994] I-3215, paragraph 10.

XII *"...che la questione sollevata raramente si limita alla richiesta di mera interpretazione della norma comunitaria, coinvolgendo sovente anche la compatibilità con quest' ultima della norma interna, e, dall'altro, che la sentenza della Corte puó, per il contenuto che la caratterizza nello specifico caso, porsi come immediatamente decisoria della controversia pendente dinanzi ai giudici nazionali, oppure essere fonte di ulteriori accertamenti di fatto in capo al giudice nazionale"* (Melis 2005: 401); *"The functions of the ECJ and the national courts are distinct. The first is limited to the interpretation of Community Law and to deciding whether actions by the Community or its institutions are valid. The latter has to apply Community Law (as interpreted and explained by the ECJ) to the facts of the case. This functional separation between interpretation and application is not as strict in practice as it may be in theory, because the ECJ renders its ruling within the factual context of the referred case. The facts and circumstances may be so specific that the ECJ's preliminary ruling may not be generally applicable"* (van Brederode 2009: 61). See also Nucera 2010: 62 and Scuffi 2005: 6529.

XIII Case C- 231/89, *Gmurzynska-Bscher*, [1990] I-4003; Case C-66/99, *Wandel*, [2001] I-00873.

XIV Case C-326/11, *Komen,* [not yet reported] dated 12 July 2012.

XV Case C-492/10, *Immobilien Linz GmbHm,* [not yet reported] dated 1 December 2011.

XVI Joined Cases C-80/11 and C-142/11, *Mahagében kft and Peter David,* [not yet reported] dated 21 June 2012.

XVII Case C-104/79, *Foglia v Novello*, [1980] 00745; Case C-244/80, *Foglia v Novello,* [1981] 03045.

XVIII Case C-104/79, *Foglia v Novello*, [1980] 00745, paragraph 10.

XIX Case C-152/03, *Ritter-Coulais*, [2006] I-01711.

XX Case C-343/90, *Lourenço Dias,* [1992] I-04673.

XXI Case C-200/98, *X AB and Y AB*, [1999] I-8264, paragraph 22; Case C-436/00, *X e Y,* [2002] I-10829.

XXII Case C-105/94, *Celestini,* [1997] I-2971, paragraphs 23-26.

XXIII See also Case C-150/88, *Provide,* [1989] I-3891, paragraph 12*: "the documents before the Court do not allow any doubt as to the genuineness of the dispute in the main proceedings or, therefore, the propriety of the request for a preliminary ruling."*

XXIV Joined cases C-98, 162, 258/85, *Bertini,* [1986], 01885, paragraph 8.

XXV Case C-36/99, *Idéal Tourisme,* [2000], I-6049, paragraph 22.

XXVI For the purpose of this article, I adopt the classification of hermeneutic criteria defined by Bengoetxea 1993: 262: *"Justificatory arguments do not appear in isolation; they mutually support each other, and the final, law-applying or law-interpreting decision is justified not by this or that particular argument, but rather by the cumulative weight of all the*

arguments brought together in the Court's opinion as a coherent, mutually supporting structure"; See also Bengoetxea, MacCormick and Moral Soriano 2001.

[xxvii] Case C -173/88, *Henriksen*, [1989] 02763.

[xxviii] Case C-421/10, *Stoppelkamp,* [not yet reported] dated 1 July 2010.

[xxix] *"With regard to linguistic criteria of interpretation, it is worth noting that the standard of the proper meaning of the words encounters a supplementary difficulty in Community law. Community provisions, in fact, are drafted in all the official languages of the European Union, which currently amount to 23 official languages for 27 Member States. It is clear that such linguistic complexity may produce not one but several '"ordinary meanings'" and raise serious interpretative questions when the different language versions are not entirely in accord with one another. How to choose? Which is the '"most official'" language of the Community?"* (Itzcovich 2009: 551).

[xxx] Case C-421/10, *Stoppelkamp,* [not yet reported] dated 1 July 2010, paragraph 22*:"However, it must be stated that the concept in question featured, prior to the amendments introduced by Directive 2000/65, not only in the German-, but also, in particular, in the Spanish-, Danish-, English-, French-, Italian-, Dutch-, Portuguese- and Swedish-language versions of Article 21(1)(b) of the Sixth Directive. Following the entry into force of that amending directive, all of those language versions now employ, in contrast to the German-language version, the concept corresponding to that of 'taxable person who is not established within the territory of the country';* In addition, Case C-169/04, *Abbey National plc*, **[**2006] I-04027, paragraph 41; Case C-152/02, *Terra Baubedarf*, [2004] I-05583, paragraph 34.

[xxxi] See the key importance of systemic and teleological methods of interpretation in Paunion and Lindroos-Hovinheimo 2010. See also Azoulai 2009b: "*L'interprétation autonome est une modalité de l'interprétation téléologique…Mais, plus souvent, ce qui ressort de la jurisprudence est une constante volonté d'encadrer la signification et la portée des notions inscrites dans le droit communautaire".*

[xxxii] *"With regard to linguistic criteria of interpretation, it is worth noting that the standard of the proper meaning of the words encounters a supplementary difficulty in Community law. Community provisions, in fact, are drafted in all the official languages of the European Union, which currently amount to 23 official languages for 27 Member States. It is clear that such linguistic complexity may produce not one but several "ordinary meanings" and raise serious interpretative questions when the different language versions are not entirely in accord with one another. How to choose? Which is the "most official" language of the Community?"* (Itzcovich 2009: 551).

[xxxiii] Case C-421/10, *Stoppelkamp*, [not yet reported] dated 1 July 2010: *"23.That concept, unlike that used in the German-language version of the Sixth Directive, not only features in other provisions of the latter, including Article 17(4), but has also been defined in a separate provision of European Union law. 24.Article 1 of the Eighth Directive defines the concept of 'taxable person not established within the territory of the country' (judgment of 16 July 2009 in Case C244/08 Commission v Italy, paragraph 26)".*

[xxxiv] Case C-421/10, *Stoppelkamp,* [not yet reported] dated 1 July 2010, paragraph 34.

[xxxv] Case C-339/99, *ESTAG,* [2002] I-08837, paragraph 37. In addition, this interpretative approach is reproduced in Case C-36/86, *Dansk Sparinvest,* [1988] 00409, paragraph 14; Case C-71/00*, Develop Baudurchführungs- und Stadtentwicklungs GmbH*, [2002] I-08877, paragraphs 21-27.

[xxxvi] In Case C-35/09, *Speranza*, [not yet reported] dated 1 July 2010. The Court skirts the semiotic criteria of interpretation.

[xxxvii] The refusal of the systematic hermeneutic approach of the Directive is also put forward in Case C-138/00, *Solida Raiffeisen Immobilien Leasing GmbH and Tech Gate Vienna Wissenschafts- und Technologiepark GmbH,* [2002] I-08905, paragraph 34: *"Second, having regard to the scheme of Directive 69/335, the wording of Article 4 thereof, concerning its material scope, must prevail over that of Article 5, relating to the basis of assessment of capital duty, where it is a matter of deciding the conditions which a transaction has to satisfy in order to come within the scope of that directive."*

[xxxviii] Case C-50/91, *Commerz-Credit-Bank AG - Europartner v Finanzamt Saarbrücken,* [1992] I-05225, paragraph 11: *"It is apparent from the preambles to those directives that the purpose of the fiscal derogation is to avoid transfers of assets between companies being impeded by tax obstacles, in order to facilitate the reorganization of undertakings, in particular the grouping within one undertaking of various entities carrying on identical or complementary activities."*

[xxxix] This term is coined in Weitzel 1994 : 83-87.

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New Evidence of Asian Economic Integration: Prospects and Challenges of a Trilateral FTA between China, Japan and South Korea

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Abstract

Free Trade Agreements (FTAs) as a powerful trade policy instrument increasingly play an important role in Asian economic growth. Asian countries have sought to deepen their economic integration to achieve sustainable economic development by applying FTAs ever since the Asian Financial Crisis in 1997. The emerging trilateral FTA negotiation between China, Japan and South Korea (CJK) provides new evidence of ongoing Asian economic integration. In this paper, by analyzing recent FTA developments in Asia as well as prospects and challenges of the FTA-CJK negotiation, we find that the FTA-CJK will expand the intra-regional trade volume and stimulate economic growth in all three counties. However, given the tremendous differences in economic structure and development stage between the three countries as well as political economy considerations, the establishment of the FTA-CJK will not be a smooth process. Pragmatic and practical strategies during the FTA-CJK negotiation are needed to create a win-win-win situation.

Key-words

Asia, economic integration, FTAs, FTA-CJK

1. Introduction

On May 15th, 2012, the three largest economies in East Asia, the People's Republic of China (hereafter, China), Japan and South Korea, officially agreed to launch negotiations for a Free Trade Agreement (FTA) by the end of that year. The emerging FTA talks between China, Japan and South Korea (hereafter, FTA-CJK) highlights the rapid development of economic integration mainly driven by FTAs in Asia. Given the economic size of the three countries and their respective shares in the global trade system, it also implies that there will be a significant impact across the world. In particular, the recent sluggish recovery of the US economy and the spreading of the crisis throughout Europe underline the significance of the forthcoming FTA-CJK for the global economy.

Undoubtedly, the FTA-CJK will significantly impact on the economic development and trade volume of the three countries. But exactly how much the FTA-CJK is to impact on the three countries' output and trade volume once the FTA-CJK is in effect needs to be empirically assessed. Lee *et al.* (2005: 27-43), applying computable general equilibrium (CGE) model, find that the macroeconomic effects of the FTA-CJK would be 5.15 per cent of GDP growth for South Korea, 1.54 per cent for China and 1.21 per cent for Japan. A similar model is employed by Yoon *el al.* (2009: 9-17). They find that corresponding effects on the GDP growth would be 2.53 per cent for South Korea, 0.99 per cent for Japan and 0.60 per cent for China. Considering the increasingly different performance in economic development and the fluctuation of trade volumes in the three countries as well as the uncertain global economy of the last few years, it is meaningful to analyze the prospects and challenges of the FTA-CJK for the three countries. In this article, we are not interested in assessing the potential macroeconomic impact of the FTA-CJK on the GDP or trade volume of the three countries, which has already been done quite well by official feasibility studies of the three governments and other scholars. Instead, here we discuss the recent FTA developments in East Asia as well as the prospects for and challenges of the FTA-CJK negotiation. Such an analysis provides us with a profound understanding of the forthcoming FTA-CJK as new evidence of deepening Asian economic integration.

The structure of this paper is as follows. Section two introduces the development of FTAs in Asia, followed by section three, which contains background information on the

trilateral FTA-CJK and policy analyses for China, Japan and South Korea. The prospects for and challenges of the FTA-CJK negotiation are discussed in section four and five respectively, while section six concludes.

2. The Development of FTAs in Asia

The Asian economy, mainly driven by foreign trade and foreign direct investment (FDI), has achieved a remarkable economic growth over the past several decades. FTAs played a unique role in boosting Asian countries' exports and motivating Asian economic integration during this process, especially for East Asian countries, which are also called the "*world factory*". Along with innovation and technological progress, removing tangible and intangible foreign trade barriers through bilateral and multilateral FTAs has significantly improved Asia's intra-regional and international trade with the rest of world. It appears that the past success in economic growth has encouraged Asian policymakers to deepen regional economic integration by adopting cooperative and mutually beneficial economic policies. FTAs, regarded as powerful trade policy instruments, increasingly play an important role in promoting Asian countries' participation in global supply chains and production networks (Kawai and Wignaraja, 2010: 3-5).

The creation of the EU Single Market in 1957 and the North American Free Trade Agreement (NAFTA) in 1994 also positively motivated Asian countries to adopt FTAs as trade policy instruments to expand their trade shares, thereby improving their international competitiveness in the global market. Asian FTAs initially started with the Asia-Pacific Trade Agreement (APTA)[I] in 1975. The ASEAN Free Trade Area (AFTA), regarded as a cornerstone of Asian FTA expansion, was signed by the member nations of the Association of Southeast Asian Nations (ASEAN) in Singapore in 1992. The Asian financial crisis in 1997 appeared to accelerate the process of creating a more deeply integrated Asia when Asian countries realized that economic integration and policy cooperation were critical for Asian economies, which had remained relatively vulnerable to the fluctuation of the global economy. The recent global financial crisis of 2007-2008, followed by the still ongoing European debt crisis and the euro crisis, which significantly reduced the demand for Asia's production, reinforced Asia's commitment to strengthening

its degree of economic integration. By January 2012, there were, in Asia, 99 FTAs signed and in effect and 27 FTAs signed but not yet in effect (see Table 1). 64 FTAs are still being negotiated by Asian countries. In addition, the number of proposed FTAs has increased rapidly since 2003: an additional 60 FTAs have been proposed or studied in Asia. From Table 1, we can see that the number of Asian FTAs has dramatically increased, from two FTAs in 1980 to more than 100 FTAs in effect in 2011. This indicates the increasing importance of FTAs for Asian countries to maintain economic growth, particularly for those outward-oriented economies such as China, Japan, South Korea, Taiwan and ASEAN countries.

Table 1: Asian FTAs by status (cumulative), 1975-2012

Year	Proposed[1]	Under Negotiation		Concluded		Total
		Framework Agreement Signed/Under Negotiation[2a]	Under Negotiation[2b]	Signed but not yet In Effect[3a]	Signed and In Effect[3b]	
1975	0	0	0	1	0	1
1976	0	0	0	0	1	1
1980	0	0	0	1	1	2
1981	0	0	0	0	2	2
1982	0	0	0	1	2	3
1983	0	0	0	1	3	4
1989	1	0	0	1	3	5
1991	1	0	0	2	5	8
1992	1	0	0	6	5	12
1993	1	0	0	5	9	15
1994	1	0	0	8	11	20
1995	1	0	0	15	14	30
1996	1	0	0	18	19	38
1997	2	0	0	20	20	42
1998	2	0	0	19	23	44
1999	4	0	1	19	24	48
2000	3	0	6	19	25	53
2001	2	0	8	18	28	56
2002	8	2	8	19	31	68
2003	18	4	9	25	36	92
2004	32	14	15	27	43	131
2005	44	18	28	27	51	168
2006	49	18	37	23	64	191
2007	47	18	42	26	70	203
2008	47	16	42	25	80	210
2009	54	16	45	25	86	226
2010	57	17	48	26	92	240
2011	60	17	48	26	99	250
2012	60	16	48	27	99	250

Source: Asia Regional Integration Center, Asian Development Bank, until January 2012.
Notes:
1. Proposed - parties are considering a free trade agreement, have established joint study groups or joint task force, and are conducting feasibility studies to determine the desirability of entering into an FTA.
2a. Framework Agreement Signed/Under Negotiation - parties initially negotiate the contents of a framework agreement (FA), which serves as a framework for future negotiations.
2b. Under Negotiation - parties begin negotiations without a framework agreement (FA).

3a. Signed but not yet in Effect - parties have signed the agreement after negotiations have been completed. Some FTAs require legislative or executive ratification.
3b. Signed and on Effect - when the provisions of an FTA become effective, e.g. when tariff cuts begin.

This rapid increase of FTAs in Asia, however, also raises questions which are called Noodle Bowl Effects (or "Spaghetti Bowl effects", by Bhagwati, 1995). Different FTAs contain different Rules of Origin (ROOs) [II], a fact which results in the increasing complexity and costly use of FTAs. Crisscrossing FTAs among Asian countries have not only increased the administrative costs of managing FTAs and transaction costs for enterprises, but they also impair the effectiveness of FTAs. Therefore, having too many bilateral FTAs in Asia poses challenges to overall Asian trade liberalization. The majority of existing FTAs in Asia are bilateral or small-scale FTAs, from which less developed Asian countries are believed to be excluded. Thus, Asian countries need wider, region-wide FTAs rather than excessively overlapping bilateral and pluribilateral FTAs. On the other hand, analyzing enterprise-level data from five Asian countries, Kawai and Wignaraja (2009: 10-22) find that the noodle bowl effects of overlapping FTAs in Asia are not severely harmful to Asian countries' business activities. But they also point out that cooperative policies are needed to address the increasing complexity of noodle bowl effects, given the fact that more of the proposed FTAs (incl. those under negotiation) in Asia are bilateral and prulilateral rather than region-wide. Although there are some challenges to the development of Asian FTAs, the successful past experience proves that FTAs, as trade policy instruments, do make significant contributions to Asia's economic growth. Undoubtedly, from a pragmatic perspective, Asian countries still need FTAs to strengthen their international competitiveness and promote their shares in the global trade system.

3. Background of the Forthcoming Trilateral FTA between China, Japan and South Korea

By signing the Trilateral Agreement for the Promotion, Facilitation and Protection of Investment at the Fifth Trilateral Summit Meeting on May 15th, 2012, the three economic giants in East Asia – China, Japan and South Korea – have displayed their efforts in the area of economic cooperation to achieve sustainable economic growth against the background of the uncertainty of the global economy. The leaders of the three countries

also agreed to officially launch the FTA-CJK negotiation by 2012, after a decade of discussions and preparations. This provides new evidence showing that Asian countries are seeking to deepen their economic integration by applying FTAs as a trade policy tool. The population of the three countries, as a whole, accounts for 21.82 per cent of the world's total population (see Table 2). The total GDP of the three countries, which was US$ 14.3 trillion in 2011, accounts for 20.43 per cent of the world's total GDP. In addition, and even more strikingly, the share of goods exported and imported by the three countries in the world's total exports and imports is 18.20 and 43.62 per cent, respectively, in 2011. This indicates the tremendous potential of the FTA-CJK to further improve their shares in the international trade system.

Table 2: General information on China, Japan and South Korea

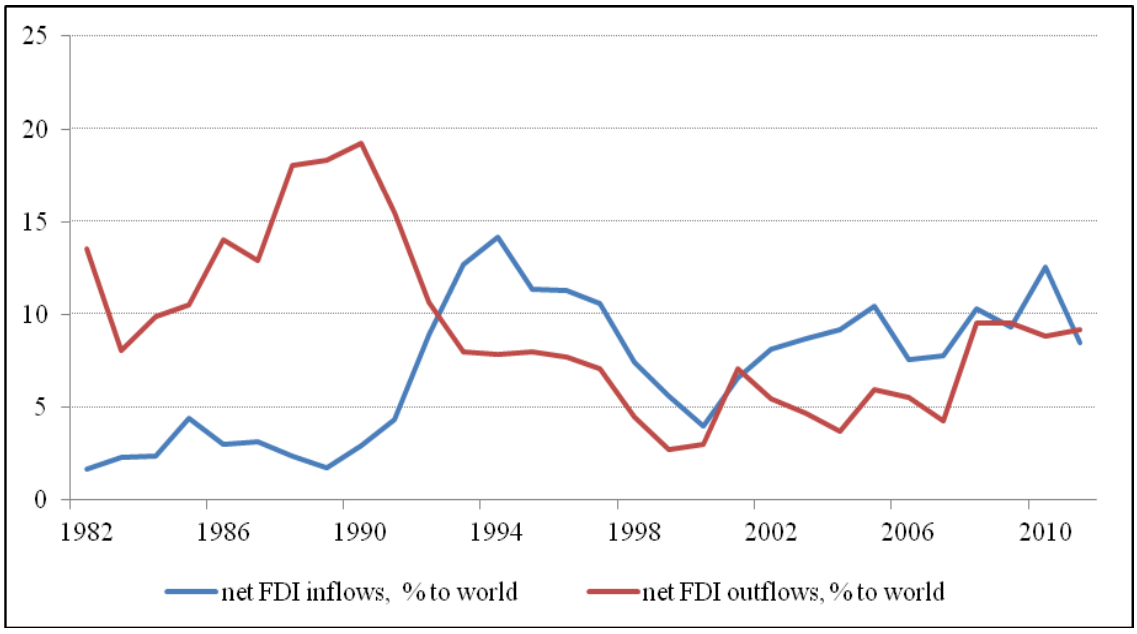
	Population			GDP			Goods exported			Goods imported		
	CJK	World	% of world	CJK	World	% of world	CJK	World	% of world	CJK	World	% of world
1982	1166,4	4606,8	25,32	1396,2	67,5	12,47	178,4	1817,2	9,82	379,5	1797,2	21,12
1983	1182,5	4688,8	25,22	1531,1	71,9	13,38	188,2	1772,7	10,62	388,1	1758,4	22,07
1984	1197,2	4770,4	25,10	1645,3	70,3	13,85	218,4	1891,0	11,55	427,5	1874,5	22,81
1985	1212,6	4853,9	24,98	1787,8	75,4	14,33	225,8	1901,7	11,87	427,1	1891,4	22,58
1986	1229,5	4940,2	24,89	2460,2	89,3	16,67	265,6	2076,4	12,79	449,8	2062,7	21,81
1987	1247,7	5028,7	24,81	2895,6	89,9	17,27	306,8	2450,5	12,52	562,9	2419,7	23,26
1988	1266,2	5117,9	24,74	3512,4	90,1	18,73	362,0	2813,4	12,87	702,7	2766,7	25,40
1989	1284,1	5206,6	24,66	3591,5	99,2	18,25	375,8	3032,8	12,39	815,1	3003,5	27,14
1990	1301,6	5296,2	24,58	3724,4	116,7	16,95	397,9	3471,2	11,46	917,4	3424,5	26,79
1991	1318,0	5383,0	24,48	4224,5	124,1	18,32	438,3	3559,3	12,31	1037,4	3520,9	29,47
1992	1332,9	5465,6	24,39	4605,3	130,3	18,68	480,1	3808,9	12,60	1053,8	3745,9	28,13
1993	1347,0	5548,9	24,28	5217,6	128,9	20,87	512,3	3774,2	13,57	1099,9	3682,3	29,87
1994	1361,2	5631,1	24,17	5833,0	135,2	21,73	583,5	4273,5	13,65	1317,7	4149,9	31,75
1995	1375,4	5714,7	24,07	6579,1	147,4	22,09	682,0	5154,9	13,23	1701,2	4992,0	34,08
1996	1388,8	5796,2	23,96	6119,9	167,0	20,14	681,3	5410,9	12,59	1900,3	5272,4	36,04
1997	1402,1	5878,0	23,85	5793,2	193,4	19,12	730,4	5621,6	12,99	1865,1	5470,5	34,09
1998	1414,6	5959,0	23,74	5279,5	205,4	17,48	691,7	5523,9	12,52	1295,4	5425,9	23,87
1999	1426,0	6038,6	23,61	5961,3	219,1	19,03	743,4	5721,0	12,99	1609,0	5663,8	28,41
2000	1436,5	6118,1	23,48	6463,1	220,5	19,99	886,8	6443,5	13,76	2151,6	6435,5	33,43
2001	1446,4	6195,7	23,34	5989,3	248,5	18,64	800,9	6178,6	12,96	1927,2	6163,8	31,27
2002	1455,5	6272,5	23,20	6010,6	289,0	18,00	885,4	6453,1	13,72	2073,2	6395,3	32,42
2003	1464,0	6349,2	23,06	6587,7	271,8	17,54	1087,1	7510,3	14,47	2493,3	7415,7	33,62
2004	1471,9	6426,1	22,90	7309,4	263,9	17,29	1392,6	9102,1	15,30	3146,9	9023,6	34,87
2005	1479,6	6503,2	22,75	7673,6	285,2	16,80	1619,9	10340,2	15,67	3672,4	10293,1	35,68
2006	1487,1	6580,5	22,60	8021,5	330,0	16,21	1922,1	11944,8	16,09	4337,2	11837,7	36,64
2007	1494,3	6658,5	22,44	8899,6	371,9	15,95	2287,8	13801,7	16,58	5002,1	13619,8	36,73
2008	1501,3	6737,2	22,28	10302,4	400,2	16,83	2615,9	15848,4	16,51	6077,6	15726,8	38,65
2009	1508,1	6815,8	22,13	10860,5	432,1	18,76	2107,3	12304,1	17,13	4659,5	12087,7	38,55
2010	1514,6	6904,6	21,94	12433,8	461,7	19,69	2773,0	14987,4	18,50	6180,4	14721,9	41,98
2011	1521,7	6973,7	21,82	14301,9	324,5	20,43	3243,6	17820,4	18,20	7684,3	17615,0	43,62

Source: World Bank and own calculations.
Note: CJK means China, Japan and South Korea as a whole. The unit for population is million people; the unit for GDP and export & import is US$ billion.

Foreign trade and FDI have significantly contributed to the "East Asian miracle"

(World Bank, 1993). FDI has been complementary to, rather than a substitute for, foreign trade expansion in East Asia over the past several decades (Kawai and Urata, 2002: 1-6). Conversely, the expansion of intra-regional trade driven by FTAs has also stimulated intra-regional FDI, because the higher interdependence with foreign trade has promoted intra-regional FDI. In addition, some FTAs contain not only terms of foreign trade, but also concern FDI liberalization[III]. Therefore the increasing FDI between China, Japan and South Korea reflects their higher interdependence with intra-regional trade. It requires more trade policies such as the FTA-CJK to improve intra-regional trade in East Asia.

Figure 1: Share of total FDI inflows and outflows in China, Japan and South Korea from the world's total FDI inflows and outflows, 1982-2011 (in percentages)



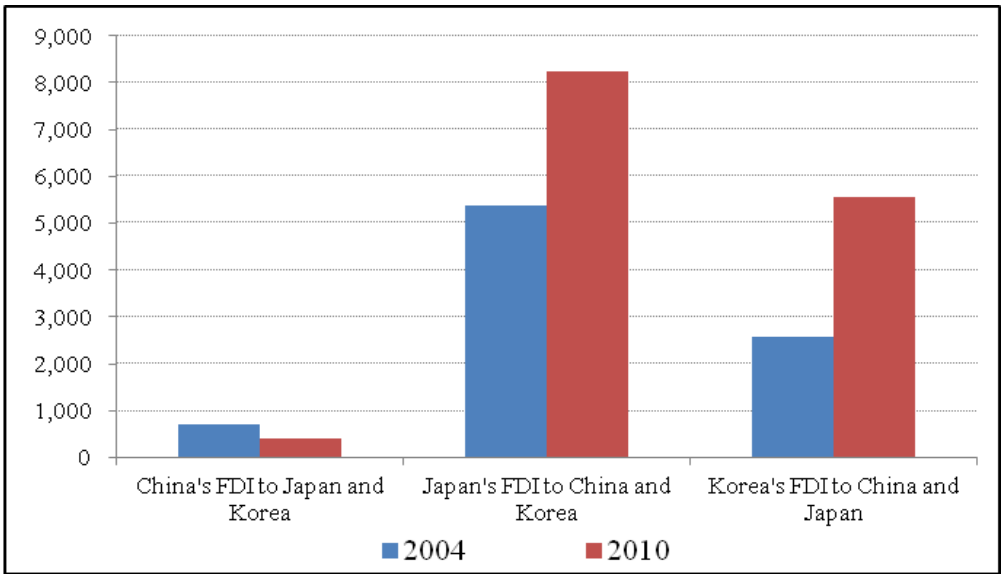
Source: World Bank and Ministry of Commerce of People's Republic of China.

China has been the largest FDI recipient country for decades until 2010. But, more recently, China's outward FDI has also increased substantially, from US$ 2.7 billion in 2002 to US$ 74.65 billion in 2011[IV]. Japan and South Korea as the most developed economies in East Asia have been the main capital output countries. The share of total FDI inflows and outflows of the three countries to the world's total FDI has increased steadily, since 2000, even though it declined in 1995-1999 (see Figure 1). In 2011, their share of the world's total inward and outward FDI represented 8.5 and 9.2 per cent, respectively. Intra-regional

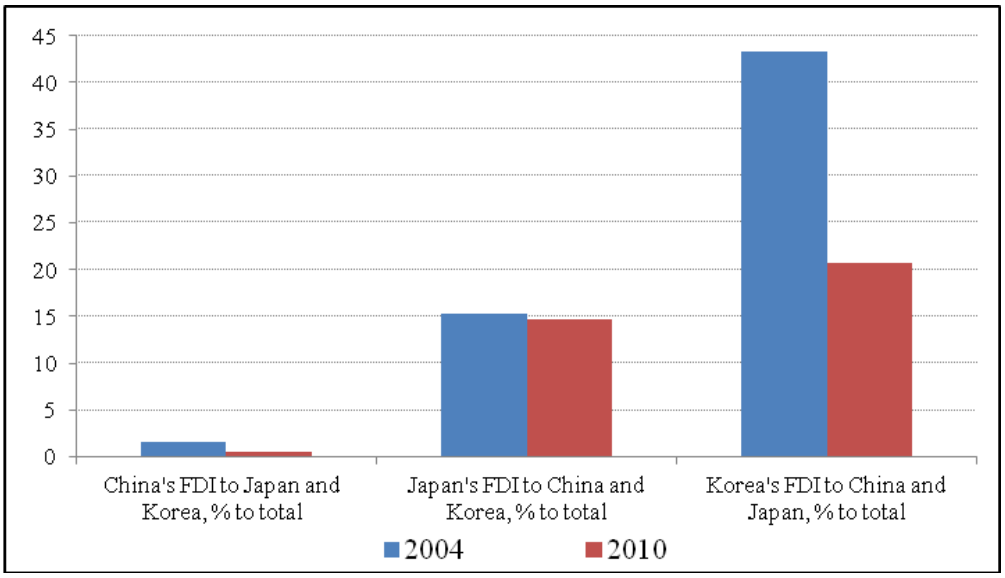
FDI among China, Japan and South Korea has also increased dramatically, except for China (see Figure 2). South Korea's FDI in China and Japan nearly doubled between 2004 and 2010. Similarly, Japan's FDI in China and South Korea grew considerably, from US$ 5,378.80 million in 2004 to US$ 8,226.93 million in 2010. By contrast, China's FDI in Japan and South Korea declined from US$ 704.52 million in 2004 to US$ 418.16 million in 2010. Moreover, the share of Japan's FDI in China and South Korea of its total outward FDI remained almost the same, at about 15 percent between 2004 and 2010, while South Korea's share of FDI in China and Japan accounting for its total outward FDI dropped sharply, from 43.25 to 20.75 per cent, during the period of 2004 to 2010. Finally, the percentage of China's FDI in Japan and South Korea of its total outward FDI also dropped, from 1.57 to 0.55 per cent, during the same period. It is notable that the share of South Korea's inward and outward FDI in the other two countries was much higher than the comparable figures for Japan and China. This reflects that China has been Japan's and South Korea's main investment target country over the past decade. But the majority of China's investment went to South America, Africa and Australia, which are natural resources-rich regions, rather than to Japan and South Korea. FDI inflows from Japan and South Korea have significantly contributed to China's economic growth through promoting China's FDI-induced exports and improving the productivity over the past several decades. Meanwhile, the Japanese and South Korean economies also benefited considerably from China's huge market and economic growth.

Figure 2: Intra-regional FDI of China, Japan and South Korea, in 2004 and 2010

Amount of intra-regional FDI, in US$ million



Share of total outward FDI (in %)



Source: OECD and 2010 Statistical Bulletin of China's Outward Foreign Direct Investment, Ministry of Commerce of the People's Republic of China.

Intra-regional trade among China, Japan and South Korea has grown considerably over the last decade. China has become both Japan's and South Korea's biggest trading partner. China's exports to Japan and South Korea reached US$ 270.49 billion in 2011, up from US$ 101.32 billion in 2004, which is more than double, although the share of China's exports to Japan and South Korea from China's total exports dropped from 17.08 per cent

in 2004 to 12.03 per cent in 2011 (see Table 3). This is mainly so because bilateral trade between China and the EU increased significantly during that period. The EU has become China's largest trade partner since 2004. By contrast, Japan's exports to China and South Korea grew substantially, from US$ 118.02 billion in 2004 to US$ 227.33 billion in 2011. Its share also increased from 20.90 per cent in 2004 to 27.70 per cent in 2011. Exports from South Korea to China and Japan jumped to US$ 173.90 billion in 2011, compared to US$ 84.26 billion in 2004. The share of South Korea's exports to the other two countries remained stable, at about 26 per cent, between 2004 and 2011. In addition, we can see from Table 3 that, in terms of foreign trade, China, Japan and South Korea are all important for each other. The dynamics of trade and FDI among the three countries over the past decade implies that the FTA-CJK negotiation is a crucial step for China, Japan and South Korea to expand their intra-regional trade and to strengthen their competitiveness in the global market.

Table 3: Intra-regional trade between China, Japan and South Korea in 2004 and 2011

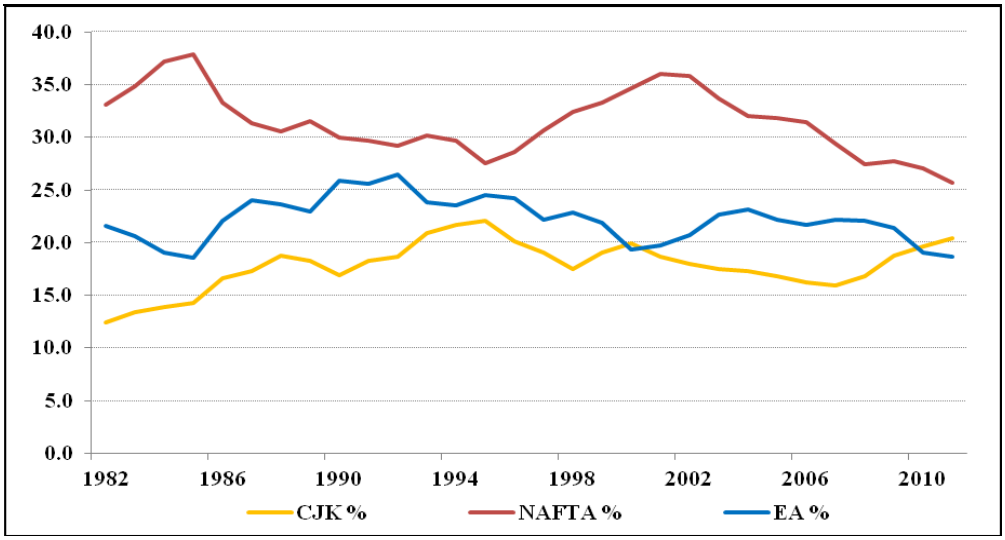
	2004			**2011**		
	Japan & South Korea	**China & South Korea**	**China & Japan**	**Japan & South Korea**	**China & South Korea**	**China & Japan**
China's exports to	101.32 (17.08%)	-	-	270.49 (12.03%)	-	-
Japan's exports to	-	118.02 (20.90%)	-	-	227.33 (27.70%)	-
South Korea's exports to	-	-	84.26 (26.83%)	-	-	173.90 (26.15%)

Source: Japan External Trade Organization, National Bureau of Statistics of China, Country Report of Ministry of Commerce of People's Republic of China, World Bank and own calculations.
Notes: total value of each country's exports to other two countries, in billion US$; percentage in brackets represents share of country's total exports.

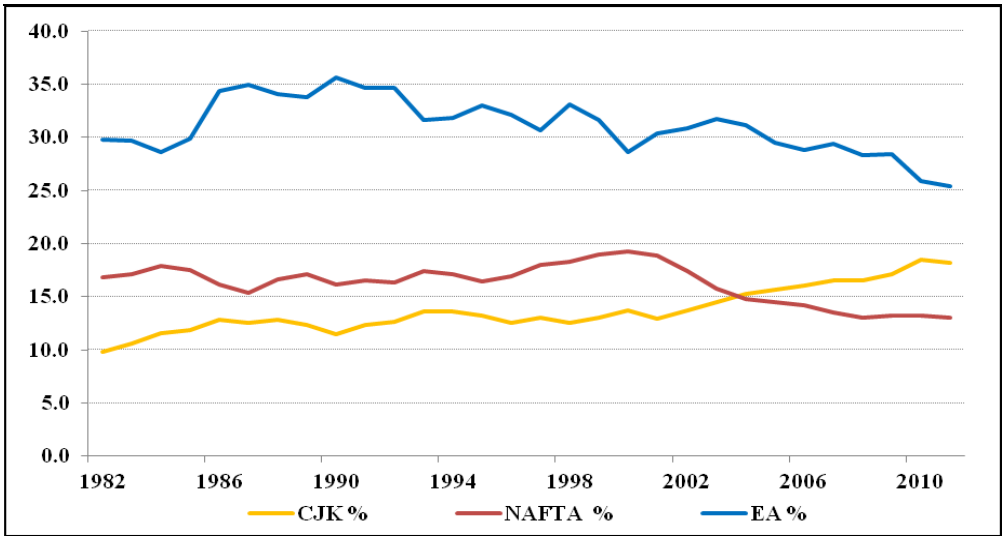
Comparing with the Euro Area (EA) and North American Free Trade Area (NAFTA), two of the largest existing free trade areas in the world, the forthcoming FTA-CJK also illustrates the tremendous potential to become another large free trade area in the world. Figure 3 shows that the FTA-CJK is comparable to both the EA and NAFTA in terms of economic size and trade volume. The GDP of China, Japan and South Korea together

accounts for 20.43 per cent of the world's total output in 2011, which is less than the 25.70 per cent of NAFTA but higher than the EA's share, which is 18.68 per cent. What is more, the share of the EA's and NFATA's GDP of the world's total GDP has declined since 2003-2004. The FTA-CJK's total GDP share, however, has shown a strong upward trend since 2007. For exports, the share of the three countries' exports together from among the world's total exports continuously grew, from 1982 to 2011, in stark contrast with the decline of both the EA's and NAFTA's respective shares. In 2011, compared to the 12.99 per cent of NAFTA and the 25.45 per cent of the EA, the share of China's, Japan's and South Korea's exports together accounted for 18.20 per cent of the world's total export volume. The above analysis clearly shows that the economic interdependence between China, Japan and South Korea has been significantly enhanced through global production networks and the international trade system over the past several decades. The establishment of the FTA-CJK would thus significantly impact on the Asian and worldwide economy through further increasing intra-regional trade between China, Japan and South Korea.

Figure 3: Comparison of FTA-CJK, EA and NAFTA
Share of (combined) GDP from the world's total GDP



Share of exports from the world's total exports



Source: World Bank and own calculations.
Note: CJK represents China, Japan and South Korea combined.

China, Japan and South Korea, the three largest economies in East Asia, are still export-oriented economies. They are committed to expanding their share of foreign trade and enhancing their participation in global supply chains and production networks to sustain economic growth. FTAs, as a way to liberalize trade, are especially meaningful for these three counties. Over the past decades, these three countries have been the most active participants in the Asian FTA development. China has signed 12 FTAs with other countries up to September 2012 (see Table 4). Currently, there are six FTAs under negotiation. In addition, seven FTAs have been proposed to be discussed between China and other countries. Japan is also a very active FTA participant country; FTA studies were conducted much earlier than in other Asian countries. Until September 2012, Japan has implemented 13 FTAs (one FTA was signed but is not yet in force). Also, two FTAs are under negotiation and eight FTAs are proposed or being studied. South Korea has signed nine FTAs (one FTA was signed but is not yet in force). More strikingly, there are more FTAs that are being proposed or negotiated (seven FTAs are under negotiation and eight FTAs are proposed/under consultation and study). Finally, in Asia as a whole, more than 100 FTAs have been concluded and more and more FTAs are under negotiation or were proposed until September 2012. This shows us that FTAs are expanding rapidly in Asia.

Table 4: China, Japan and South Korea's FTAs at different stage of development

	Proposed/Under Consultation and Study	Under Negotiation		Concluded		Total
		(FA) Signed/FTA under Negotiation	Under Negotiation	Signed but not yet In Effect	Signed and In Effect	
China	7	2	4	0	12	25
Japan	8	0	2	1	12	23
South Korea	16	2	5	1	8	32
Asia	72	14	43	29	92	250

Source: Asia Regional Integration Center, Asia Development Bank, until September 2012.
Note: Asian FTAs are those FTAs engaged with by any of the 48 ADB member countries in the Asia-Pacific region with another country or economic bloc within or outside that region.

The three countries are both the key and most active participants in the process of Asian FTA development. China, the largest economy in Asia, has signed 12 FTAs until September 2012. Besides the 'Closer Economic Partnership Arrangement' with Hong Kong and Macau (signed in 2004) and the 'Economic Cooperation Framework Agreement' with Taiwan (2010), China also signed FTAs with its most important trade partners, the ASEAN and some ASEAN member countries. In addition, China also signed non-Asian FTAs with Chile (2006), Costa Rica (2011), Peru (2010) and New Zealand (2008). Japan seems to put more attention on ASEAN member countries. Eight of Japan's 12 Economic Partnership Agreements (EPAs) or FTAs are with ASEAN and ASEAN member countries. Moreover, Japan implemented EPAs with Chile (2007), India (2011), Mexico (2005) and Switzerland (2009). South Korea, which is the fourth largest economy in Asia, has signed only nine FTAs, less than other two countries. However, South Korea has signed FTAs with the US and the EU, which are the largest economies in the world. The US and the EU, as the main importers, are crucial trading partners for Asian export countries such as China and Japan. We find that China, Japan and South Korea have all adopted active FTAs strategies. Partly this is because the three countries have used FTAs as a strategic tool to strengthen their relationships with their trading partners, such as ASEAN member countries (Urata, 2004: 7-10). A bilateral FTA between any two of these three countries would force the third country to join because no country wishes to be excluded from the regional market.

Table 5: List of all bilateral and plurilateral FTAs with China, Japan and South Korea

	Free Trade Agreements signed and in effect	**Date of signed and in effect**
China	China and Chile FTA	01 Oct., 2006
	China and Costa Rica FTA	01 Aug., 2011
	China and Hong Kong Closer Economic Partnership Arrangement	01 Jan., 2004
	China and Macau Closer Economic Partnership Arrangement	01 Jan., 2004
	China and Pakistan FTA	01 Jul., 2007
	China and Peru FTA	01 Mar. 2010
	China and Singapore FTA	01. Jan., 2009
	China and Taiwan Economic Cooperation Framework Agreement	12 Sep., 2010
	China and Thailand FTA	01 Oct., 2003
	Asia-Pacific Trade Agreement	17 Jun., 1976
	ASEAN and China Comprehensive Economic Cooperation Agreement	01 Jul., 2005
	New Zealand and China FTA	01 Oct., 2008
Japan	Japan and Brunei FTA	31 Jun., 2008
	Japan and Chile Economic Partnership Agreement	03 Sep., 2007
	Japan and India Comprehensive Economic Partnership Agreement	01 Aug., 2011
	Japan and Indonesia Economic Partnership Agreement	01 Jul., 2008
	Japan and Malaysia Economic Partnership Agreement	13 Jul., 2006
	Japan and Mexico Economic Partnership Agreement	01 Apr., 2005
	Japan and Philippines Economic Partnership Agreement	11 Dec., 2008
	Japan and Singapore Economic Agreement for a New-Age Partnership	30 Nov., 2002
	Japan and Switzerland Economic Partnership Agreement	02 Sep., 2009
	Japan and Thailand Economic Partnership Agreement	01 Nov., 2007
	Japan and Vietnam Economic Partnership Agreement	01 Oct., 2009
	ASEAN and Japan Comprehensive Economic Partnership	01 Dec., 2008
South Korea	South Korea and Chile FTA	01 Apr., 2004
	South Korea and European Free Trade Association FTA	01 Sep., 2006
	South Korea and European Union FTA	01 Jul., 2011
	South Korea and Peru FTA	01 Aug., 2011
	South Korea and Singapore FTA	02 Mar., 2006
	Asia-Pacific Trade Agreement	17 Jun., 1976
	ASEAN and South Korea Comprehensive Economic Cooperation Agreement	01 Jun., 2007
	India and South Korea Comprehensive Economic Partnership Agreement	01 Jan., 2010

Source: Asia Regional Integration Center, Asian Development Bank, until September 2012.
Note: lists the Free Trade Agreements engaged into by China, Japan and South Korea with another country or economic bloc within or outside the region.

4. Prospects for the FTA-CJK

China, Japan and South Korea are still export-oriented economies which account for around 20 per cent of the world's total exports. The FTA-CJK would help the three countries to further enhance their competiveness in the global market through improving trade volume and FDI, thereby maintaining economic growth. More particularly, China's economic growth benefited considerably from the trade liberalization after joining the World Trade Organization (WTO) in 2001. The FTA-CJK would allow China to expand its

trade volume with other two countries, which are two of China's largest trade partners. For Japan, FTAs are expected to work as a catalyst for economic growth because Japan has experienced a sluggish economy for decades. To maintain Japan's international competitiveness and stimulate economic growth, the Japanese government needs to undertake a structural reform of its economic system (Urata, 2005: 8). The FTA-CJK, applying external pressure, could contribute to such a reform. South Korea's economy finally showed quite high a flexibility and resilience during the periods of both the 1997 Asia Financial Crisis and the 2008 Global Financial Crisis. Most studies on FTAs show that South Korea benefits more from East Asian FTAs than China and Japan (Lee *et al.*, 2007: 37-43 and Abe, 2007: 13-21). After establishing FTAs with ASEAN, the EU and the US, to conclude FTAs with China and Japan, South Korea's two very important neighbors and trade partners, is South Korea's next strategic goal.

The empirical literature assesses the macroeconomic impact of FTAs on economic growth and trade volume by applying the CGE model, which is the most widely used model in FTA analysis. The Global Trade Analysis Project's (GTAP) various databases have been employed in CGE model studies related to FTA analysis. But the relatively new FTA-CJK has not been extensively studied. Table 6 lists recent studies of the FTA-CJK by applying the CGE model and GTAP's database. We can easily conclude that the South Korean economy would gain the most from the FTA-CJK in terms of GDP growth. Meanwhile, the impact of the FTA-CJK on China's exports and imports seems to be bigger than that on Japanese and South Korean trade. The effect of the FTA-CJK on Japan would also be smaller than for the other two countries in term of GDP growth and trade volume. In previous simulation studies on the FTA-CJK we also find that the FTA-CJK would expand the trade volume and increase economic growth in all three countries.

Table 6: Previous studies of the macroeconomic impact of the FTA-CJK, using the CGE model

Papers	**Database used for analysis**	**Aggregation of regions and sectors**	**Findings (complete liberalization)**
Lee, Choi and Park (2003)	GTAP database: version 5.0 (1997)	8 regions and 17 sectors	GDP, %: China: 2.31; Japan: 0.93 and South Korea: 2.25 Welfare, %: China: 0.97; Japan: 0.48 and South Korea: 3.55

Lee *et al.* (2005)	GTAP database: version 6.0 (2001)	-	GDP, %: China: 1.54; Japan: 1.21 and South Korea: 5.15 Welfare, %: China: 0.69; Japan: 0.28 and South Korea: 3.45 Exports, %: China: 12.18; Japan: 5.19 and South Korea: 9.77 Imports, %: China: 16.28; Japan: 5.82 and South Korea: 10.62
Abe (2007)	GTAP database: version 6.0 (2001)	24 regions and 25 sectors	Welfare, US$ mn: China: 4,789; Japan: 5,398 and South Korea: 14,163
Yoon, Gong and Yeo (2009)	GTAP database: version 6.0 (2001)	6 regions and 12 sectors	GDP percentage change: China: 0.60; Japan: 0.99 and South Korea: 2.53 Exports, %: China: 5.98; Japan: 2.13 and South Korea: 3.17 Imports, %: China: 8.37; Japan: 4.58 and South Korea: 5.98 Welfare (equivalent variation), US$ mn: China: 3,595.32; Japan: 5,938.79 and South Korea: 6,133.04 Terms of Trade, %: China: -0.24; Japan: 1.07 and South Korea: 1.20

Source: own summary.
Note: see Baldwin and Venables (1995) for the impacts on national welfare.

In addition to the macroeconomic impact of the FTA-CJK on the three countries, wider geopolitical factors need to be carefully considered, too. China, Japan and South Korea are the most important economic and political powers in East Asia. Each of the three countries looks at FTAs as an important strategic tool to strengthen its influence in East Asia, which is one of the most important growth engines of world economy. The recent completion of bilateral FTA negotiations between ASEAN & China, ASEAN & Japan and ASEAN & South Korea is evidence for this. For China, East Asia is not only a destination of its exports but also the supplier of energy and other natural resources. Japan and South Korea do not provide China with natural resources. However, China imports a great deal of electronic components and other intermediate products from Japan and South Korea. On the other hand, Japan and South Korea, like China, also consider FTAs as a strategic tool to establish a stable market network to compete in the global market. Furthermore, in addition to being a powerful neighbor, China's huge market and economic potential are very attractive for Japan and South Korea to promote exports to China. Therefore, the establishment of the FTA-CJK would meet the three countries' strategic goals both economically and politically.

5. Challenges of the FTA-CJK

However, the FTA-CJK negotiation is not a smooth process, but plastered with many economic and political obstacles. The three governments will encounter fierce opposition in their own countries. China's high-tech and manufacturing sectors, particularly the automobile industry, are relatively less developed and vulnerable compared to those in Japan and South Korea. China's government would try to protect its automobile industry in the FTA-CJK negotiation. On the other hand, Japan's agricultural sector is always sensitive when Japan negotiates FTAs with other countries. Opposition from labor unions in Japan is another challenge for the Japanese government. Finally, South Korea, in addition to having an agricultural sector that is less competitive than that of China, is also concerned by its excessive dependence on China's market and Japan's core components and technology. Nevertheless, South Korea has showed more interest in a bilateral FTA with China, which is South Korea's largest trade partner. South Korea is reluctant to enter into a bilateral FTA with Japan because of the similarity in industrial structure and its own relative competitive advantage over Japan. Thus the FTA-CJK will be more difficult to be established than any bilateral FTA between two of the three countries.

The emerging Trans-Pacific Partnership (TPP), which involves nine countries from the Asia-Pacific area, has added further complications to the FTA-CJK negotiation. Japan and South Korea expressed enthusiasm to join the US dominated TPP to strengthen ties with other Asia-Pacific countries, especially with the US. South Korea has already signed FTAs with most of the TPP countries. So it will not be overly complicated for South Korea to join the TPP talks. Japan also showed a willingness to participate in the TPP talks and became an observer in 2010. It seems that China is excluded from the TPP at the current stage. China apparently showed only a passive attitude to joining the TPP talks. This is partly so because China regards the TPP as part of the US "Return to Asia" strategy to enhance its economic influence in East Asia. Instead, China was more actively involved in FTA-CJK and FTA+6[V] talks to counteract the effect of its exclusion from the TPP. But China also understands that it cannot remain an outsider to this trans-Pacific free trade area forever, especially not once the TPP comes into effect. On the other hand, none of TPP participant countries can ignore China's huge market and economic potential. Each of the

three countries has adopted a different strategy during the TPP and FTA-CJK preparation. Together, they could use the FTA-CJK negotiation to strengthen their bargaining power in the TPP talks. In the same way, the TPP talks may ultimately change the three countries' strategies in the FTA-CJK negotiations. Thus the TPP talks render the FTA-CJK negotiations more complicated.

In reality, however, political economy considerations significantly affect the process of FTA-CJK negotiations. Recent territorial disputes between the three countries about islands in the East China Sea and the Sea of Japan underline the uncertainty and difficulties of FTA negotiations. Historical conflicts, political distrust and territorial disputes among China, Japan and South Korea will always haunt the three countries in the foreseeable future. This inevitably hinders the process of FTA-CJK negotiation. In addition, differences as regards the political system are another factor which could impair the negotiation of the FTA-CJK. But, in the long term, the three countries need to enhance their economic cooperation to eventually achieve economic integration and political understanding. Europe's successful experience as regards economic and political integration proves that economic integration improves mutual understanding and political cooperation. Thus the FTA-CJK could be expected to play a positive role in enhancing the economic and political ties in East Asia.

6. Conclusions

The emerging FTA-CJK provides new evidence that Asian countries are seeking to deepen their economic integration by applying FTAs as a policy tool to achieve sustainable economic growth. Empirical studies and policy analyses illustrate that the FTA-CJK would expand the intra-regional trade volume and stimulate economic growth in all the three counties. However, given the tremendous differences in economic structure and development stage among the three countries, as well as political economy considerations, the FTA-CJK negotiation will not be a smooth process. In order to identify winners and losers in each industry in each of the three countries, a sector-based assessment is needed. It is necessary and important for the three countries to adopt a more pragmatic and practical strategy in the FTA-CJK negotiations to create a win-win-win situation.

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[I] APTA, which came into effect in 1976, is the first preferential trade agreement between developing countries in the Asia-Pacific region. Today, member countries include Bangladesh, China, India, South Korea, the Lao People's Democratic Republic (Laos), Sri Lanka, Nepal, and the Philippines.

[II] Rules of origin (ROOs) describe the criteria needed to determine the national source of a product for the purposes of international trade.

[III] Some free trade agreements are called Economic Partnership Agreements (EPAs) and include the deregulation of investments and immigration in addition to trade liberalization.

[IV] See 2011 Statistical Bulletin of China's Outward Foreign Direct Investment from the Ministry of Commerce of the People's Republic of China.

[V] Japan supports the ASEAN+6 FTA comprises the 10 ASEAN member nations and China, Japan, South Korea, Australia, New Zealand and India. While China proposed and strongly supports ASEAN+3 FTA (the ten ASEAN member nations and China, Japan and South Korea). But recently China presented more flexibility and showed more interest in ASEAN+6 FTA and FTA-CJK.

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The Introduction of the "Balanced Budget" Principle into the Italian Constitution: What Perspectives for the Financial Autonomy of Regional and Local Governments?

by

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Abstract

This paper analyses the impact on regional and local authorities of Articles 117 and 119 of the Italian Constitution (hereafter referred to as "IC") as amended by Constitutional Law no. 1/2012.

In particular, it attempts to verify whether the new formulation of these constitutional provisions materializes the risk of a significant reduction in the financial autonomy of both Regions and Local Governments.

With the constitutional reform the legislative competence of "*harmonization of public account*" has become an exclusive State competence, the "*balanced budget*" principle has been extended to Regions and local authorities and public borrowing has been broadly prohibited.

What is the actual significance of the changes introduced by Constitutional Law no. 1/2012 for the financial autonomy of Italian sub-national authorities?

Is it time to recognise that the goals of financial independence of Italian fiscal federalism, launched by the reform of Title V of the IC, must give way to a new organization of public finance, where a central role is played by the central government in order to comply with the financial constraints arising from new challenges of the European economic integration process?

Key-words

harmonisation of public accounts, public finance coordination, balanced budget, public borrowing, fiscal federalism, multilevel financial system

1. The European and Italian legal framework in which the constitutional reform took place

In April 2012, the Italian Parliament enacted Constitutional Law no. 1/2012 with the aim of intensifying the Italian commitment to restore public finances in accordance with the constraints imposed by the *Europlus Pact* and the *Six Pack,* now strengthened by the *Fiscal Compact* .

The law modifies Articles 81, 97, 117 and 119 of the IC, introducing specific rules in order to ensure that in the economic cycle - consisting of favourable and adverse phases - public budgets are constructed in a way to guarantee a progressive equilibrium between revenue and expenditure.

Since the launch of the Economic and Monetary Union (EMU), the Treaty of Maastricht has imposed that the ratio of the annual government deficit to Gross Domestic Product (GDP) must not exceed 3% at the end of the preceding fiscal year. In case of failure, a government is required to at least reach a level close to 3%, consenting only exceptional and temporary excesses. At the same time, the Treaty of Maastricht imposed onto the EMU Member States a ratio of gross government debt to GDP not exceeding 60% at the end of the preceding fiscal year.

These constraints on Member States' fiscal policy were further strengthened by the *Stability and Growth Pact,* which imposed upon the Member States the obligation to guarantee, in the medium term, a break-even public deficit, while in the short term a limit of 3% of deficit/GDP ratio was not to be exceeded.

More recently, the Fiscal Compact bolstered these rules even more, imposing upon all Contracting Parties[I] an "annual structural balance" - defined in Article 3, Paragraph 3, letter *a*, of the Treaty as *"the annual cyclically-adjusted balance net of one-off and temporary measures"* - that must not exceed 0.5% of GDP, as well as a reduction in public debt at a regular rate (5% per annum) until the achievement of the reference level of 60% of GDP[II].

These provisions involve a sort of "enhanced" golden rule because the budgetary balance, which must substantially be in equity, also includes investment expenditure (Article 3.1, letters *a* and *b*, of the Fiscal Compact); conversely, in the classic theory of public finance, the most popular version of the "golden rule" requires that current spending must be financed through tax incomes, whilst investment spending has to be

financed through the current budget surplus or by issuing government bonds (Majocchi 2012: 45-46).

Article 3.2 of the Fiscal Compact requires the Signatory States to make the new rules binding within their respective legal systems "*through provisions of binding force and permanent character, preferably constitutional*", at least one year after the entry into force of the Treaty.

Constitutional Law no. 1 of 2012, therefore, is the legal instrument by which the Italian Parliament introduced into the Italian Constitution the stringent limits imposed at European level by the new rules of economic governance.

In this regard it is, first of all, interesting to notice that reforming specific constitutional provisions contrasts with the traditional rigidity of the Italian Constitution vis-à-vis changes caused by the European integration process.

Until now, in fact, Article 117 of the Italian Constitution has been the only constitutional provision to be modified as a result of the above process.

In the Italian experience, indeed, compliance with the duties arising from participation in the European Union has mainly been provided through a "Europe-oriented" interpretation of the already existing constitutional provisions.[III]

In antithesis to this trend, the implementation of the new economic rules in the domestic order have occurred through a constitutional reform that has been qualified as "hetero-directed" insofar as it was requested by European institutions in order to "restore market confidence" (Groppi 2012: 6).

From a substantial point of view, the constitutional reform basically prescribes the balance between revenues and expenditures for the State budget and for the budgets of Regions and local authorities and allows for public borrowing only in some "*exceptional cases*".

Before analysing the amendments introduced by Constitutional Law no. 1/2012 to Articles 117 and 119 of the Constitution, it seems appropriate to make some introductory remarks in order to understand the general framework in which the constitutional reform is taking place.

First of all, it is necessary to take into account that after the adoption of Constitutional Law no. 1/2012, the Italian Parliament adopted a "Reinforced" Law[IV] on 24 December 2012 (Law no. 243/2012) in order to implement the "balanced budget" principle, thus complying with the provisions of Paragraph 6 of the reformed Art. 81 of the Constitution.

Additionally, it is necessary to notice that in 2012, many government complaints (or "Commissioner of the State complaints", in the case of the Region of Sicily) about spending and budget laws of the Regions (and even of those with special status) were issued[V].

The numerous appeals are of a certain interest for us because they show that the "justiciability" of the "balanced budget" principle is to some extent a congenial operation for the State in order to control the budgets of Regions and local authorities and thus the financial autonomy of the various levels of government[VI]. On the other hand, a judicial review of the State balance tends to fade away and becomes not easily feasible, essentially because of the lack of entitled claimants legitimate to appeal against the State budget law (Scaccia 2012: 4).

Finally, in order to give an overview of the complex articulation of Italian public finance coordination between the central State and sub-national authorities, it is necessary to report that the Italian Parliament also approved Law no. 213/2012 (converting the Legislative Decree no. 174/2012[VII]) aimed at strengthening the auditing system of the management of financial resources by territorial authorities carried out by the Court of Auditors[VIII].

The Legislative Decree basically prescribed the Court of Auditors' control over regional expenditure laws through a special report to be transmitted to the Regional Councils and then to the Presidency of the Council of Ministers (Prime Minister). Moreover, the Legislative Decree established the control of the Regional Sections of the Court of Auditors over the budget plans and financial statements of Regions, the entities of the Regional Health Service, and of local authorities in order to verify their compliance with the goals fixed by the Internal Stability Pact. Finally, another very important novelty introduced by the Legislative Decree is the extension of the "Parification Judgment" (*giudizio di parificazione*) to the financial statements of all Italian Regions, whilst previously it applied only to Regions with Special Statute (except Aosta Valley).

2. The "*harmonisation of public accounts*" as an exclusive State competence

After the Constitutional Reform no. 1/2012, the new Article 117, Paragraph 2, letter *e*,

of the Constitution states that the matter of "*harmonisation of public accounts*" is no longer a legislative competence shared between State and Regions but becomes an exclusive State competence[IX].

This change involves the relevant legal repercussions, since the matter of "*harmonisation of public accounts*" takes shape as a subject different and independent from that of "*public finance coordination*", which is still a matter of shared competence between State and Regions[X].

If we take into consideration the decisions of the Constitutional Court after the reform of Title V of the Italian Constitution on the subject of "*harmonisation of public accounts and public finance coordination*" on appeals launched by either the State or the Regions, there is insufficient information to draw a clear dividing line between the two subjects, as they have always been considered a single matter of shared competence between State and Regions[XI].

The attribution of both areas to the shared competence of State and Regions had taken place through the reform of Title V of the Italian Constitution[XII] (Constitutional Law no. 3/2001) with the aim to implement a so-called "*fiscal federalism*".

Through a new and more detailed division of legislative powers in financial matters, the exclusive competence "*State taxation and accounting systems*" and "*resource equalization*" was attributed to the State, while it was povided that the field of "*harmonisation of public accounts and public finance coordination and tax system*" would become a shared competence between State and Regions[XIII].

The main goal of that Constitutional Reform was creating a system of relations between the State and the several levels of government able to establish a direct relationship between the taxes collected in a specific area of the country - municipalities, provinces, and Regions - and the proceeds used by the same governments of these areas.

As a matter of fact, it is relevant to underline that from the Constitutional Reform of Title V of the Italian Constitution in 2001 until the approval of Law no. 42/2009 (specifically designed to implement the "fiscal federalism" designed by that constitutional reform), the central government dictated the fundamental principles of the harmonization of public accounts, public finance coordination and the tax system by means of the *Finance Act* (now called "*Stability Law*") in a very "authoritative" way, i.e. through introducing a whole series of constraints[XIV] for the Regions and local authorities budgets (Carboni 2011: 651-652).

It was only in 2009, with the approval of Law no. 42, that the Italian Parliament gave a boost to the federalist process.

Through the recognition of the "*general principles of public finance coordination and tax system*[XV]" and through delegating to the national executive the task of implementing these principles using legislative decrees, the legislator intended to lay down the foundations for a financial coordination based on the joint participation of all levels of government that was supposed to be essential for the implementation of fiscal federalism.

A process that – although still being difficult to implement, more than a decade after the reform of Title V of the Constitution – now seems destined to suffer from a setback with the entry into force of Constitutional Law no. 1/2012.

The subject of "*harmonisation of public budgets*" having become a State exclusive competence, the central government will be no more limited to a mere determination of fundamental principles (as wanted by the reform of Title V of the Constitution). Instead, it will benefit from an autonomous competence, of the exclusive type, which might, presumably, allow it to approve much more detailed regulations that are able to bind the financial autonomy of regions and local authorities much more tightly.

It is, therefore, clear that all depends on the interpretation that will be given to the concept of "harmonization" in the field of "public budgets".

In European Union Law, the concept of "*harmonisation*" summarizes the process by which the refinement of legal systems (or, more specifically, the refinement of national laws governing a particular matter) becomes possible in order to perform the implementation of a common, supranational purpose[XVI].

Harmonisation thus involves an "approximation" of different legislations that is realized by directives indicating objectives and incorporating principles and guidelines from which is excluded, in principle, the possibility to outline more detailed regulations.

The question should thus be whether this meaning of "harmonization" might be used with reference to the notion of "*harmonization of public accounts*".

If so, the State would be authorized to enact legislation containing only general principles, but not also detailed regulations.

However, such an interpretation would make the constitutional reform meaningless to the extent that it makes the matter of "*harmonisation of public budgets*" an exclusive competence, and no longer a shared one.

Only a different meaning of "harmonisation", which does not coincide with that which is of European derivation, might make sense of the new allocation of the subject matter into the exclusive competence of the central government.

On the other hand, however, it is impossible to state that the constitutional reform assigns the State an unlimited legislative power in the field of "public budgets".

"*Harmonization of public account*", as the State's exclusive competence, cannot automatically imply a central government unification of the balance procedures because, if so, it would loosen the minimum and essential guarantee of financial autonomy of decentralized governments (Salerno 2012: 161).

Indeed, it is important to emphasize that, despite the transfer of legislative competence, the term "harmonization" remains within the constitutional provision. Hence, it is necessary to attribute the proper relevance to this choice made by the constitutional legislator.

In other words, the term "harmonization" of Article 117, Paragraph 2, Italian Constitution, should be granted a meaning that, on the one hand, does not coincide with its European intention (in order to render the transfer of legislative competence meaningful) but that, on the other hand, is able to prevent the State from adopting an unlimited, detailed fiscal discipline, leaving in this way the Regions with an only limited margin of legislative autonomy.

At the same time, it would be interesting to figure out what kind of consequences is implied by the possibility of the central government to not only enact principles and general criteria, but also precise and detailed rules in the subject of "*harmonization of public budgets*".

One of the consequences might be the possibility of Regions to appeal against all too detailed regulation adopted by the State in the subject of "*harmonisation of public budgets*". In fact, a situation in which a subject matter is an exclusive competence of the central government could mean that it will no longer be possible for the Regions to appeal to the Constitutional Court for violations of shared competences.

In this way, there would only be two possibilities left for Regions to appeal against State regulations regarding the harmonization of public budgets: when State legislation is suspected not to fall within the field of harmonization but, more properly, in the field of public finance coordination; or if a Region considers that the State has adopted detailed

regulations in this area that go beyond the limitations inherent in "harmonisation" interpreted as a "restricted" legislative technique.

Secondly, the transfer of the "*harmonisation of public accounts*" matter into the exclusive State legislation sphere may determine the simultaneous assignment to the State of the regulatory power related to this specific field in accordance with the sixth Paragraph of Article 117 of the Italian Constitution, which stipulates that "*regulatory powers shall be vested in the State with respect to the subject matters of exclusive legislation, subject to any delegations of such powers to the Regions. Regulatory powers shall be vested in the Regions in all other subject matters*".

It is not predictable whether and how much the influence of the central government on the financial autonomy of the various levels of government will grow, the State being in the ideal position to transfer many of the contents of the "*public finance coordination*" matter into that of "*harmonization of public finance*".

Furthermore, the content of the bill on a constitutional amendment submitted by the Italian Government on 15 October 2012 regarding a thorough reform of Title V of the Constitution is perfectly consistent with this hypothesis: Article 2, Paragraph 1, letter *c* of this bill repeals Article 3 of the Constitutional Law 1/2012 and defines the whole matter of "*harmonisation of public accounts, public finance coordination and tax system*" as an exclusive State competence.

3. The extension of the "balanced budget" principle to Regions and local authorities and the introduction of the obligation of complying with European economic and financial constraints

Up to now, the Italian sub-national governments' contribution to achieving the fiscal objectives fixed by the *Stability and Growth Pact* - adopted by the Amsterdam European Council in June 1997 – has mainly been governed by the State through the so called "*Internal Stability Pact*[XVII]"(Law no. 448/1998).

In particular, the *Internal Stability Pact* was conceived in order to guarantee the convergence of the Italian internal economic and financial system towards common specific criteria established at European level through the Stability and Growth Pact and the Treaty of Maastricht.

To reach this goal, it was considered essential to secure sub-national government cooperation in achieving the two primary objectives of "economic cycle stabilization" and "public finance sustainability".

Along these lines, over the years Italian public finance coordination mainly consisted of the State imposing financial constraints onto sub-national governments.

The primary objective of the fiscal rules contained within the Internal Stability Pact was to supervise the net public borrowing of sub-national authorities. This goal was pursued, on the one hand, by imposing constraints in order to achieve incremental savings compared to the results achieved in previous years and, on the other hand, through a progressive reduction of State transfers to those authorities.

Moreover, beyond the provisions of the Internal Stability Pact, the imposition of specific financial constraints by the State on sub-national authorities also took place through a succession of various "Stability Laws", financial manoeuvres implemented by Law-Decrees arising from Article 77 IC, and provisions raised in many sector-specific national laws.

The high number of State measures, however, failed to ensure compliance with the parameters set by the European Union.

The reports submitted by the Court of Auditors revealed a high level of debt at all levels of Italian government and a massive recourse to public borrowing[XVIII].

Therefore, no effective control of net borrowing by sub-national governments was achieved. Some sub-national governments found themselves in very bad financial conditions and were even subjected to deficit repayment plans.

The "balanced budget" constitutional reform aims at disrupting such heavy conditions of financial distress faced by regional and local authorities.

The second Paragraph of Article 119 IC, as amended by the Constitutional Law 1/2012, now states that: "*Municipalities, Provinces, Metropolitan Cities and Regions shall have revenue and income autonomy in compliance with their balanced budgets, and shall contribute to ensure the observance of the economic and financial constraints deriving from the European Union*."

As it is possible to notice, on the one hand the new constitutional provision extends the balanced budget principle to the regional and local authorities. On the other hand, it constitutionalises the principle of regional, provincial and municipal contribution to fulfilling the economic and financial constraints imposed by the European Union.

The new formulation of Paragraph 1 of Article 119 IC does not ensure that territorial authorities have the opportunity to make reference to the needs of fiscal policies in function of the economic cycle, as instead it is afforded to the State by the amended Paragraphs 1 and 2 of Article 81 IC.

This means that only the central government has a certain flexibility in the budget choices concerning the balance between income and expenditure, being authorised to take into consideration the trends of the economic cycle and in the event of exceptional circumstances (Article 81, Paragraph 6, IC).

Moreover, it must be stressed that the expression "*in compliance with their balanced budgets*" means that the balanced budget principle has to be applied to each territorial authority individually, and not to territorial authorities as a whole. In fact, each of them is required to ensure compliance with this principle within its own budget, and this kind of "individual" responsibility guarantees the observance of the obligations deriving from the European legal system through the complexity of institutions in the multilevel financial system.

The provisions of the constitutional reform have been fully implemented through the "reinforced" law (Law no. 243/2012) that was specifically designed to introduce "*the basic standards and criteria to ensure the balance between revenue and costs of the budgets* (...) *of all the public administrations*" in accordance with the amended Article 81, Paragraph 6 IC.

This Law, consolidating at central level control over national public finance, seems able to overcome some of the structural problems that since the reform of Title V of the Constitution have characterized the fragmented Italian public finance coordination.

In particular, Article 9 clarifies under which conditions it is possible to consider as "balanced" the budgets of the Regions (both of the autonomous Regions with a special statute and Regions with ordinary statute), Municipalities, Provinces, Metropolitan Cities and the autonomous Provinces of Trento and Bolzano/Bozen. It is necessary that, both at the budget formation and approval stages, such authorities show: *a)* a non-negative commitment- and cash-based balance of final revenues and final expenditure; and *b)* a non-negative commitment- and cash-based balance of current revenues and current expenses, including principal repayment instalments on loans (Article 9, Paragraph 1).

Article 9 also states that in case of failure to achieve the "*balanced budget objective*" arising from the management report and in case of a negative balance in one of the two mentioned circumstances, "*the Region or the authority in question shall adopt corrective measures to*

ensure budgetary realignment within three years" (Article 9, Paragraph 2). By contrast, any surplus shall be used to pay off any accrued debt or, if related to current revenues and current expenditures, may be used to finance investment expenditures, in the way established by the subsequent Article 10 of the Law (Article 9, Paragraph 3).

The latter obligations regarding the surplus are, furthermore, set only for Regions and local authorities, inasmuch the Law does not prescribe a similar obligation for the central government.

Finally, Article 9 charges the State with the task of establishing an *ad hoc* sanction system in the event in which Regions and local authorities fail to achieve the "*balanced budget objective*" through the provision of *"specific repayment plans*".

4. The prohibition of public borrowing

With the constitutional reform, public borrowing has been prohibited, both with reference to central government and as regards territorial authorities.

More specifically, following the literal tenor of Article 81, Paragraph 2 IC, State public borrowing is prohibited except in the event it is made "*in order to consider the effects of the economic cycle*". There are therefore only two cases in which State public borrowing is permitted. The first does not require parliamentary authorization if public borrowing is made in order to guarantee adjustment to the economic cycle. In the second case, public borrowing is permitted in case of the occurrence of "exceptional events" whose existence has to be certified through parliamentary authorization taken with absolute majority (Lupo 2012: 130).

On the other hand, a stricter provision has been introduced as regards public borrowing by regional and local authorities.

The new Article 119 IC states that Municipalities, Provinces, Metropolitan cities and Regions "*shall borrow only to finance investment expenditure with the contextual definition of the harmonization schedules and under the condition that for the complex of entities of each Region the budget balance is respected*".

It has to be noted that the provision limiting borrowing exclusively to finance investments had already been introduced into Article 119, Paragraph 6 IC, by the reform of

Title V of the Constitution in 2001. To be precise, even before its introduction into the Italian Constitution the principle of public borrowing limited to investment expenditure had been recognised by Italian ordinary legislation (Article 10, Paragraph 2 of Law no. 281/1970 for the Regions and Article 202 of the Local Authorities Act –"TUEL" – see Legislative Decree no. 267/2000).

Now the new formulation of Article 119, Paragraph 6 IC, requires two more conditions to be fulfilled before Regions and Local authorities can resort to public borrowing to finance investment expenditures.

First of all, a contextual definition of the amortization schedule is required.

Secondly, it is required that the balanced budget rule is respected by all the local governments within a Region.

As it has been noted by the Dossier of the "Servizio Studi Senato della Repubblica A.S. 3047", requiring a definition of the amortization schedule means that compliance with the balanced budget principle becomes a kind of "intertemporal obligation" for territorial authorities.

Each authority is in fact required to ensure a balanced budget over the whole period considered, also taking into account depreciation charges.

Moreover, the opportunity for every single authority to borrow is subject to the condition that the balance budget principle is respected by each public administration of that Region. In other words, this means that, in case of a deficit by one local government, this must be covered with the surpluses produced by the other authorities within that Region, thus ensuring an overall balanced budget of that regional aggregate.

This seems to represent a new and very strict limit for territorial authorities' political self-determination. Each local authority, in fact, even if fully respecting the balanced budget principle, would be unable to borrow just because the neighbouring authority's financial mismanagement caused an imbalanced "*consolidated regional budget*"(Cecchetti 2012: 7).

Law no. 243/2012 on the implementation of the balanced budget principle clarified what the expression "*the complex of entities of each Region"* means. Indeed, it was not clear whether also the Region itself should have been considered as part of that "complex of entities". Excluding the Region from the complex of entities would mean that the budget of a local authority of that Region had to be compensated only by the balances of the other

entities of the considered aggregate, excluding that of the regional government as itself not being part of the complex.

Actually Article 10, Paragraph 3, of the Law explicitly established that also the Region had to be considered part of the "complex".

However, it must be noted that considering Municipalities, Provinces and Metropolitan Cities as "entities of a Region" might conflict with the "principle of autonomy" stipulated by Article 114 IC which explicitly states that: "*Municipalities, Provinces, Metropolitan Cities and Regions are autonomous entities having their own statutes, powers and functions in accordance with the principles laid down in the Constitution*".

Finally, Law no. 243/2012 also established the conditions and limitations of borrowing to cover investment expenditures.

In particular, Article 9, Paragraph 2, states that the borrowing transaction must take place through the contextual definition of the amortization schedule, whose duration remains closely linked to the investment and whose content should emphasize "*the incidence of the obligations on the individual future accounting periods as well as how to cover the corresponding expenses*".

5. Conclusions

The constitutional reform which introduced the "balanced budget" principle into the Italian Constitution essentially intervened on two fronts, as it directly regards the financial autonomy of both Regions and local authorities: On the one hand, by moving the subject of "*harmonization of public accounts*" from the list of shared competences to that of exclusive state competence and, on the other, by modifying the constitutional provisions regarding the financial autonomy of territorial authorities contained in Art. 119 IC, in order to extend the same "balanced budget" principle to Regions and local authorities and reiterating that they are obliged to comply with the economic and financial constraints deriving from the EU legal order.

At the same time, Law no. 243/2012 constituted the corollary of the constitutional reform by implementing its general principle and goals.

In fact, after a brief analysis of some of its dispositions, one might argue that the latter regulatory intervention coherently integrates the general operation of narrowing the regional and local financial autonomy set forth by the mentioned constitutional reform.

In other words, it is possible to affirm that the constitutional reform of Articles 117 and 119 IC, as well as introducing correction mechanisms of different nature in order to respond to emergencies arising from the financial crisis, seems to conceal the intention of reversing the "fiscal federalism" process started in Italy with the reform of Title V of the Constitution in 2001, which laid out a progressive and increasing allocation of relevant functions to Municipalities, Provinces, Metropolitan Cities and Regions through the recognition of the need for adequate financial independence at every level of government.

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I The Fiscal Compact - formally "*Treaty* on Stability, Coordination and Governance in the EMU" (TSCG) - was signed on 2 March 2012 by all Member States of the EU except the Czech Republic and the United Kingdom.

II Article 3.1 Fiscal Compact: "*The Contracting Parties shall apply the rules set out in this paragraph in addition and without prejudice to their obligations under European Union law:*

(a) the budgetary position of the general government of a Contracting Party shall be balanced or in surplus;

(b) the rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0,5 % of the gross domestic product at market prices. The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks. Progress towards, and respect of, the medium-term objective shall be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, in line with the revised Stability and Growth Pact."

III Through judgment no. 183 of 1973 (on the primacy of Community Law, even with the reserves of so-called "*controlimiti*"), and judgment no. 170 of 1984 (concerning the direct effect of EU Law in the Italian legal system), the Constitution becomes, to some extent, fully "available" for the Constitutional Court so that, through constant reference to Article 11 IC, it provides coverage for the sovereignty limitations arising from the European framework, on the one hand, and seems to lay the groundwork for a lack of responsibility of the State legislature in modifying and adapting the Constitution to EU Law, on the other (Costanzo 2008).

IV We talk about "reinforced" law due to the special majority required. The Constitutional reform prescribed this special majority both for the authorization of public borrowing in presence of "exceptional events" (Article 81, Paragraph 2, IC) and for the adoption of the "Reinforced Law" *ex* Article 81, Paragraph 6, IC. In this way it is possible to ensure the involvement of the opposition both in "systematic" and "contingent" most important parliamentary decisions of public finance (Lupo 2012: 134).

V In order to give some examples, the Commissioner of the State last year appealed against the Region of Sicily's Bill no. 801/2012 entitled "*Disposizioni programmatiche e correttive per l'anno 2012. Legge di stabilità regionale*". This complaint was soon followed by the appeal against Bill no. 898/2012 ("*Autorizzazione al ricorso ad operazioni finanziarie*") approved by the same Region, because it confirmed the content of the previous Bill. The President of the Council of Ministers, on the other hand, appealed during the year against several regional laws such as Law no. 18/2012 enacted by Region of Puglia ("*Assestamento e prima variazione di bilancio di previsione per l'esercizio finanziario 2012*"); Law no. 25/2012 enacted by Region Friuli Venezia Giulia ("*Riordino istituzionale ed organizzativo del servizio sanitario regionale*"); Law no. 30/2012 enacted by the Region Valle d'Aosta/Vallée d'Aoste ("*Adeguamento del bilancio di previsione per l'anno 2012 agli obiettivi complessivi di politica*

economica e di contenimento della spesa pubblica previsti dal decreto-legge 6 luglio 2012, n. 95 (Disposizioni urgenti per la revisione della spesa pubblica con invarianza dei servizi ai cittadini nonché misure di rafforzamento patrimoniale delle imprese del settore bancario). Modifiche a disposizioni legislative"). All these complaints were mainly based on a suspected violation of the distribution of competences between State and Regions in the subject of "*public finance coordination*" (Article 117, Paragraph 3, IC), or, on the other hand, on the suspected violation of the principles of public finance established by Article 81 IC.

[VI] As regards the conflicts between the constituent entities of the Italian Republic, on the basis of Article 134 of Italian Constitution, "*The Constitutional Court shall pass judgement on controversies on the constitutional legitimacy of laws and enactments having force of law issued by the State and Regions or conflicts arising from allocation of powers of the State and those powers*".

Article 39 of Law no. 87/1953 ("R*ules on the establishment and functioning of the Constitutional Court")* specifies that if a Region violates the State's or another Region's sphere of competence as assigned by the Constitution, the State or the concerned Region may, respectively, appeal to the Constitutional Court in order to solve the conflict. Otherwise, also a Region whose constitutional competence is violated by a State act can appeal to the Constitutional Court. However, such an appeal in matters of competence regulation shall indicate the so called "*interest in appealing*" by showing "*how the conflict of competence arose*" and "*the act by which the competence is violated, as well as the provisions of the Constitution and the constitutional laws that are considered violated*".

On the other hand, Italian Constitution does not allow that local authorities appeal directly to the Constitutional Court.

[VII] Article 1 of the Decree Law no. 174/2012 is entitled "*Strengthening of the Court of Auditors' participation on the control of the territorial authorities' financial management*".

[VIII] As established by Article 100, Paragraph 2, of the Italian Constitution, "*The Court of Accounts exercises preventive control over the legitimacy of Government measures, and also ex-post* auditing *of the administration of the State Budget. It participates, in the cases and ways established by law, in auditing the financial management of the entities receiving regular budgetary support from the State. It reports directly to Parliament on the results of audits performed*". Moreover, Article 103, Paragraph 2, of the Italian Constitution, states "*The Court of Accounts has jurisdiction in matters of public accounts and in other matters laid out by law*".

[IX] "*In Italian constitutional law, there are three typologies of competences. The first are competences exclusive to the State, which are listed in Article 117, paragraph 2, of the Constitution. The second are shared (or* concurring*) competences where State and Regions co-legislate, a "portion" of the matter being acknowledged to each. It is up to the State to give the fundamental principles of the legislative regime by means of legislation known as* "framework law" (c.d. "legge-quadro"), *and it is up to the Region to fill in* ("complete") *the framework by giving the detailed provisions, which should be consistent with the fundamental principles laid down by the State act*" (Martinico 2011: 33-36).

[X] In the former formulation of Article 117 of Italian Constitution both "*harmonization of public accounts*" and "*public finance coordination*" were matters of shared competence between State and Regions.

[XI] With judgment no. 17/2004, the Constitutional Court stated that the terms "*harmonization of* public *accounts*" and "*public finance coordination and tax system*" constituted an "hendiadys", in which the two terms used would express, in substance, the same concept.

By the following judgment no. 414/2004, the Constitutional Court even went beyond the definitional problem, stating that "*harmonization of public accounts and public finance coordination*" does not have to be understood as a "matter" in the strict sense, but rather as a "functional competence", because it does not properly identify "objects", but strategic "goals" that stand for the constitutional basis on which the State legislative power is based, ensuring the financial balance of the whole Italian Republic while safeguarding the autonomy of the various components in which it is divided.

[XII] Before the reform of Title V of the Italian Constitution, "*public finance coordination*" was an exclusive state competence. The central government undertook to satisfy regional and local needs through a resource transfer system.

[XIII] Article 117, Paragraph 2, IC as amended by Constitutional Reform of Title V, stated the following: "*The State has exclusive legislative powers in the following matters: (…)*

e) the currency, savings protection and financial markets; competition protection; foreign exchange system; state taxation and accounting systems; equalization of financial resources."

At the same time, Paragraph 3 of Article 117 stated that "*Concurring legislation applies to the following subject matters:* (…) *harmonization of public accounts and co-ordination of public finance and taxation system*."

[XIV] Pending the conclusion of the implementation process of Article 119 IC, the 2004-2008 Financial Acts have introduced measures such as the suspension of some State transfers to local authorities (Article 2,

Paragraph 20, Law no. 350/2003) or the recognition of the regional power to vary the additional IRPEF rates and the IRAP rates (Law no. 311/2004) to cover the regional health system's deficits. At the same time they granted the municipalities the right to vary the IRPEF rates up to a maximum limit. The 2009 Financial Act (Law no. 203/2008) set upper spending limits for the Regions and laid down new rewarding or penalizing rules for the municipalities with more than 5,000 inhabitants, depending on whether they achieved a positive or negative final balance. (Carboni, 2011)

[XV] Article 2 of Law no. 42/2009 recognised a series of general objectives and criteria, including: revenue and expenditure autonomy; greater administrative, financial and accounting liability for all levels of government; enforceability and consistency of individual taxes and of the tax system as a whole; tax system simplification; identification of the fundamental principles of public budget harmonisation in order to ensure a uniform and predefined provision of municipal, provincial, metropolitan and regional budgets; a gradual overcoming, at all the government levels, of the "historical spending" criterion in favour of the "standard requirements" criterion to finance the "essential levels" (indicated by Article 117, paragraph 2, letter m of the Italian Constitution) as well as "basic functions" (indicated by Article 117, paragraph 2, letter d, of the Italian Constitution).

[XVI] Article 249 (ex 189) of the Treaty of Rome 1957 stipulates that directives are binding as to the result to be achieved, but that each individual Member State can use its discretion on how to implement it ("[a] *directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods*").

[XVII] The "*Internal Stability Pact*" was introduced into the Italian legal system through the Financial Act no. 448/1998 in order to guarantee the participation of local authorities in reaching the public finance goals arising from the Italian commitment to the Stability and Growth Pact adopted by the European Council of Amsterdam in 1997.

As regards local authorities, see the recent report " *La finanza locale nei rendiconti 2011 – Valutazioni di sintesi*" (*Deliberazione n. 7/SEZAUT/2013/FRG*), available at http://www.corteconti.it/export/sites/portalecdc/_documenti/controllo/sez_autonomie/2013/delibera_7_2013_frg.pdf. Among the reports concerning the Regions, see in particular "*Relazione sulla gestione finanziaria delle Regioni negli esercizi 2009-2010*" *(Deliberazione n. 6/SEZAUT/2011/FRG)*, available at http://www.corteconti.it/export/sites/portalecdc/_documenti/controllo/sez_autonomie/2011/delibera_6_2011_e_relazione.pdf.

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The international role of the European Parliament: The SWIFT Affair and the 're-assessed' European institutional balance of power

by

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Abstract

Dominated since its early beginning by the Member States, the Common Foreign and Security policy (CFSP) has long been criticized for its lack of democratic legitimacy. The entering into force of the Lisbon Treaty enhanced the European Parliament's role in that field and although it cannot act as a full legislator, it nonetheless acquired new powers for acting internationally. One of the most important achievements regards the EP's role in the conclusion of international agreements. The new Art. 218, para. 6 TFEU finally provides for the EP's mandatory approval before the conclusion of all EU international agreements for which the internal co-decision procedure is required.

The international role of EP is thus gradually accepted in the academic literature.

In this line, the aim of the paper is to provide empirical evidence and to identify the most significant aspects that have emerged in parliamentary practice. The paper focuses on the SWIFT affair and, by looking at the novelties introduced by the Lisbon Treaty, investigates the EP's international role and the extent to which the new powers impact on both the internal inter-institutional balance and EU external relations.

Key-words

European Parliament, institutional balance of power, European Union, international relations, SWIFT affair, data protection, human rights, counterterrorism cooperation, USA

Introduction

Set up as an unelected institution, the European Parliament (EP) has always fought a battle to extend its powers over those areas with limited legislative capacity. Hence, by using non-legislative means of contestation for interfering with the decision-making process, it has been able not only to extend its area of influence, but the informal practices have even found their realisation in the formal recognition by the Treaties (Crum 2006).

From this perspective, identified as a constant in the European institutional architecture (Fasone Lupo 2012), the gradual and increasing parliamentarisation of the European Union (Maurer *et. al.* 2005; Costa 2009) fits particularly well with the field of foreign affairs.

The EP, in spite of having few formal powers, has always attempted to play an active role in the formulation of EU foreign and external policies (Piening 1997; Maurer *et al.* 2005) and, by extensively using "the inter-institutional agreements and its budgetary powers" (Jacqué 2004: 388), mostly managed to influence the Council's decisions.

The Lisbon Treaty has further expanded the parliamentarisation of the European Union and formally recognised the EP's enhanced role. Even in the field of foreign affairs, although it cannot act as a full legislator, it nonetheless acquired new oversight functions on the international ground. One of the most important achievements regards the EP's role in the conclusion of international agreements. The new Art. 218, para. 6 TFEU finally provides for the EP's mandatory approval before the conclusion of all EU international agreements for which the internal co-decision procedure is required. Although exceptions still persist in the area of CFSP, the EP can thus exercise a veto over the conclusion of the abovementioned international agreements.

Having set the background, the purpose of this paper is to investigate which changes have been brought about by the Lisbon Treaty. Specifically, it scrutinizes the empowered EP capacity to act internationally and, it examines the potential impact of the new functions on the internal institutional balance of power and on the EU external relations.

Following these premises, the paper investigates, on both legal and political grounds, the case of the SWIFT affair (EU-US agreement on the sharing of financial data). The choice of the case is related to two main reasons. First, the SWIFT affair represents the first case that sees the EP directly and formally involved in the international affairs. Second, the affair illustrates particularly well the *passage* from the pre- to the post-Lisbon *era*.

Moreover, the SWIFT affair deals with highly salient issues and it is worth noting from the outset that the EP has always been active in the area of human rights and data protection within Europe (Servent and Mackenzie 2011). In this line, the paper – set in a historical perspective – provides evidences that the reaction of the EP in the SWIFT affair was coherent with its past attitude with regard to that issue.

The paper is structured as follow. At the outset, in the first section a brief overview over the concept of institutional balance is provided. In the second section, the paper sets out the background to the Lisbon Treaty provisions, mainly with regard to international agreements. In the third section, the paper underlines the role of the EP in areas dealing with data protection. In the fourth section, the paper examines the implementation of the Lisbon provisions and specifically investigates the SWIFT affair. Finally, the last section explores the impact of the entering into force of the Lisbon Treaty as regards the internal inter-institutional balance as well as EU external relations.

1. The Institutional balance of power

Before entering into the core of the paper, this section introduces the concept of institutional balance, which can be deemed as the quintessential concept of the EU framework.

The concept involves two different lectures of the inter-institutional relations among EU institutions: the fist legal, the second political.

Speaking in legal terms, the concept of institutional balance is conceived as the constitutional principle according to which the EU institutions and the Member States have to act within the limits of their respective spheres of competence as provided for by the Treaty. The concept was introduced by the Court of Justice of the European Union

(CJEU) in the famous *Meroni case* in 1958 and the concept has been used by the Court itself as an alternative to the principle of the separation of powers (Jacqué 2004: 384). In this line, based on the principle of conferral, as stated in Art. 13(2) TEU, the concept is essentially conceived of in a static way, aimed at protecting the legal prerogatives and safeguarding the interests of institutions and the rights of individuals.

Speaking in political terms, the concept is understood as the relative power position of European institutions. In this sense, and contrary to the legal approach, from a political point of view the concept has always had a positive and dynamic application, which refers not only to the distribution of competences and the changes brought about by the recent Treaty reforms but, rather, scrutinises the institutional behaviour of as well as the power relationship between the institutions.

According to the political approach, the balance has thus significantly evolved over time not only because of the Treaty reforms but also through the practical exercise of powers and procedures defined in the Treaties.

In 1988 the Court, reconciling for once the legal to the political approach, acknowledged for the first time the dynamic application of the concept. In this case, the Court – recognizing the active right of the EP to bring an action of annulment in defence of its own prerogatives – stated:

"Those prerogatives are one of the elements of the institutional balance created by the Treaties set up a system for distributing powers among the different Community institutions, assigning to each institution its own role in the institutional structure of the Community and the accomplishment of the tasks entrusted to the Community. Observance of the institutional balance means that each of the institutions must exercise its powers with due regard for the powers of the other institutions. It also requires that it should be possible to penalize any breach of that rule which may occur."[I]

Having in mind this statement, it is undeniable that both the legal and political concepts become fundamental for understanding the European institutional balance. Because, despite the lack of a unique definition of what exactly that balance is, it is nonetheless clear that for any inter-institutional quarrel the institutions involved have

always used their own capacity and all the means available to them in order to change the institutional balance to their own advantage. Changes which are fostered either through legal means within the formal rules of the Treaty or through more informal mechanisms outside Treaty procedures. On the same point, Prof. Craig summed up the two understandings and confirmed that the concept of institutional balance "presumes by its very nature a normative and political judgment as to which institutions should be able to partake of legislative and executive power, and it presumes also a view as to what constitutes the appropriate balance between them" (Craig 2011: 42).

Following this premise and applying the concept to the role played by the EP over time, studies have shown that, in legal terms, the "EP power over political outcomes has increased dramatically with the successive Treaty reforms" (Hix 1999) and, in political terms, also "confirm[ed] that the EP's legislative impact has increased [and] that the EP has used its power of scrutiny, investiture and censure to influence the executive actions of the Commission" (Hix 1999).

This process has been more evident on issues subject to the so-called intergovernmental method. In most of the cases, the EP has successfully sought to extend its own power of consultation. One example is the 1983 "Solemn Declaration on European Union", where the Council, without any formal provisions in the Treaties, accepted to answer all parliamentary questions. Moreover, the EP has extensively used "the inter-institutional agreements to develop its power […] and it made full use of its budgetary powers in order to influence the legislative action of the Community" (Jacqué 2004: 388). This is also what happened in foreign affairs, where the EP lengthily recurred to its power to oversee the expenditure of the Common Foreign and Security Policy (CFSP) in order to influence the Council's decisions in that field (Keukeleire and Macnaughtan 2008: 120; Thym 2008: 223)[II]. A power today further reinforced by the post-Lisbon provisions which extend the EP's oversight functions over the Union's non-compulsory expenditure (Art. 314 TFEU).

The constant attempt of the EP "to extend its powers, using the means of pressures it had on other institutions"(Jacqué 2004: 284) clearly rests on its own vision of its role inside the institutional architecture. The EP never considered itself as part of a "finished

institutional system" but as of one "requiring evolution or even transformation into something different, based on more parliamentary principles" (Corbett *et al.* 2003: 294); thus it had to "fight hard to take its place in the system of decision making" (Krauss 2000: 218).

Obviously, all of this has had a profound impact on the European institutional balance of power and the Lisbon Treaty represents the legal recognition of the increasing EP involvement in EU foreign affairs, which has relevant consequences for the entire European constitutional settlement (Koutrakos 2011).

2. The Lisbon Treaty and International Agreements

The constant dialectic over the dynamic and static concept of institutional balance finds in the momentum of Treaty revisions a potential *de facto* equilibrium, where the debate over the legal framework combines with an in-depth analysis of the evolving practice.

The constant attempt of the EP to extend its powers over the other institutions reflects what has been identified in the literature as a constant in the evolution of the European institutional architecture: the progressive formal extension of the EP's powers (Fasone and Lupo 2012: 329).

In this way, the Lisbon Treaty abolishes the pillar structure and expands the co-decision procedure – today simply labelled the ordinary legislative procedure – over forty new legislative areas over which the EP and the Council act as a "bicameral legislative authority" (Corbett *et al.* 2007: 215).

The EP's powers are thus extended into areas previously reserved for intergovernmental methods and, as far as foreign affairs are concerned, one of the main novelties brought about by the Lisbon Treaty regards the new provisions on the conclusion of international agreements.

The former Art. 300 TEC has been replaced by the new provisions established in Art. 218, para. 6 TFEU which enlarge the EP's competences from a simple consultative role to the recognition of a real veto power over the conclusion of international agreements.

Thus, with the exception of CFSP, the new setting has established "a sort of 'parallelism' between the internal and external competences" (Fasone and Longo 2012: 6;

see also Thym 2008). In this perspective, the EP has to consent to all international agreements negotiated on matters which internally are subject to the ordinary legislative procedure or where the consent of the EP is needed.

This reform has undeniably increased the role of the EP in the international arena; all the more so if one scrutinizes the practice of the consent procedure in the EU framework. Apparently because of only a minor impact with respect to the ordinary legislative procedure, it should instead be wondered how much the consent procedure differs from it (Chamlers *et. al* 2010: 112).

In fact, the procedure "grants Parliament an infinite power of delay and an absolute power of rejection" (Westlake 1994: 96), which obliges the other institutions to collaborate with it and take into account the EP's position.

Of the same opinion, in 1988 the CJEU, referring to the consent procedure, used the term 'joint decision' that, translated into French, corresponds to "co-decision" (Passos 2011: 50). In this way, as already argued by legal scholars, the use of the word 'consent' should in reality be understood as a 'co-decision' procedure because one institution cannot adopt an act without the consent of the other (Isaac 1999: 70).

Extending this interpretation to international agreements, a direct involvement of the EP from the outset of negotiations should be expected. And in fact, the EP already and extensively used this power[III] (Corbett *et al.* 2011: 253; Zanon 2005), which endorses the thesis that it "must not merely passively take note of the actions of the other institutions, but it may also bring some influence to bear on the Commission and the Council, in order to facilitate its consent on the final text" (Passos 2011: 53).

Today, with the entering into force of the Lisbon Treaty, this interpretation is further supported by the provision laid down in paragraph 10 of Article 218 TFEU, stating that "the EP shall be immediately and fully informed at all stages of the procedure". This to some extent reflects the already mentioned 1983 Solemn Declaration on European Union, where the Council had already agreed to keep the European Parliament informed about negotiations with third countries.

The EP thus has new powers for making its voice heard and it is the duty of the other institutions to take that into account and to respect the obligation to inform the Parliament. In this line, listening to the Parliament becomes fundamental not only in the

name of loyal cooperation, but rather it forms the core of EU credibility on the international ground. Because, if not respected, the Parliament can use the threat of suspending or refusing to give its assent in order to influence negotiations.

In the next section, the paper gives an overview of the EP's role in the field of data protection. The section is relevant for two reasons. Firstly, it represents a highly salient issue and the EP has always been concerned with assuring its citizens an adequate level of protection; therefore, in a historical perspective, it will be easier to understand the EP's attitude in the SWIFT affair. Secondly, in terms of institutional balance and EU external relations, the section outlines how the EP has always tried to make its voice heard on the international ground, also when no formal powers were in place.

3. Data Protection

In the field of data protection, the EP has always been concerned in assuring its citizens an adequate level of protection. In fact, contrary to the passive Council and Commission attitude, since the 1970s the EP has been attentive to that issue (de Hert et al. 2008; de Hert and de Shutter, 2008) and, in 1974 already, called for a directive on data processing and freedom.

Two years later, the EP adopted a resolution which, on the one side, invited the Commission to take early action for collecting data "as a basis for the preparation of a Community legislative proposal" and, on the other side, requested its Committee on Legal Affairs to define a catalogue of actions to be taken in order to safeguard "the rights of the individual in the face of developing technical progress in the field of automatic data-processing"[IV].

In the 1979, the EP adopted a new resolution which called '*once again*' upon the Commission to take its recommendations into account and to "prepare a proposal for a Directive on the harmonization of legislation on data protection to provide citizens of the Community with the maximum protection"[V].

Despite the EP's resolutions, the Commission and the Council remained inactive until the 1990s. Finally, in 1995 – strongly supported by the EP – the first European regulation

on data protection for community matters was approved and a high level of protection of the privacy of personal data was successfully established[VI] (Pearce and Platten 1998; Fromholz 2000). However, the Data Protection Directive – further complemented by Regulation 45/2001[VII] – was not extended to the third pillar; and although the EP stressed the need "for an all-embracing framework that would also cover the third-pillar measures" (Servent and Mackenzie 2011: 393), the two separate legal regimes persisted and the EP continued to be largely excluded from the decision making process in the public security framework. Moreover, even after the coming into force of the Lisbon Treaty and the subsequent disappearance of the pillar structure, exceptions still persist in the field of Common Foreign and Security Policy (CFSP), which now has its own data protection provisions under Art. 39 TEU (O'Neill 2010).

Despite all of this, the EP's requests[VIII] did not remain unheard. On January 2012, the Commission finally published two legislative proposals[IX], which also include a directive on the processing of personal data in the field of police and judicial co-operation in criminal matters. The aim is "to build a stronger a more coherent data protection framework in the EU"[X] which could solve the existing legal fragmentation. These proposals are currently scrutinized by the Parliamentary Committee on Civil Liberties, Justice and Home Affairs (LIBE Committee) and some of the parliamentary amendments aim at broadening the concept of personal data and strengthening the consent requirements for its processing. Moreover, in order to assure a higher citizens' protection with regard to third countries, the EP stresses the need to take a strict approach regarding data transfer.

On this point, the EP's position has always been clear. After the tragic event of 11 September 2001 and the enhanced EU-US counter-terrorism cooperation, the EP adopted several resolutions against the extended practice of data-sharing with the US.

Moreover, the lack of any clear idea of what should be the right balance between the adequate level of data protection and public security made this "grey area" a place of disagreement between the Council and the Parliament, with the latter continuously trying to extend its own authority over the issue and "to develop strategies of contestation that did not involve legislative influence" (Ripoll Servent and Mackenzie 2011: 39).

The EP thus became "one of the major actors in the transatlantic debate over the data

protection" (Pawlak 2009: 39) and the international and European ideological conflict over data protection turned out to be strictly intertwined with "a more down-to-earth debate about the institutional power" (Pawlak 2009: 38).

One of the first important cases where the EP tried to make its voice heard on the international ground was in the Passenger Name Records case (PNR) on the transfer of passenger's personal data to the US[XI]. At that time, the EP had no power to influence the content of the agreement but – as established by art. 300 TEC – only the right to be consulted.

For this reason, the only way for contesting the agreement was to make use of other means of contestation. As such, the EP – considering the level of data protection insufficient – decided to start proceedings before the CJEU. However, the EP did not dispute the fact of not having been consulted, but instead focused on the legal bases of the agreement. The EP claimed the application of the 1995 European Data Directive to the agreement, which would have implied the extension of the co-decision procedure to that issue and thus its full involvement in and authority over the agreement.

In May 2006, the CJEU annulled the agreement, however not based on the reasons claimed by the EP. Specifically, the Court concluded that the transfer of data for public security reasons does not benefit from the protection of the 1995 Data Protection Directive but instead falls under the legal framework of the third pillar.

Although a victory in terms of obtaining the annulment of the EU-US agreement, the EP nonetheless had lost all competences over any subsequent agreement on the issue and, obviously, was not the outcome that the Parliament had been aiming for. However, the EP's contestation did not remain unheard. On the opening up of the negotiations for a new PNR agreement, the EP was involved in the process and, for the first time in history, on 14 May 2007 the Homeland Security Secretary Chertoff held a speech before the EP Civil Liberties committee[XII].

Thus, the EP had made its voice heard on the international ground and – despite lacking formal powers – was able to interfere with the decision making process. Moreover, by entering into opposition with both the Council and the Commission, as well as with the US, it coherently tried to guarantee an adequate level of data protection.

The next section stresses this point through an analysis of the SWIFT affair. As already underlined, the affair illustrates particularly well the *passage* from the pre- to the post-Lisbon *era*, thereby giving evidence as to how "significantly the Lisbon Treaty has changed the internal balance of power between the EU institutions" (Monar 2010: 145).

4. The SWIFT Saga

Set up in Belgium in 1973, the Society for Worldwide Interbank Financial Telecommunication (SWIFT) was created by the collaboration of 239 banks from fifteen different countries. The aim was to establish "a shared worldwide data processing and communications link and a common language for financial transaction"[XIII]. Today, the cooperative is responsible for more than 80 per cent of the world's financial messages (Servent and MacKenzie 2011; Kaunert *et al.* 2012), which includes personal data, "ranging from the names of the payer and payee to, in some cases, communications in text form that can accompany transaction" (Fuster *et al.* 2008: 192).

After the terrorist attacks of 11 September 2001, the United States made "tracking terrorist financing a top priority" (Connorton 2007: 283) and the SWIFT cooperative became the centre of the US Security Plan. The US Department of Treasury launched the Terrorist Finance Tracking Program (TFTP) and started to issue administrative subpoenas[XIV] to SWIFT.

At that time, SWIFT had two operations centres, one in Belgium and the other in Virginia and was thus – being under double jurisdiction – obliged to cooperate with the US authorities, while violating the more stringent Belgian and EU privacy law which expressly forbade the transfer of personal data to nations that do not ensure an adequate level of protection[XV], such as the United States (Connorton 2007; VanWasshnova 2007-2008).

Kept in the dark, the existence of the TFTP system came to be known on the side of the European institutions and the Belgian authorities only in late 2006. On 23 June that year, the *New York Times, Los Angeles Times* and *The Wall Street Journal* all disclosed the secret programme which immediately caused a strong reaction in the EU. Both data protection

authorities and EU institutions were deeply concerned about the potential threats caused by the TFTP program to privacy and data protection.

The issue, already one of the most contentious in transatlantic relations, lay also one in of the EP's most sensitive areas. The EP – already strongly disappointed by the just concluded CJEU decision on the PNR agreement – was among the first to denounce the system. Moreover, the fact of having just been relieved of competence further increased the EP's concerns about data protection and fostered its strong reaction to the issue.

Lacking formal legislative powers, the EP "worked hard to claim competence over the issue and to shape the political discussions and decisions" (de Goede 2012: 218). Relying on the strength of public opinion and non-governmental organisations, it tried to influence the Council and the Commission's position through the organization of parliamentary hearings and the mobilisation of the media.

In this line, on 6 July 2006 the EP adopted a resolution expressing "its serious concern at the fact that a climate of deteriorating respect for privacy and data protection [was] being created" [XVI].

In October, after the report issued by the Belgian Privacy Commission had concluded that SWIFT violated Belgian Data Protection Law[XVII], the EP organised a public hearing. This gave a chance to Francis Vanbever – financial director of SWIFT – to present the company's position and investigated about the European Central Bank's (ECB) involvement in the SWIFT affair[XVIII].

On the same opinion, in November 2006, the 'Article 29 Working Party'[XIX] condemned the affair and concluded that the system violated "the fundamental European principles as regards data protection and [was] not in accordance with Belgian and European law"[XX].

Finally, in 2007 the EP adopted a new resolution, which stressed the existence of "a situation of legal uncertainty with regard to the necessary data protection guarantees for data sharing and transfer between the EU and the US for the purpose of ensuring public security and, in particular, preventing and fighting terrorism"[XXI]. In this line, it called again for the conclusion of an international agreement on the matter and stressed the need for parliamentary involvement.

In all its resolutions, the EP explicitly demanded the respect for data protection and although its impact on the case was rather limited, the joint dissent coming from both the EP and other EU authorities forced the reaching of an EU-US compromise regarding the SWIFT Program. Agreed on 27 July 2007, the compromise assured that the data obtained through the SWIFT Program would be used exclusively for counter-terrorism purposes[XXII].

4.1. The SWIFT *interim* agreement and the entering into force of the Lisbon Treaty

This compromise was, however, merely a temporary solution and although the EP had always been calling for the conclusion of an EU-US agreement with its full involvement in the negotiations, it was not before the end of 2009 that the US sought to conclude an agreement with the EU on the transfer of financial messaging data. The need for an agreement arose after SWIFT had announced to change its operational architecture and to move its mirror from the US to Switzerland, which would have implied complete EU jurisdiction over the society.

Again, the role of the EP was very limited, as it was not even consulted and again the EP received notice of the actual negotiations only because revealed so by the press in July 2009.

Immediately, on 20 July 2009, Ms Sophie in 't Veld, member of the EP and Vice-Chair of the LIBE Committee, requested access to the opinion of the Council's Legal service concerning the 'recommendation from the Commission to the Council to authorise the opening of negotiations'[XXIII].

On 17 September 2009, a few days after the Council's refusal to give access to the document[XXIV], the EP passed a new resolution where it denounced that neither the negotiating directives nor the opinion of the Council's Legal Service on the choice of the legal basis were publicly available. Moreover, stressing 'the need to strike the right balance between security measures and the protection of civil liberties and fundamental rights', the EP listed a series of requirements that the agreement should "as a very minimum ensure […| the utmost respect for privacy and data protection" [XXV].

However, despite the EP's resolution, "the negotiators did not appear to pay much attention to the opinion of the European Parliament" (Kaunert *et al.* 2012: 488).

With regard to the access to the document, on 28 September Ms Sophie in t'Veld sent a confirmatory application, asking the Council to reconsider its position. However, on 23 October 2009, the Council authorised only a partial access.

With regard to the content of the agreement, because of its limited powers, only few of the EP's requests were taken into account.

The reaction of the EP was therefore not surprising: on 30 November 2009 – the day before the entry into force of the Lisbon Treaty – the Council authorised the Presidency to sign the interim agreement. The "decision sparked the fury of the EP" (Ripoll Servent and MacKenzie 2011: 395) and the attempts by the Commission and the Council to contain the opposition in the EP by stressing the *interim* nature of the agreement had no effect.

On 25 January 2010, just a few days before its provisional entering into force, the SWIFT *interim* agreement was formally forwarded to the EP.

Thus, with only a limited timeframe to come up with a report, the LIBE Committee – on the basis of its new (post-Lisbon) parliamentary prerogatives – recommended the rejection of the agreement. In its report, the committee outlined the importance of transatlantic cooperation for counter-terrorism purposes, but also stated the need to respect "the European legal requirements for fair proportionate and lawful processing of personal information"[XXVI]. Moreover, focusing on inter-institutional relations, it strongly criticised the failure to give the Parliament full information, including the opinion of the Council Legal Service, and claimed a breach of the principle of sincere cooperation between institutions as set out in Article 13(2) TEU.

Alarmed by the risk of rejection, both EU and US authorities "launched an unprecedented lobbying effort" (Monar 2010: 145). However, all of this in vain as even the last attempt made by the Council with its Declaration issued the day before the parliamentary vote was ineffective[XXVII].

In this Declaration, the Council tried to assure the Parliament of the interim nature of the agreement and called upon the Commission to adopt draft negotiation guidelines for a longer term agreement that would be negotiated under the new Lisbon provisions where the EP would then be fully involved. Moreover, the Council recognized the need of the EP

to have easier access to classified information and committed itself to negotiate an inter-institutional agreement on that issue.

Despite all this the EP, already feeling deprived of its new powers, on 11 February 2010 made full of use of them. Approving the resolution rejecting the agreement, it immediately proved how considerably the Lisbon Treaty had enhanced the EP's role.

4.2. The long-term SWIFT Agreement

The parliamentary refusal of the EU-US interim agreement fiercely showed the novelties introduced by the Lisbon Treaty.

The empowerment of the EP in foreign affairs implies that – as established in Art. 218 TFEU – the Commission and the Council have to take into account the parliamentary position in all international agreements. Moreover, through the rejection of the SWIFT agreement, the EP made clear that its involvement should be assured as early as in the opening negotiation phase.

This is actually what then happened in the negotiations of the long-term SWIFT agreement between the EU and the US. Since the opening phase, both European and US authorities made sure to consult and involve the EP in the process. On 24 March 2010, a new draft mandate was issued by the Commission and agreed upon by the Council on 11 May. This draft was then sent to the EP who, 5 May 2010, adopted a resolution on the Commission's draft negotiating mandate. The EP "welcome[d] the new spirit of cooperation demonstrated by the Commission and the Council and their willingness to engage with Parliament, taking into account their Treaty obligation to keep Parliament immediately and fully informed at all stages of the procedure"[XXVIII].

On the US side, several MEPs were invited to Washington. Moreover, on 6 May US Vice-President Joseph Biden held a speech before the plenary and, by making reference to the SWIFT agreement, underlined the need to work together for overcoming all parliamentary concerns on the issue[XXIX].

In this line, the new agreement was revisited taking into account most of the EP's requests and finally approved by the Parliament on 8 July 2010[XXX].

5. Assessing the new EP role

In the SWIFT case, the EP has showed fiercely how the consent procedure should actually be conceived: not just as a limited power to pronounce itself on the final proposal, but rather as a power to bring influence to bear also over the content of the agreement itself. In other words, as "the power to indicate to what it would say 'yes'" (Nugent 2006: 413)[XXXI]. Moreover, in order to guarantee the stability of international relations, the consent procedure should thus be considered as a continuous dialogue between the European institutions, with the Council and the Commission taking into account the EP's position.

This interpretation of the procedure was already made clear in the EP internal Rules of procedures. Since 2004, the EP has always claimed full involvement in the procedure and, in Rule 83, called for its own right to (a) suspend the opening negotiations, (b) be kept "regularly and thoroughly" informed of the progress in the negotiations, and to (c) "to adopt recommendations and require that these be taken into account before the conclusion of the international agreement under consideration"[XXXII].

Obviously, this was the interpretation made by the EP and its Rules of Procedure are not binding upon other institutions. Nonetheless, this proves once again its distinctive ability to exploit the loopholes left by formal legal provisions and its capacity to use all the means available in order to change the institutional balance to its own advantage.

During the SWIFT case, the different positions with regard to how the EP should be involved into the procedure emerged and it became one of the main issues of dispute. Contrary to the narrow interpretation made by the Council, the Legal services of the EP stressed this point and argued precisely that "the *ratio legis* of the duty to inform is not to allow the Parliament passively to take note of the actions of the other institutions, but to afford it the opportunity of bringing some influence to bear on the Commission and the Council as regards the content of the agreement, in order to facilitate its consent on the final text"[XXXIII].

Finally, with the entering into force of the Lisbon Treaty, the political interpretation of the consent procedure, as fostered by the EP, was formally recognized in the Treaty. The full involvement of the EP since the opening negotiation phase is today supported by the

provision laid down in paragraph 10 of Article 218 TFEU, which states that "the EP shall be immediately and fully informed at all stages of the procedure". Moreover, focusing on the precise wording of Article 218 TFEU paragraph 10, the duty to inform Parliament means that it must be promptly and completely informed, which implies the possibility to have access to all the relevant information and documents concerning a given issue.

The Lisbon Treaty thus represents the legal recognition of the new institutional balance of power; in the SWIFT affair, the constant dialogue between its political and legal concept emerged.

At the crossroads between the pre- and post-Lisbon settlement, the Council tried to exclude the EP from the negotiation of the agreement and, on 8 September 2009, when the Council refused to give complete access to its documents, thus instigated the reaction of the EP over the issue.

Against the Council's decision, the EP – in all its resolutions – strongly criticised the failure to give Parliament full information about the agreement and argued for a breach of the principle of sincere cooperation between institutions set out in Article 13(2) TEU. The question was the brought before the CJEU by Ms Sophie in 't Veld.

However, it was not before the entering into force of the Lisbon Treaty that the Council, alarmed by the new powers conferred by it to the EP and by the risk of rejection, sought to use this as a means of leverage. The Council committed itself to negotiate an inter-institutional agreement to assure easier access to classified information. Despite this promise, the EP made full of use of the new powers and, by rejecting the agreement, immediately proved how considerably the Lisbon Treaty had enhanced its own role.

In this saga, on 16 November 2010 the Council finally submitted a proposal for an inter-institutional agreement. However, it took almost two years before both the CJEU's decision and the inter-institutional agreement found their way ahead.

With regard to the Court's decision, on 4 May 2012 the CJEU finally declared a partial annulment of the Council's decision. On the basis of Art. 4(2) of Regulation No. 1049/2001, the CJEU declared that the Council had failed to establish the existence of an overriding public interest, such as the protection of personal data, which would have justified a fuller disclosure of the document. However, the CJEU only partly extended access to the undisclosed parts of the document to the EP. Specifically, those parts that

were not "related to the specific content of the agreement envisaged or the negotiating directives which could reveal the strategic objectives pursed by the European Union in the negotiations" were excluded[XXXIV].

The new inter-institutional agreement was established on 13 September 2012 and to some extent assures the proper application of Art. 218(10). However, the agreement only covers classified information which is not related to common foreign security policy, as this latter continues to be regulated by the inter-institutional agreement of 20 November 2002 until other provisions are settled.

6. Assessing the impact on the internal institutional balance of power and on the EU external relations

The growing importance of the EP in foreign affairs has thus increasingly been recognised. However, this has profound implications on (1) the internal institutional balance of power as well as on (2) EU external relations.

In terms of institutional balance, during the SWIFT affair the relationship between the political and legal concept became evident. The EP, despite having few formal powers, has always attempted to play an active role in the formulation of EU foreign and external policy (Piening 1997) and, by extensively using alternative means of contestation and through the support of civil society, managed not only to influence the Council's decisions, but also to see its increased power of influence over the other institutions legally recognized. Today, the Lisbon Treaty represents the legal recognition of the EP's new prerogatives. Hence, the EP now has formal powers for making its voice heard and it is a duty for the other institutions to take it into account and respect the obligation to inform the Parliament. In this line, listening to the Parliament becomes fundamental not only in the name of loyal cooperation, but rather forms the core of EU credibility on the international ground. Because, if not respected, the Parliament can use the threat of suspending or refusing its assent to influence negotiations

In terms of EU external relations, it is worth citing President Obama's National Strategy for Counterterrorism. In June 2011, the President declared that in addition to working with European allies bilaterally, "the United States [would have continued] to partner with the European Parliament and European Union to maintain and advance CT

efforts that provide mutual security and protection to citizens of all nations while also upholding individual rights" (in Archick 2013). Examining the precise wording of this statement, the direct mention to the EP, as distinct from the European Union, immediately reveals the autonomous role attributed to the EP. However, it also entails both a positive and a negative assessment on how the US perceive the EP. On the one hand, the US finally recognise the EP and its role on the international ground; on the other, the fact of having been differentiated from the EU reveals a vision which considers the EP as an outsider to the EU framework.

This vision can be explained by looking at the SWIFT saga: "while the Council and the Commission shared largely similar normative views on how to negotiate with the US […], the emergence of the European Parliament as an important actor has changed this dynamic. Building on different normative frames, particularly a stronger insistence on fundamental rights and data protection, the European Parliament has challenged the pre-existing EU political framework on counterterrorism." (Kaunert et. al 2012: 477)

It follows that, in international affairs, the EP has emerged in opposition to the other EU institutions, as it not only fought an internal institutional struggle for power but also established its own peculiar position on the international ground.

Conclusion

Initiated as an issue with strong data protection implications where the EP has always been concerned in assuring its citizens an adequate level of protection,

> "European Parliamentarians and (supra)national privacy bodies manifested themselves strongly in this debate, generating conflict between not just the EU and the United States, but also *within* the EU itself. This conflict involved more than the complex processes of decision-making that generally typify the EU, but entailed a fundamental struggle for authority concerning issues that cut across what used to be called the 'first and third pillar' amidst the shifting legal landscape of the Lisbon Treaty coming into force" (De Goede 2012: 217).

In the SWIFT case, the EP – by entering in opposition to both the Council and the Commission, as well as the US – not only coherently preserved its own role as "one of the major actors in the transatlantic debate over the data protection" (Pawlak 2009: 39) but

also once more proved its distinctive ability to exploit the loopholes left by formal provisions. In this way, the international and European ideological conflict over data protection turned into a more internal "down-to earth debate about the institutional power" (Pawlak 2009: 38).

It is worth mentioning that, also before the entering into force of Lisbon Treaty, the EP, in spite of having few formal powers, always attempted to play an active role in the formulation of EU foreign and external policy (Piening 1997) and, by extensively using "the inter-institutional agreements and its budgetary powers" (Jacqué 2004: 388), mostly managed to influence the Council's decisions. In the same way, in the SWIFT case the EP, through alternative means of contestation and through the support of civil society, fiercely showed its position with regard to the issue. However, it was only with the entering into force of the Lisbon Treaty that it could finally impose its stance. In line with the new Art. 218 TFEU, the EP approved the resolution rejecting the agreement and thus immediately showed how considerably its powers had been enhanced.

The growing importance of the EP in foreign affairs has been thus increasingly recognised. However this does not come without consequences for both the internal institutional balance of power and the EU's external relations.

In terms of institutional balance, during the SWIFT saga the relationship between the political and legal concept emerged and the EP, using non-legislative means of contestation for interfering with the decision-making process, was able not only to extend its area of influence but then even saw its new powers formally recognized by the Lisbon Treaty.

With regard to the interpretation of the consent procedure, the EP fiercely showed how the procedure should actually be conceived. Not just as a limited power to pronounce on the final proposal, but rather as a power to bring influence to bear over the content of the agreement itself. The full involvement of the EP since the opening negotiation phase is today supported by the legal provision laid down in paragraph 10 of Art. 218 TFEU. Moreover, focusing on the precise wording of Art. 218 TFEU paragraph 10, the duty to inform Parliament means that it must be promptly and completely informed, which implies the possibility to have access to all the relevant information and documents about a given issue. In order to guarantee the proper application of the Art. 218(10) and finally solve the dispute between the Council and the EP over classified information, on 13 September 2012

a new inter-institutional agreement was established. Hence, the informal practices have finally found their appeasement in the formal recognition by the Treaties and other legal documents.

In terms of EU external relations, the reform has undeniably increased the EP's international role. Today, the EP has acquired an autonomous recognition and its position is taken into account beyond the EU borders. Moreover, on the side of EU institutions, listening to the Parliament becomes fundamental not only in the name of loyal cooperation, but rather has come to form the core of EU credibility on the international ground.

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I Case 70/88, Parliament v. Council, [1990] ECR I-2041, paras. 21-22

II About EU foreign policy "For the Council, this has two implications. Firstly, the Council must always reach agreement with the EP to adopt the financial Framework and the yearly CFSP budget. Secondly, if appropriations in the CFSP budget are insufficient to finance Council decision… the EP's agreement is required to obtain a supplementary budget…" (Keukeleire and Macnaughtan 2008: 120).

III See for example the case of the ECC/Israel Association Agreement in 1988 and the EU-Turkey customs union agreement in 1995.

IV OJ C 100/27 3.5.1976, Resolution on the Protection of the rights of the individual in the face of developing technical progress in the field of automatic data processing, Minutes of Proceedings of the Sitting of Thursday, 8 April 1976.

V OJ C 140/36 5.6.1979, *Resolution on the protection of the rights of the individual in the face of technical developments in data processing,* Minutes of Proceedings of the Sitting of Tuesday, 8 May 1979.

VI Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to processing of personal data and on the free movement of such data, OL L 281/31.

VII Regulation (EC) No. 45/2001 of the European Parliament and of the Council on the protection of individuals with regard to the processing of personal data by the Community institutions and bodies and on the free movement of such data, OJ L 8/1.

VIII See EP resolution of 25 November 2009 on the Communication from the Commission to the European Parliament and the Council – An area of freedom, security and justice serving the citizens. Stockholm programme- Multi-annual programme 2010-2014 regarding the area of freedom, security and justice. Document P7_TA(2009)0090.

IX Commission proposals COM(2012)10 Directive of the European Parliament and of the Council on the protection of individuals with regard to the processing of personal data by competent authorities for the purposes of prevention, investigation, detection or prosecution of criminal offences or the execution of criminal penalties, and the free movement of such data , COM(2012)11 Regulation of the European Parliament and of the Council on the protection of individuals with regard to the processing of personal data and on the free movement of such data (General Data Protection Regulation)

X http://www.europarl.europa.eu/oeil/popups/summary.do?id=1188884&t=e&l=en.

[xi] Since 2003, European airlines flying to US have been obliged to provide the U.S. customs authorities with electronic access to the personal data contained in their system. Annulled by the Court in 2006, the Commission is currently negotiating the new proposal with the Council of Ministers and the European Parliament.
[xii] http://useu.usmission.gov/may1407_chertoff_roundtable.html.
[xiii] www.swift.com.
[xiv] "An Administrative subpoena does not require prior judicial authorization and only needs to meet a reasonableness standard" (Kiirkegaard 2011: 452).
[xv] Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection if individuals with regard to the processing of personal data and on the free movement of such data OJ No, L 281/31
[xvi] 6 July 2006 on the interception of bank transfer data from the SWIFT system by the US secret services (OJ C 303 E, 13.12.2006.
[xvii] Royaume de Belgique Commission de la Protection de la Vie Privée, Opinion No. 37/2006, available at http://www.privacycommission.be/sites/privacycommission/files/documents/avis_37_2006_0.pdf.
[xviii] European Parliament, Public Hearing, 'The interception of Bank Transfer Data from the SWIFT System by the Use of US Secret Service'. Available at http://www.europarl.europa.eu/hearings/20061004/libe/programme_en.pdf.
[xix] The European Commission's independent advisory board on data protection and privacy
[xx] Press Release, European Union Article 29 Working Party, Press Release on the SWIFT Case, available at http://ec.europa.eu/justice/policies/privacy/news/docs/PR_Swift_Affair_23_11_06_en.pdf.
[xxi] Resolution of 14 February 2007 on SWIFT, the PNR agreement and the transatlantic dialogue on these issues (OJ C
287 E, 29.11.2007. Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2007:287E:0349:0353:EN:PDF.
[xxii] The same EP declared in a later press release on 17 September 2009 that "*Following pressure by the European Parliament, guarantees regarding privacy were given to ensure that the data collected was used purely for anti-terrorist purposes*" http://www.europarl.europa.eu/sides/getDoc.do?language=en&type=IM-PRESS&reference=20090915IPR60697.
[xxiii] Document 11897/09.
[xxiv] 8 September 2009.
[xxv] European Parliament Resolution of 17 September 2009 on the envisaged international agreement to make available to the United States Treasury Department financial payment messaging data to prevent and combat terrorism and terrorist financing (2010/C 224 E/02), SWIFT P7_TA(2006)0016, OJ C 224 E/8, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:224E:0008:0011:EN:PDF.
[xxvi] European Parliament, Recommendation on the proposal for a Council decision on the conclusion of the Agreement between the European Union and the United States of America on the processing and transfer of Financial Messaging Data from the European Union to the United States for purposes of the Terrorist Finance Tracking Program (05305/1/2010REV – C7-0004/2010 – 2009/0190(NLE)), Committee on Civil Liberties, Justice and Home Affairs, doc. A7-0013/2010, 5 February 2010.
[xxvii] Council of European Union, EU-US Agreement on the Transfer of Financial Messaging Data for purposes of the Terrorist Finance Tracking Programme, Brussels, 9 February 2010 doc. 6265/10 (Presse 23).
[xxviii] European Parliament resolution of 5 May 2010 on the Recommendation from the Commission to the Council to authorise the opening of negotiations for an agreement between the European Union and the United States of America to make available to the United States Treasury Department financial messaging data to prevent and combat terrorism and terrorist financing, doc P7_TA(2010)0143.
[xxix] Speech available at http://www.whitehouse.gov/the-press-office/remarks-vice-president-biden-european-parliament.
[xxx] For an in-depth content analysis of the agreement see Pfisterer 2010.
[xxxi] In this sense and before the entering into force of the Lisbon Treaty, the EP had already extensively used this power a Specifically "to take action on the human rights records of third countries that have signed association and cooperation agreements" (Nugent 2006, 413).
[xxxii] Rules of Procedure of the European Parliament, 16th edition, July 2004 (OJ 2005 L44/1).
[xxxiii] EP Legal Service http://www.statewatch.org/news/2010/feb/ep-libe-cttee-opinion-legal-service-eu-usa-swift.pdf.

[xxxiv] Point 60 of the case T-529/09 Judgment of the General Court (Fifth Chamber) 4 May 2012 "Access to document- Regulation (EC) No 1049/2001- Opinion of the Council's Legal Service on a recommendation from the Commission to authorise the opening of negotiations for an international agreement- Partial refusal to grant access- Exception relating to the protection of the public interest in the field of international relations- Exception relating to the protection of legal advice- Specific and foreseeable threat to the interest in question- Overriding public interest".

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The Territoriality of Fiscal Solidarity: Comparing Swiss Equalisation with European Union Structural Funding

by

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Abstract

This article theorises the territorial solidarity and fiscal federalism and compares Switzerland with the European Union. While inter-territorial solidarity is a prerequisite for legitimate fiscal equalisation, such equalisation in turn also contributes to the legitimacy of and solidarity within federal political systems. By cutting across territorial and ethno-national communities, fiscal transfers often contribute to both a "civic" sense of belonging and a "cosmopolitan" identity. After placing types and degrees of (inter-)territorial solidarity at the heart of our conceptual perspective, we discuss the effects of such solidarity through an analysis of two different forms of "federal" equalisation. Comparing the recently reformed Swiss fiscal equalisation system with the EU structural funds allows us to infer if, and how, the fiscal dimension of federalism matters for feelings of solidarity, reciprocity, unity and, ultimately, for the legitimacy of the very (nation-state or Union) structures that are to contribute to the ever-growing prosperity and happiness of their people(s). In Switzerland, a civic understanding of nationhood and cross-cutting cleavages were necessary conditions for extensive, effective and legitimate fiscal equalisation. We infer that, for the EU, this means that strengthening the equalisation component of the structural funds would contribute to an ever closer Union in a political sense: because fiscal equalisation and inter-territorial solidarity are interdependent, reinforcing the one also means cementing the other. Future studies of the EU and federal-type arrangements are advised to pay more explicit attention to the solidarity-element of territoriality – or the territoriality of (fiscal) solidarity.

Key-words

Territorial solidarity, fiscal federalism, European Union, Switzerland

Introduction

This article theorises solidarity in multi-level systems and compares the recently reformed fiscal equalisation scheme of Switzerland with the EU's structural funds. Our point of departure is that inter-territorial solidarity (between cantons, *Länder*, states, provinces, autonomous communities or EU Member States) is a prerequisite for fiscal equalisation, as much as inter-personal and inter-group solidarity are for many national-level redistributive policies. Equalisation in turn contributes to the overall legitimacy of a polity because – ideally – transfers contribute to a "civic" sense of belonging and a "cosmopolitan" shared identity by cutting across entrenched ethno-national communities, creating *une solidarité de fait*, as Robert Schumann (1950) once described. Fiscal federalism and connected financial equalisation schemes can also contribute to a stronger feeling of a "shared destiny" among the territorial units and the people within a federal system. This feeling of solidarity and reciprocity is a key element of federal democracy and federal political culture (Burgess 2012). To what extent this ideal applies to the EU, particularly by scaling down to the regional level (Hooghe and Marks 2001), is the focus of this article.

Our method to answer this question empirically is to offer a short analysis of Swiss fiscal equalisation, which maximises both the legitimacy and solidarity dimension and whose political system, through strong cantonal identities and due to its confederal nature especially in the fiscal domain, approximates the EU system better than any other currently existing political system (Church and Dardanelli 2005).[I] The stability of the Swiss system, the creative character of its fiscal equalisation (in force only since 2008), and its resemblance to the EU as regards bottom-up, executive federalism allow us to draw conclusions on when, how and why fiscal equalisation is able to maximise solidarity. We then apply these conclusions to the EU in the form of hypotheses, analysing in particular a) the constellation of "fiscal losers" and "winners" at Member State level; b) the impact of this constellation on EU-wide feelings of inter-territorial solidarity; and c) potential avenues to increase inter-territorial solidarity – plus, through this, to achieve a stronger feeling of common belonging and shared identity at Union-level – by reforming the EU's fiscal equalisation.

The first section conceptualises territorial solidarity in connection to fiscal equalisation. The second describes Swiss fiscal equalisation while the third section is dedicated to analysing both equalisation and solidarity within the EU. The fourth section compares the two systems before we conclude.

1. Inter-territorial solidarity and fiscal equalisation

The literature on solidarity and fiscal equalisation is both vast and scarce. It is vast, because scholars from political economy, federalism, EU integration and even nationalism studies have at times discussed the importance of the fiscal dimension for polity-building (e.g. Burgess 2006a; Kymlicka 2001; Lijphart 1977). The importance of fiscal arrangements as part of the "self-rule" and "shared-rule" dimension in federal states has already been pointed out by Kenneth Wheare (1964). Other authors, such as Oates (1999) and Dafflon (2012), have also pointed towards the connection between federalism, fiscal relations and solidarity. However, scarcity arises in the sense that rarely has a causal connection between inter-territorial solidarity (as different from inter-personal solidarity) and fiscal equalisation been made, let alone been "tested" empirically. The recent outpour on "multi-level governance" (e.g. Bache & Flinders 2004, Benz 2009, Piattoni 2010) has only partially filled this lacuna.

The problem is that while we may observe a "re-territorialisation" (Burgess 2006b) of politics, the various mechanisms that link territory to politics at the nation-state level – e.g. collective identity (Risse 2010), imagination (Anderson 1983), control (Sack 1986), instinct (Ardrey 1975 [1966]), or societal diversity (Livingston 1956) – cannot be transformed "upwards" (to the EU) or "downwards" (to the regional level) without not also modifying their scope. A case in point is solidarity. For solidarity to make analytical sense in multilevel polities such as the EU, inspiration must thus be drawn from federal political systems, where both the constituent units and the overarching polity have a direct effect on the citizenry (Forsyth 1981). Moreover, the relations between states, regions and the European level become even more complex than in federal states, because in addition to the interaction between the European, state and regional level, in the EU also bargaining *among* states (and competition between regions) can be observed (Keating 1988, Bartolini 2005).

There also exists a *direct* link between regions and the European level symbolised by the Committee of the Regions.

Nevertheless, even in federal studies solidarity as a key element of fiscal equalisation is rarely made explicit, so that one has to turn to political geography and studies of state formation to make sense of a) what binds people together not so much within, but rather across different territories; and this b) to an extent that they are willing to sacrifice some of their own wealth in favour of that of others.

The Oxford English Dictionary defines solidarity as "unity or agreement of feeling or action, especially among individuals with a common interest; mutual support within a group." Less visible but equally crucial, solidarity underpins most redistributive policies at nation-state level, not just since the advent of the welfare state (Companje et al. 2009). Such policies in turn contribute to ever-growing feelings of solidarity (de Beer and Koster 2009, 50). For the EU, this translates into output-oriented legitimacy (Scharpf 1999, 5), which in turn depends on a "rescaling" of policies, politics and polity (Delaney 1997, Somerville 2004) to the European and/or the regional (and even local; cf. the European Charter of Local Self-Government of 1985).

Deductively, then, we can imagine solidarity between individuals and solidarity between collectives; additionally, there is solidarity between territorial and solidarity between non-territorial collectives. Significantly for us, the Lisbon Treaty lists both under Article 2: "solidarity between generations and […] solidarity between Member States." Table 1 shows all three possible combinations of solidarity – by definition, individuals are non-territorial, hence the one empty cell.

Level/Basis	*Non-territorial*	*Territorial*
Individual	Inter-personal solidarity	-
Collective	Inter-group solidarity	Inter-territorial solidarity

Table 1: Forms of solidarity

Classic accounts of liberal democracy have tended to focus on the first column and placed individual rights above territorial claims to justice (Greer 2006), which is precisely why federalism can be perceived as having a slightly undemocratic touch (Basta Fleiner 2000: 94). In the French ideal of republican equality and in the Anglo-American conception

of liberty, the state is either regarded as a means to foster unity and cohesion (through Jacobin centralisation) or to be kept small to allow markets to thrive (privatisation). And yet only a federal ideology "in the weak sense" (King 1982) is able to reconcile all three forms of solidarity in a legitimate way.

First, by reconciling deep-seated collective *and* territorial imaginations with the need to collaborate in a mutually binding way on a greater scale. Federations, by breaking larger entities down into several smaller polities, allow for inter-personal solidarity in, ideally, the same homogeneous entities that Rousseau envisaged as *conditio sine qua non* for democracy to work.[II]

Second, within the overarching whole, these entities are the bearers of territorial group rights, whether in essentially bi-national (e.g. Canada or Belgium), multinational (e.g. Bosnia), and multi-lingual federations (Switzerland), or in the traditional mono-national federations (Germany, Australia, USA). This creates the basis for inter-territorial solidarity – or its waning, if to strengthen ties within a community means questioning those between them.

Finally, any remaining collective but non-territorial interests (be they socio-economic, ideational, religious, or non-territorial minority groups) can organise at the "national", "regional" and/or the "local" level to argue their place in deciding on inter-group solidarity. Consequently, it can be argued that the application of the federal principle to diverse societies contributes to inter-group solidarity by allowing a re-adjustment of political categories on different political and territorial levels as well as between them, and therefore contributes to a greater sense of justice in both a normative and a practical sense (Wayne 2001, Requejo 2005).

Focusing on inter-territorial solidarity in particular, its importance for federal political systems[III] is expressed in the need for fiscal equalisation to address both horizontal and vertical imbalances (Watts 1996: 41). Equalisation in narrower terms refers to transfers that stem from

> a recognition that disparities in wealth among regions within a federation are likely to have a corrosive effect on cohesion within a federation. Indeed, it is for this reason that in most European federations equalisation transfers have been labelled "solidarity" transfers. (Watts 1996: 45)

Because disparities might threaten unity, equalisation is an expression of solidarity. But the relationship between inter-territorial solidarity, fiscal equalisation and overall legitimacy can only be circular, as we show in Figure 1.

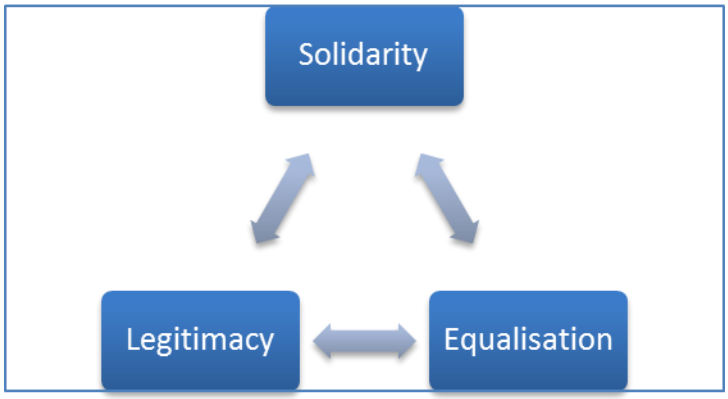

Figure 1: The circularity of inter-territorial solidarity

There are thus three interactions at work. First, between solidarity and equalisation: a minimum level of solidarity is a condition for fiscal equalisation. Both the extent and the very existence of fiscal equalisation constitute the ultimate test of inter-territorial solidarity. However, some examples demonstrate a fundamental dilemma in this circular relationship: whether it is Catalonia's call for fiscal autonomy à la Basque Country and Navarre, or even for independence because it does not want to fund the other Spanish regions' expenditures by having to cut its own budget; Bart De Wever's disagreement over Flanders having to "pay for the unemployed in Wallonia"; or Bavaria's appeal to the Constitutional Court over the current inter-*Länder* fiscal equalisation.[IV] Thus, solidarity and equalisation are permanently contested and re-negotiated in federal systems, because commitments to financial equalisation among federal units can be seen as a limitation to the autonomy of the (richer) units in a federal system.

Second, financial equalisation has become more and more frequent in federal and non-federal countries – but also more contested – since it also relates to wider economic questions of fair competition and fiscal discipline (Rodden 2006). Thus, to be perceived as legitimate, equalisation must give expression to territorial differences on both sides of the equation, i.e. at the paying as well as at the receiving end. Equalisation only contributes to the legitimacy of a polity if not only the net recipients, but also the net contributors regard

it as necessary. The EU accomplishes this sort of "output legitimacy" with the trick of "rescaling" its projects to the regional level, but then consistently aggregating the benefits to the national level – in this way, because every Member State has regions that receive money, there simply are no losers.

Third, legitimacy strengthened in such a way contributes to solidarity and makes the circle come to a close. This is because the legitimacy of each policy contributes to the aggregate legitimacy of political decisions in general. Equalisation is thus not only a consequence, but also a cause of solidarity through the provision of specific benefits. Hence, one would expect those who profit the most from a given equalisation system to be amongst the most ardent favours. Therefore, in a democratic setting where decisions are taken by majorities (i.e. anything ranging from simple plurality to unanimity), equalisation can only work if there are more winners than losers, defined in the very territorial terms used by the equalisation system itself. As the Swiss description below demonstrates, the new fiscal equalisation scheme was overwhelmingly approved because all but very few (and small) cantons are now better off. The open expression of such a form of inter-cantonal solidarity (in a nation-wide referendum) has in turn significantly strengthened the overall legitimacy of the Swiss political system.

Some argue that the EU will never be able to reproduce societal togetherness with the same intensity as has been achieved at the national level. Hence, no (inter-*personal*) "duty to accept solidaristic sacrifices derived from the premises of essential sameness" will ever arise (Scharpf 1999: 12). At the same time, however, the crises in Greece, Portugal, Ireland and Cyprus and the adoption of the European Stability Mechanism (ESM) have lifted EU-wide (inter-*territorial*) solidarity – at least for the Eurozone-members – to an unprecedented level that could well pave the way for a banking union and, indeed, to the "ever closer union" outlined by Barroso (2012):

> The stronger countries must leave no doubts about their willingness to stick together and about their sense of solidarity. […] Fairness is an essential condition for making the necessary economic reforms socially and politically acceptable and, above all, because fairness is a question of social justice. […] the economic and monetary union raises the question of a political union and the European democracy that must underpin it. […] Let us not be afraid of the word: we will need to move towards a federation of nation states.

Our argument is that in the absence of a strong sense of togetherness (or inter-personal solidarity), which at the nation-state level has been a condition for (the legitimacy of) redistributive policies, the economic challenge posed by the current crisis could well work as a trigger to increase the equalisation component within the cohesion policy to an extent that it becomes a powerful creator of inter-territorial solidarity, which in turn legitimises (further) equalisation and political union.

Centring this debate on solidarity gives expression to the fact that in multi-level polities two challenges arise: a) how to achieve solidarity between territorial communities that goes beyond mutual recognition, i.e. one that involves a willingness to make specific sacrifices that explicitly benefit others; and b) how to reconcile such inter-territorial solidarity with other (territorial or non-territorial, personal or collective) forms of solidarity. Is this a zero-sum game, or are the two mutually enhancing? For lack of space, this article deals exclusively with the first challenge. Ultimately, however, while it is true that "a solidaristic substrate is required for the formation of a collective identity" (Eriksen 2011: 83), what is equally true is that multiple layers can give rise to multiple forms of solidarity. We now turn to the Swiss case for an illustration of how the relation between inter-territorial solidarity, legitimacy and fiscal equalisation can be empirically assessed and what lessons can be learned from this.

2. Fiscal Equalisation in Switzerland

The purpose of this section is to show how fiscal equalisation and territorial solidarity relate to each other in one particular case. Studying Switzerland is useful because it is, for some, "the most federal" country in the world (Elazar 1993: 12), meaning that its three-layered structure of governance can serve as an inductive model. The second reason is that Switzerland has recently reformed its fiscal equalisation scheme: the current system was approved by a referendum in 2004 and has entered into force in early 2008. The 2004 popular vote also allows us to observe how the different cantons (that is, their electorates) have received the reform. The old system combined a convoluted list of subsidies with cantonal shares in federal revenues and scaled cantonal contributions to federal social expenditure (Dafflon 2005: 132–4). The new system is structured into three "pots", each with a different logic and payments detached from the other two. The following

subsections discuss the legal framework, provide data for the years 2008 until 2013, and draw three conclusions which we then apply to the EU.

Legal framework

The Swiss fiscal equalisation scheme is regulated by the Federal Act of 3 October 2003 on Fiscal Equalisation and Cost Compensation (*Bundesgesetz über den Finanz- und Lastenausgleich,* FiLaG) and the accompanying Ordinance of 7 November 2007 (*Verordnung über den Finanz- und Lastenausgleich*, FiLaV). The goals of the equalisation scheme are to "strengthen the financial autonomy of the cantons" and "decrease differences in terms of fiscal capacity and tax burden" between the 26 sub-national units (Art. 2a-b FiLaG). Money is redistributed both horizontally, from the "richer" cantons, and vertically, from the Confederation, to the "poorer" cantons in both cases. There are two ways in which the dichotomy of "rich"/"poor" is defined: cantonal economic resources and extra "costs" arising from a canton's topographical and/or social structure. Finally, there is a temporary compensation (for the 28 years from 2008 until 2036) for the losers in the transition away from the previous system.

First, the "resource" or "tax potential" of each canton represents the sum of taxable income of private individuals, their property, and the taxable profit of corporations divided by the resident population (Art. 3.2 FiLaG; see Dafflon 2005: 156, for the precise formula). The nationwide average forms the benchmark against which each canton is then measured. Cantons below this average count as "resource poor", cantons above as "resource rich" (Art. 3.5 FiLaG). Figure 2 shows the Swiss cantons and their position in the resource index for 2012. The money received from this and the other two pots can be disposed of freely by the cantonal authorities – unlike in the previous system, where around 75 per cent of the money distributed vertically was earmarked for specific projects (through matching grants in the form of subsidies; Dafflon 2005: 140).

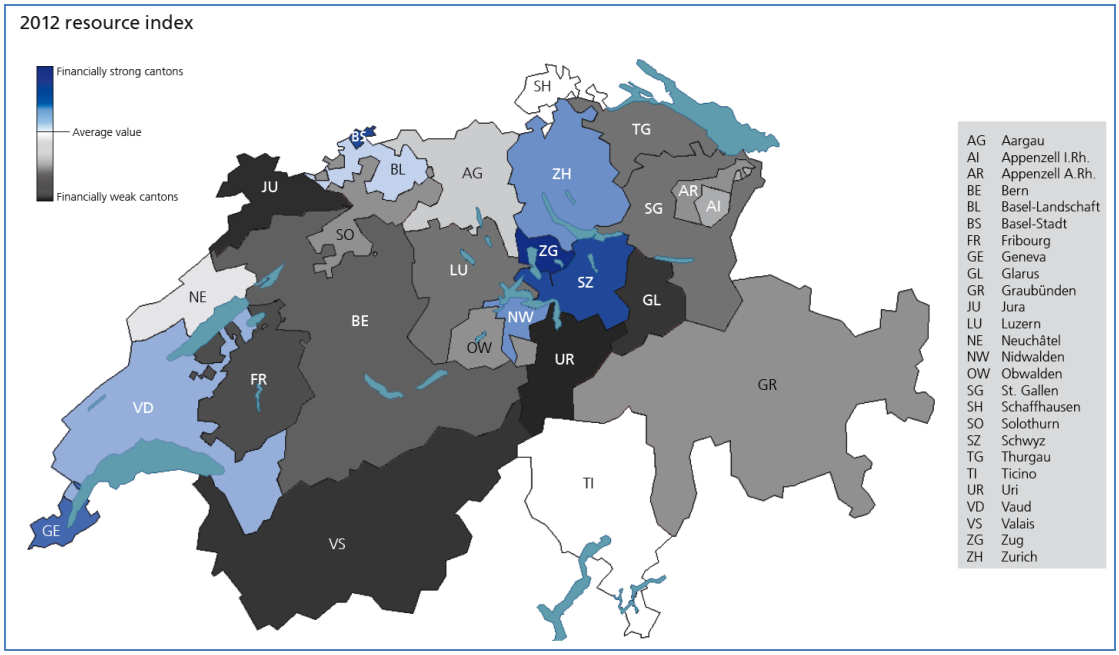

Figure 2: The "rich" and "poor" Swiss cantons (EFV 2012: 11)

Figure 2 clearly outlines that despite the fact that Switzerland is generally seen as a very rich country, with a strong tradition of banking and solid fiscal policies, there is nevertheless a strong pattern of economic diversity among the cantons. In this, the differences between the cantons in term of fiscal possibilities not only cut across classic cleavages, such as the linguistic[V] and the religious[VI] cleavage, but also across a newer, urban-rural divide (Linder et al. 2008), given that both the urban cantons Zurich (ZH), Geneva (GE), Basel-City (BS) and Vaud (VD), as well as the more "peripheral" cantons Zug (ZG), Schwyz (SZ), Nidwalden (NW) and Basel-Countryside (BL) count as rich in this sense.

The second fiscal equalisation stream centres on extra costs. Significantly, this stream was added at a later stage in the reform process and was meant to buy the support of net contributors by giving them something in return (Cappelletti et al. 2012: 12–3). It pays money to cantons suffering from either or both of two types of burdens: those arising from peripheral location, inaccessibility of the cantonal territory, and/or low density structures (Art. 7 FiLaG), on the one hand, and extra costs arising from an above-average proportion of elderly, poor, and/or unemployed persons (Art. 8 FiLaG), on the other. A total of eight geo-topographical and socio-demographic variables are taken into account for

the operationalisation of "costs" of this kind: average altitude, terrain steepness, settlement structure, and inverse population density for the first compensation mechanism; poverty, age, share of foreign nationals, and a "core city indicator" for the second (EFV 2012, 14). Some of these criteria lack economic justification (Dafflon 2005: 170-2) and respond more to the needs of creating a sufficiently large majority of cantons in favour of the overall system – a "package deal", as Cappelletti et al. (2012: 9–10) call it.

This is even more valid for the third stream, limited in time to 2036 and designed to compensate cantons that excessively lost in the transition away from the old equalisation scheme (Schaltegger and Frey 2003: 252). In allusion to EU terminology, the official English translation of this third stream is "cohesion fund" (EFV 2012, 15), but the literal translation of the German *Härteausgleich* would be "duress equalisation" (Art. 19 FiLaG). Figure 3 depicts the financial flows for 2012 including all three fiscal streams.

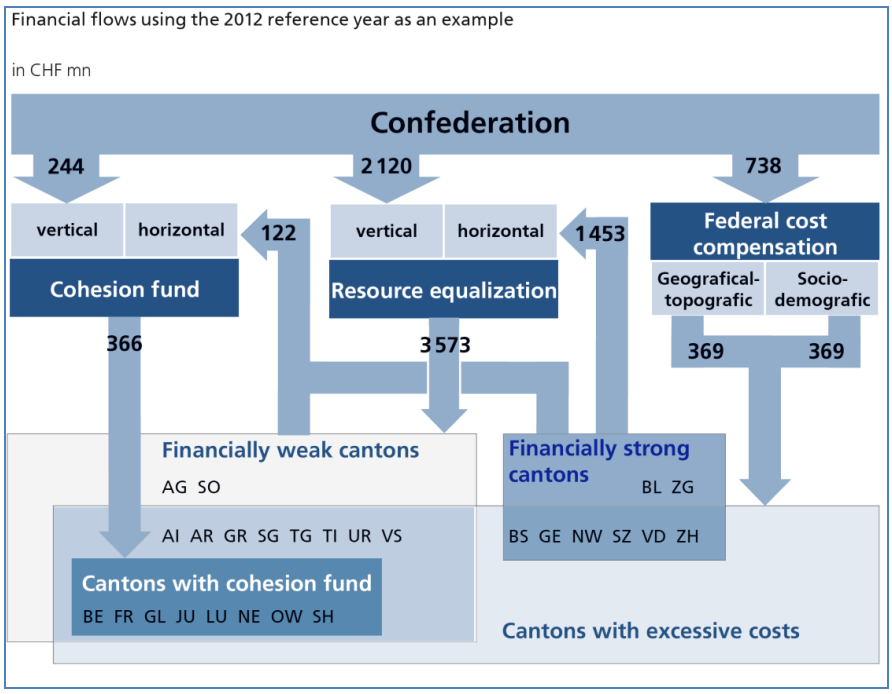

Figure 3: Swiss fiscal equalisation, 2012 (EFV 2012: 17)

As can be seen, five groups of cantons emerge. Eight cantons (bottom left) draw a net profit from the cohesion fund, are financially weak and subject to excessive costs. Hence, they are *triple winners*. Of the eight financially strong cantons (on the right), on the other hand, only two do not fall prey to excessive costs and are therefore payers on all three

accounts (*triple losers*). The other six financially strong cantons at least profit from cost equalisation, although situated above the Swiss average in terms of financial resources (*cost winners*). Two other cantons (Aargau (AG) and Solothurn (SO)) are financially weak, but do not have excessive costs, nor are they transition losers (*resource winners*). A final group of eight cantons is financially weak and has excessive costs, but does not receive payments through the – transitional – cohesion fund; cantons in this group we can be called *cost and equalisation winners*.

Winners and losers

All but the two cost compensation mechanisms (second stream) are funded by *both* federal and cantonal contributions. The ratio of this division is one third for the cantons and two thirds for the Confederation, for the Cohesion Fund (Art. 19.2 FiLaG): all cantons pay into the fund according the number of inhabitants, but only eight also receive something in return. For resource equalisation, the cantonal share is "between at least two thirds and a maximum of 80 per cent of federal payments" (Art. 4.2 FiLaG). In 2012, the amount paid by all cantons together was equivalent to 40.7 per cent of the contribution effectuated by the Federal Government; in 2008, it had been a high 70 per cent (EFV 2012).

A more interesting statistic is that of net per capita payments. Figure 4 shows the average annual net per capita payments for each canton between 2008 and 2012 in CHF; a negative payment denotes a disbursement to a canton, a positive payment means the canton had to contribute. Seen as the aggregate over the last five years, there were thus eight "net losers" and 18 "net winners". The eight losers are the same that were expected to be net contributors at the time the federal referendum took place (Cappelletti et al. 2012: 11), so this division has remained stable over time. Moreover, the latest official policy evaluation shows that the rich cantons have grown by an average of 22.3 per cent, between 2007 and 2011, while the poor cantons have grown by "only" 17 per cent (EFV 2011, 8). The potential of Zug, Vaud and Schwyz has even increased by a record 35.7, 34.1 and 33 per cent, respectively (ibid.).

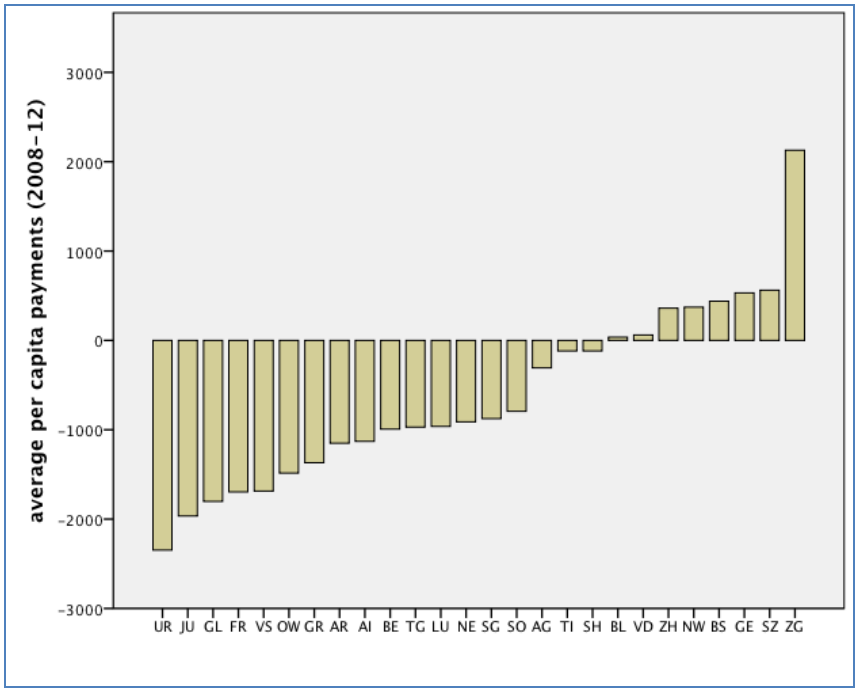

Figure 4: Net contributors and recipients in Switzerland, 2008-12

2.1. Inter-territorial solidarity in Switzerland

Because the Federal Act of which the new fiscal equalisation was part entailed wide-ranging modifications of the Federal Constitution, a popular vote had to take place that needed to muster a majority of both individual and cantonal votes (BR 2004). On 28 November 2004, a large majority of both cantons (23 out of 26) and citizens (64 per cent) agreed to the new division of tasks between Confederation and cantons and, through this, also to the new equalisation scheme (*Neugestaltung des Finanzausgleichs und der Aufgabenteilung zwischen Bund und Kantonen*, NFA). Only in three cantons did a majority of citizens reject the NFA; turnout was a low 36.9 per cent (BK 2004).

Analysing the 2004 referendum more closely allows us to draw several conclusions as to the underlying feeling of solidarity. Clearly, the more a canton was to profit from the new equalisation scheme, the more its citizens were in favour of it. Figure 5 shows the strong correlation between the share of no-votes in 2004 and the average per capita payments over the entire period for which we have data (Pearson's $r = .754$, $p < .01$). The only three cantons that rejected the NFA (Zug, Schwyz and Nidwalden) were all to consistently pay more into the equalisation schemes than they would receive (ranking first,

second and fifth in Figure 4), while the highest approval rates were registered in the cantons benefitting the most (e.g. Uri, Jura, Fribourg, Obwalden).

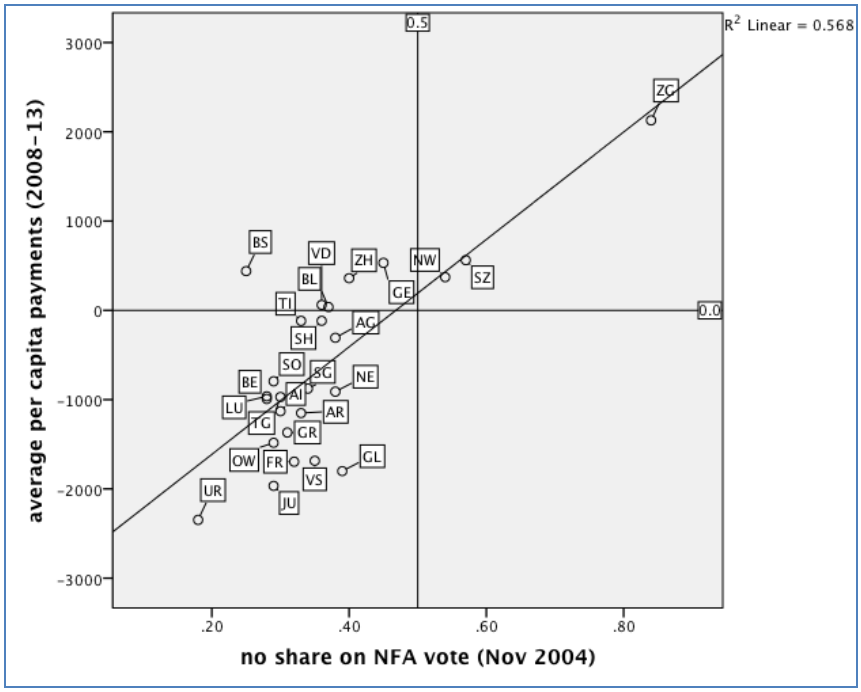

Figure 5: Benefits of Swiss fiscal equalisation by its approval rate

Three conclusions can be deduced from this. First, the perception of profit seems to have had an influence on attitudes towards nationwide solidarity. If the NFA was regarded as the most important element of nation-wide solidarity, then support for it was strongest at the receiving and weakest at the paying end of the fiscal equalisation scale.

Second, the reform managed to create few losers in the sense of consistently having to pay and never receiving anything in return. The three different pots have allowed 18 of 26 cantons to end up with a positive balance after six years. Moreover, only three of the six net payers rejected the NFA, and they are all very small and Catholic cantons, whose combined weight of no-votes (54'644) was less than, for example, the number of yes-votes in St. Gall alone (64'749). Bringing many cantons, and especially the larger ones, on board was therefore key to the success of the reform.

Third, achieving this degree of consensus is expensive. For 2012, the Swiss Confederation paid 3'102 million CHF (ca. 3.2 billion USD), whereas all the cantons together paid 1'575 million CH (ca. 1.6 billion USD). Achieving a strong sense of territorial

solidarity therefore requires a strong centre *and* strong component units, in terms of being able to share the overall financing of the system: the vertical component significantly lessens the individual contribution each canton has to make. However, where cantonal contributions rise disproportionately and in times of general fiscal crisis, fiscal equalisation is questioned as being derailed and exaggerated.[VII] We now apply these three conclusions to the EU polity.

3. The EU System

EU Regional Policy is one of the oldest policy areas of the European Union and has been a constant issue of discussion among Member States (Miric 2010, Mellors & Copperthwaite 2005 [1990], Balchin et al. 1999). While it was recognised that the creation of a Single Market, amongst a variety of Member States with different economic strengths and weaknesses, needed to be counter-balanced by some form of financial support for under-developed regions, the exact amount of money and its implementation via EU Regional Policy have been at the centre of a number of heated debates within the EU (Tondl 2004). However, the fact that Regional Policy has become the single most important policy in the EU budget demonstrates the importance of this policy. Moreover, at least one instrument explicitly makes the same point as we advance it here: the EU "Solidarity Fund", through which "the Community should show its solidarity" by providing grants to help after natural disasters (cf. Council Regulation 2012/2020, preamble). But what kind of fiscal equalisation does the EU have to give expression to inter-territorial solidarity?

EU "fiscal equalisation"

Börzel and Hosli (2003: 188) write that "in contrast to federal systems, the EU is not endowed with an overall redistributive responsibility at the central level, despite the existence of the Structural and Cohesion Funds. The EU's current setup clearly differs from most existing federal systems in its lack of a general income redistribution scheme." One reason for the absence of explicit redistributive activity is certainly a lack of a substantial EU budget. The EU's sources of income can be divided into three groups: customs duties on goods coming from outside, a share in the VAT levied on all goods sold within the EU, and Member State contributions as a percentage on their GNP (which is by

far the biggest share of the EU's overall budget). Nevertheless, precisely because most of the EU's expenditures fall into a quasi-redistributive basket based on territory, it is appropriate to regard the structural funds[VIII] as the functional equivalent to fiscal equalisation – all the more so since, again for Börzel and Hosli (2003: 191), "the EU largely resembles a system of cooperative federalism", where the upper level regulates and lower levels execute.

But unlike the current practice in Switzerland, there is no explicit horizontal transfer of funds.[IX] EU structural funding works indirectly and vertically. It is paid by the EU, whose main source of funding is through Member State contributions. But since these are based on a country's GNP, richer Member States pay more into the pot for structural funds, while poorer countries tend to have poorer regions and therefore profit more from the funds. In practice, this means that Member States contribute to the EU budget, and the EU Commission (together with governments and regional representatives of the Member States) decides which regions should be awarded funding from the EU's budget pot on regional funding. While "cohesion" has political, social, and economic connotations, specifically the first one as expressing "solidarity for the weaker regions" (Evans 2004, 21) interests us in this discussion.

At the national-level, because all EU Member States are recipients of money from the structural funds (e.g. Cadman et al. 2010), there are no losers, only those who win more and those who win less. Matters are different if we turn to what remains after a Member State's contributions are subtracted from the benefits received through the structural funds. Figure 6 lists the countries by per capita net recipients, i.e. how much money each resident theoretically received after deducting payments to the EU budget in 2010 (negative amounts mean net payments).[X] Similar to the Swiss case, there are more territorial net recipients (16) than net payers (11), but the latter constitute a much larger group, both in terms of members and population size.

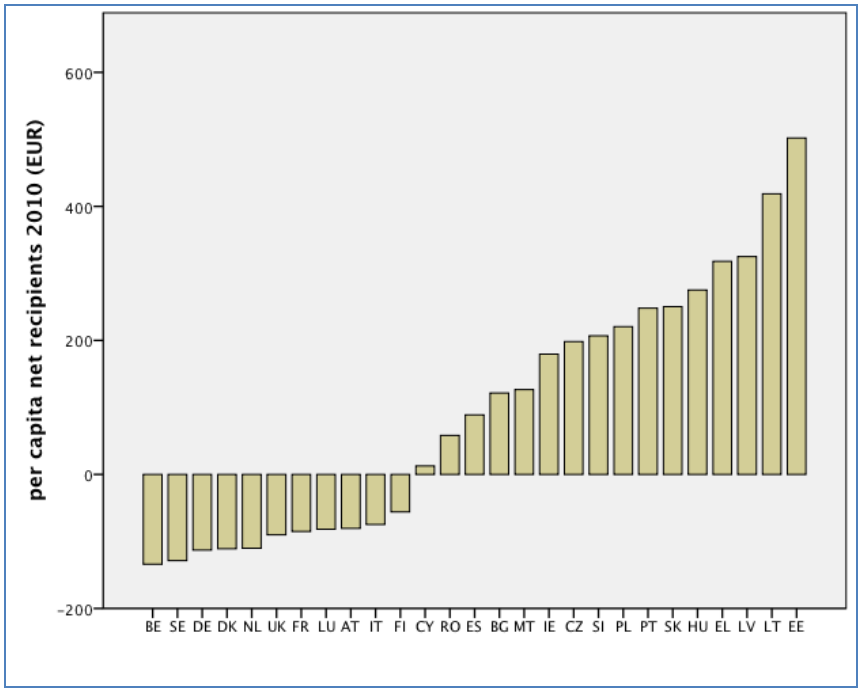

Figure 6: EU per capita net recipients in 2010

Citizen perception

EU citizens never had a chance to vote on the all-encompassing system of the structural funds in a binding way, unlike the Swiss electorate in 2004. The only way to gauge the legitimacy of the structural funds is therefore through surveys (Osterloh 2011: 2). In this section we compare EU-enthusiasts and -sceptics with net recipients and contributors using Eurobarometer and other European survey data. The main question to be answered is how Europeans perceive the current system of what we call the EU fiscal equalisation system, i.e. the structural funds. What are changes over time and across countries? Are Germans really the most sceptical because they are paying the most, as we would expect from our Swiss observation, and South- and East-Europeans the most supportive of the funds – and, by implication, also of the EU as such?

At the national level, Figure 7 plots the mean attitude to EU unification against the share of residents for whom EU membership is a good thing.[XI] While except for Latvia, the UK and Hungary all countries are situated above one of the two arithmetic means, for the overwhelming majority of EU citizens membership is principally a good thing. Obviously the two measures are positively correlated (Pearson's $r = .444$, $p < .01$).

However, while the correlation between net recipients (in 2010) and mean attitudes to

EU unification is positive and significant (Pearson's r = .420, p < .01), the correlation between per capita net recipients and mean attitudes to EU unification is only very small and insignificant (r = .106, p = .599). Moreover, the correlation between per capita net recipients and the proportion for whom EU membership is good is *negative* (r = -.315, p = .109). Indeed, the strongest and most significant correlation is that between the proportion of those for whom EU membership is a good thing and per capita contributions – but this correlation is positive, contrary to our expectations (Figure 8). Richer states are therefore more supportive of the EU than poorer ones, which clearly contradicts our expectations.

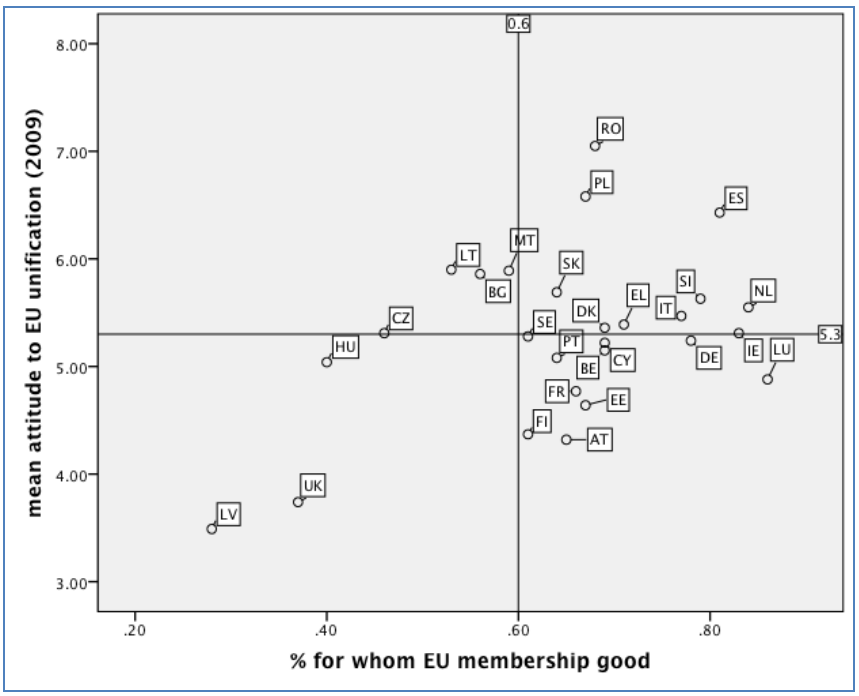

Figure 7: Citizens' perception of EU unification and membership

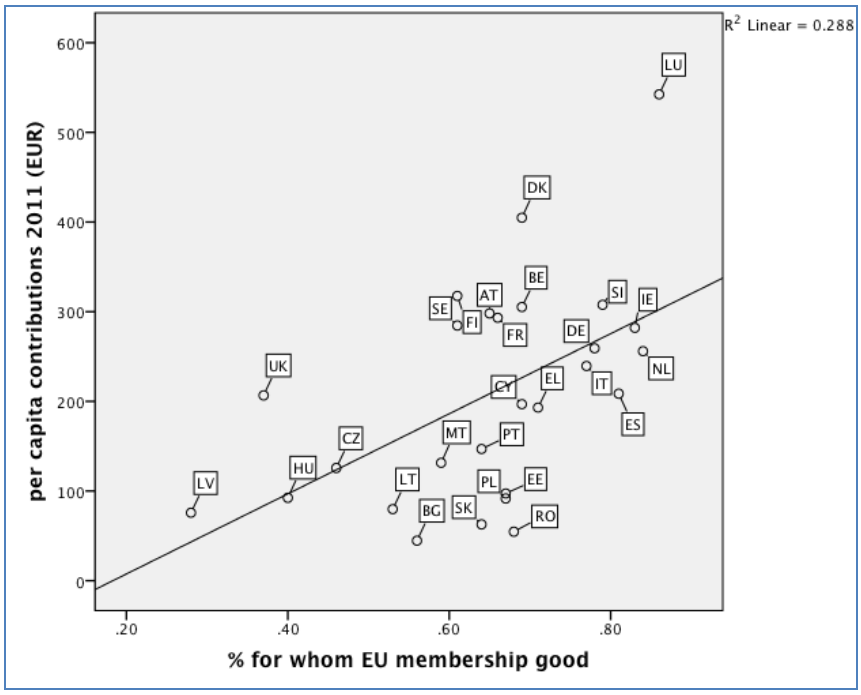

Figure 8: Contributions by perception

There are two possible conclusions: either the EU's peoples are happy to contribute in proportion to their wealth to the EU budget, or they are unable to make this connection and this correlation is spurious. The one Eurobarometer of 2008 (Flash no. 234) that asked respondents to evaluate regional policy comes to equally contradicting conclusions. Overall, 85 per cent of citizens agreed that EU Regional Policy should primarily target the poorest regions; approval was lowest but still very high in Austria (77 per cent), Denmark (79 per cent) and the Czech Republic (80 per cent) (ibid. 13–4). Nevertheless, 58 per cent also thought that the EU should help *all* its regions; only in Portugal and Spain (two "traditional" net recipients) was a majority of the view that the EU should focus on the poorest regions exclusively (ibid. 14). Finally, at the regional level, Osterloh (2011: 20–1) finds that the more *both* region *and* country benefit from structural funds, the more its citizens support EU membership, controlling for education, ideology, income, and duration of a citizen's country's EU membership, amongst others. In particular, "an increase of per capita transfers [to one's region] by 100 Euro increases the probability of being supportive of the EU to the extent of 11%" (Osterloh 2011: 19–20), and "being a direct recipient of structural funds increases the probability of supporting the EU by 13.2%" (Osterloh 2011: 27). Crucially, though, "spill-over within the countries" (Osterloh

2011: 29) makes the nation-level citizenry in general more supportive of the EU.

4. Comparative Reflections

Comparing the data on Switzerland and the EU, several observations can be made. The findings on Switzerland are much clearer in pointing to the existence of inter-cantonal solidarity and its direct link with fiscal equalisation. The vast majority of Swiss people and cantons supported the new financial equalisation system in 2004. The three cantons that voted against the new system did so not because they were generally against any form of equalisation and redistribution, but because they were net-contributors that had to contribute the most to the equalisation mechanisms and received no (Zug) or only little (Schwyz and Nidwalden) support. However, the fact that other cantons whose contributions would also be higher than their gains voted in favour of the NFA demonstrates the existence of strong bonds of solidarity and the recognition among Swiss citizens that some form of fiscal equalisation should exist to ensure equal opportunities across the country.

Moreover, while the three cantons that voted against the NFA are German speaking and predominantly Catholic, the fact that other cantons – German, French and Italian speaking as well as both Protestant and Catholic ones – voted in favour of the new fiscal equalisation scheme demonstrates that the recognition of solidarity amongst cantons cuts across established cleavages. Probably a major reason why so many people voted in favour of the NFA was the fact that it was carefully "packaged" to ensure most cantons would profit from it (hence the three pots) and that especially the bigger cantons would be in favour of it, creating thus not just a cantonal but also a popular majority (Schaltegger and Frey 2003, 253).

Our discussion and data on the EU are less clear. This has to do with the fact that the EU, unlike Switzerland, never had a referendum on Regional Policy or fiscal equalisation. Therefore, conclusions remain limited. Nevertheless, we can clearly see that most citizens believe their country's membership in the EU to be a good thing. There is also both general support for the EU's Regional Policy and a specific positive perception of the EU in recipient regions, although data on this are relatively sparse. Clearly, support for the EU is related to direct benefits from membership in the EU, be they Regional Funds, more

political prestige or an improvement of a country's security. Furthermore, the strong support for Regional Funds allows us to conclude that there is a general awareness among European citizens about the need for fiscal equalisation, which furthermore seems to "spill-over" from the regional to the national realm. While there might not (yet) be a EU "togetherness", a certain degree of implicit solidarity amongst the EU's constituent units can nevertheless be observed when interpreting the data.

Are there general lessons to be learnt from this comparison and what implications does our analysis have for inter-territorial solidarity within the EU? The first lesson is that there is a direct link between solidarity and fiscal equalisation and that the two reinforce each other. We have shown this in our analysis of Switzerland, but even the more limited analysis of the EU has demonstrated that citizens support the EU if they benefit from it, and that they are able to understand the need for fiscal equalisation in a complex multi-level system such as the European Union.

The second lesson is that the success of both fiscal equalisation mechanisms lies in the fact that many profit, while there is only a small number of "losers" – in the case of the EU, at the state-level there are literally none! This means that one of the reasons why people support the EU's structural funds across the Union and voted in favour of the NFA in Switzerland is because their canton/state would profit from it in one way or another.

A third lesson is the obvious need for constant re-negotiation and flexibility. Both within the EU and its Member States, but also among the Swiss cantons and between the Swiss cantons and the Confederation, there is a permanent dialogue about the arrangements for fiscal equalisation. Be it through regular budget debates or as part of specific reform packages, fiscal and economic conditions change and adjustments are therefore frequently required. However, this dialogue also ensures the best use of funds and is important, because it gives fiscal equalisation and therefore the whole polity more legitimacy. Debates – or "deliberation", for Besson (2007) – are what ultimately make the virtuous circle of solidarity, equalisation and legitimacy turn.

This brings us back to our theoretical discussion at the beginning. While we have stipulated that solidarity is a prerequisite for fiscal equalisation and fiscal equalisation in turn strengthens solidarity, it is important to emphasise that the existence and re-adjustment of fiscal equalisation gives polities such as Switzerland and the EU further legitimacy. If people feel that their needs are addressed and that policy decisions have a

positive long-term impact, then they are more likely to support policies and accept tough decisions by elites. It comes as no surprise therefore that access to Regional Funds is one of the main reasons why other countries want to join the EU. Thus, fiscal equalisation contributes not only to economic development, but also to creating a "factual solidarity" amongst different territorial communities.

Going back to theories on comparative federalism and federation, what can be learnt from our comparison is therefore not that fiscal equalisation is the answer to all problems of legitimacy and democratic deficits. However, fiscal equalisation, if designed properly, strengthens solidarity and this in turn increases the legitimacy of the overall political system. In that sense, the current fiscal crisis within the EU might well function as a trigger to strengthening inter-territorial solidarity through more explicit redistributive policies. What differentiates the conditions for these from a classic understanding of nation-state building is that instead of being inter-personal, solidarity now "only" needs to be inter-territorial, given that EU Member States are themselves sufficiently legitimated to ensure that the other two types of solidarity – inter-personal and inter-group – are operating within them in a complementary fashion.

5. Conclusion

This article has tried to shed some light on the complex and dynamic relations between territorial solidarity, fiscal equalisation and legitimacy in multilevel settings. We have compared two political systems: While Switzerland benefits from a high degree of solidarity and legitimacy, which together were able to make a reform of its fiscal equalisation become overwhelmingly approved (Braun 2009), in the EU equalisation is formally vertical (from the EU to the regions) but factually horizontal (inter-state payments), making it both difficult and contentious to compare each individual member's costs and benefits.

Of the many conclusions that we have already drawn, only the most important deserves to be repeated here: to be able to contribute to the legitimacy of a federal political system, fiscal equalisation needs to address inter-territorial differences and allow for an agreement on how best to transform abstract solidarity into specific benefits. For this process to work in the EU, three conditions need to be fulfilled. The EU would first have to completely overhaul its intricate system of inter-territorial funding. This should include new criteria for

regions being awarded funding and a more direct link between those who contribute and those who receive to strengthen horizontal solidarity amongst regions and countries.

Second, to alleviate tensions arising from this new situation, the EU would need to increase its own budget. An efficient and legitimate system of fiscal equalisation that produces "win-win situations" is expensive, as has been demonstrated in the case of Switzerland. Finally, the EU should allow its constituent units to bindingly express their consent. While the data used for the EU reveal strong support for EU Regional Funding, linking one of the biggest success stories of EU integration to people's perception of the overall polity would not only increase the legitimacy of the Union, but would also allow people to recognise the positive effects of their country's membership in the EU. The paradox is, of course, that all three steps require a prior commitment to "make sacrifices", i.e. an initial degree of inter-territorial solidarity. Nevertheless, the current fiscal crisis might provide exactly such an opportunity and thus create a "critical juncture" in which structural constraints are temporarily relaxed to allow for the kind of agency that Barroso himself emphasised.

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I Of course we are also aware of the differences between Switzerland and the EU, in particular the fact that the EU is neither a state, nor a mono-national polity (Dardanelli 2008). However, for the purposes of this paper and its particular focus on fiscal equalization, we believe that both similarities and differences in structures, aims and implementation of fiscal equalization allow for a useful comparison.

II On the Swiss cantons as "cantonal democracies" cf. Vatter (2002).

III In the broad sense as defined by Watts (1996: 6–7).

IV See, amongst many others, the Neue Zürcher Zeitung of 9 October 2012, p. 5; 15 October 2012, p. 3; and 18 July 2012, p. 5, as well as 6 February 2013, p. 3, respectively

V Switzerland has four official languages: German, French, Italian and Romansch. The majority of Swiss speak German, followed by French. Italian is spoken only in Ticino and some areas of Graubünden; the latter is also the only canton in which Romansch is spoken.

VI The religious cleavage divides cantons with a protestant majority and cantons with a catholic majority, and leaves only a few bi-confessional cantons.

VII E.g. by Zurich, Zug or Schwyz: cf. Neue Zürcher Zeitung of 20 October 2012, p. 11; but also by recipients like Berne: cf. Tages-Anzeiger of 14 October 2012.

VIII We shall use "structural funds" and "regional policy" interchangeably, referring to the sum total of money disbursed via the European Regional Development Fund (ERDF), the European Social Fund (ESF), the Cohesion Fund and for projects in European territorial cooperation as well as regional competitiveness and employment (cf. Evans 2004, 2).

IX This was the case until the bailouts for Greece, Ireland, Portugal and Spain. Since then the EU Member

States have set up the ESM, which casts a form of horizontal financial equalization to some extent. However, the bailouts for some Eurozone countries are not given as grants but as loans.

[X] Source: Folketing EU Information Centre, at http://www.euo.dk/euo_en/spsv/all/79 (last updated 15 February 2012, last accessed 12 October 2012). Contributions include only individual countries' contributions in the form of own resources; administration costs not included in EU expenditures. Method: a) proportion of individual country's contribution of total contribution of VAT and GNP; taken to calculate b) the amount Member State should receive from the EU if there were to be a balance between payments and receipts between the Member State and the EU; c) amount country actually receives from EU minus b) and minus individual country's contribution to financing the British rebate; d) divided by population (EUROSTAT).

[XI] Source: EES 2009; variables: q80 (respondent's attitude to European unification): from 0 = "unification has already gone too far" to 10 = "unification should be pushed further"; and q79 (EU membership good or bad): 1 = "good thing", 2 = "bad thing", 3 = "neither".

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