

THE DILEMMA BETWEEN LEGITIMATE AND FUNCTIONAL LAW IN THE EUROPEAN UNION

How the Greeks and a Financial Crisis Undermine the European
Regulatory State



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My love and gratitude extends half a world away—thank you for your support, your love, and your eyes.

For my family here in Norway, whose kindness and strength is without equal.

And lastly, for Merethe who thinks this will be dedicated to her, and so it is.

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1 Introduction

There has been a considerable amount of thought levied upon the question of legitimate governance. As John Locke phrased it, it's not a matter of whether or not there should be political power rather the great question is upon whom that political power is entrusted. In modern day political parlance, the answer to this great question is found in democracy. Democratization as a legitimizing theory is understood and widely accepted within the context of the nation-state. However, democratization as a legitimizing theory outside the context of the nation-state is not so well understood nor accepted. With the emergence of globalization and international integration, to what extent democratic theories can or should be extrapolated to legitimize trans-national and supra-national institutions are of great value.

Deliberations on this topic are vast and stratified. Many political and legal theorists have employed a democratic standard to examine the legitimacy of international institutions ranging from the United Nations (UN), to the World Trade Organization (WTO), to the European Union (EU). If one were to accept the basic normative premise that a democratization of political power results in a legitimate government then it can be deduced that legitimizing power can be realized by instituting democratic structures. If, however, democratic structures are absent or incomplete then legitimization is either lacking, nonexistent or must be found by some other means.

The EU has been a featured target of many scholars who argue that its institutions are not entirely democratic. This lack of democratic integrity has been termed the "democracy deficit" and can be understood as "the gap between the powers transferred to the Community level and the control of the elected Parliament over them, a gap filled by national civil servants operating as European experts or as members of regulation and management committees, and to some extent by organized lobbies, mainly

representing business.”¹ If the EU does indeed have a democratic deficit, then must it not also suffer to some level a crisis of legitimacy?

Questioning the democratic integrity of the EU is a bit like following the white rabbit down the rabbit hole; the journey starts with one question but ends with infinitely more. After all, what is democracy? Held has been a good source for chronicling models of democracy in both a historical and modern context.² Many other authors have added to this discussion by offering characterizing features of democracy.³ This thesis does not endeavor to enter the debate over democracy or argue for one model over the next. However, it is important for the reader to understand that the democracy deficit debate rests first upon an initial argument over what democracy is. What follows are even more questions— Should the EU be democratized? Is it even possible to democratize the EU? Are there consequences to democratizing the EU and if so, could the costs be too high? If it is possible and desirable to democratize the EU, how would democratization look and how would it work? For each question, there is a cleavage making for an extensive number of legitimizing theories.

Within the EU democracy deficit debate there are two main initial branches of thought. There are those who desire to democratize and then there are those who do not. For those who do possess a desire for democratization, there is an additional branch. From this group there are some who believe that democratization is not possible however desirable it may be, and then there are others that both desire democratization and believe it to be possible. From this point the question is either how to handle the negative consequences of the democratic deficit or how to go about solving the deficit.⁴ Included in this taxonomy is an ongoing epistemological battlefield over the heart of the EU: what is it and what it should become?

¹ Williams (1991) p. 162.

² See both Held (1995) and (1996).

³ Follesdal (1998).

⁴ Credit for the referenced classification: Karisson (2001) pgs. 130-140.

Weiler sets the stage for this discussion with his writings on the “constitution of Europe”.⁵ This rich phrase calls to question a myriad of elements of European integration: its composition, its founding principles, its founding documents, its evolution, etc. The EU has many legal institutions and a complex structure that opens up a number of possible ways for it to be democratically deficient as each EU institution—the Council, the Commission, the Parliament, the Presidency and the Courts—must pass a test of legitimacy. This constitutional understanding demands that not only must each institution be legitimate itself in connection to the member states, but they must also be legitimate in relation to each other.⁶

Much of the arguments regarding democratization fall within three groups: competitive democracy, participatory democracy, and deliberative democracy. Competitive democracy calls for policy creation as the result of political competition.⁷ Having a competitive system insures that those currently in power must react to the will of the polity or risk being replaced by a “government in waiting”.⁸ The most common reform is the increase of the European Parliament’s legislative powers.⁹ Heidrum Abromeit who argues that democratizations should come about by direct participation best exemplifies the group advocating for participatory democracy.¹⁰ Deliberative democracy is a recent attraction to many democratic scholars.¹¹ Deliberative democracy is a process that narrows down preferences through discourse. There are also social theories that argue that EU must also look to its social responsibilities and that it currently does not reflect the will of the average European citizen and that there is a policy drift from voter preference at the EU level.¹²

⁵ Weiler (1999); Weiler, Haltern and Mayer (1995); Weiler and Wind (2003). See also Mancini (2000).

⁶ See Andersen and Burns (1996) for the argument that executive power has overtaken national parliamentary power. See also Raunio (1999).

⁷ See Beitz (1989) and Schattschneider (1960) for views of democracy as a competitive political system.

⁸ For examples see Miller (1983) p. 133-155 and Schumpeter (1952).

⁹ Williams (1991).

¹⁰ Abromeit (1998).

¹¹ See Bessette (1981); Joerges and Neyer (1997a) pgs. 273-229; Joerges and Neyer, (1997b) pgs. 609-625; Joerges and Everson (2000) p 164-188.

¹² See Joerges (2005) and Joerges and Rödl (2009) for social deficit arguments and see Scharpf (1997) and (1999) for policy drift arguments.

Those seeking not to democratize the EU can be said to be advocates of the status quo. The first half of this group are those who desire democratization but do not think it is possible. Accordingly, instead of finding ways to democratize the EU, they advocate that the negative impacts resulting from the democracy deficit should be disarmed.¹³ The other half of the status quo group contends that there is nothing wrong with the EU's democracy deficit. The prominent thinkers here are Majone and Moravcsik.¹⁴

With the understanding that there are many elements to the democracy deficit debate in the EU, this paper will address only one. Particularly, this thesis will concentrate upon the theories of Giandomenico Majone. Majone advocates that the EU should not be judged as an institution requiring further democratizing. Instead, the EU should be seen as a regulatory state. There are many elements of regulatory theory, however, this thesis will concentrate solely on Majone's arguments.¹⁵ One of the essential characteristics of regulatory regimes for Majone is that they are insulated from democratic rule and therefore the current democratic deficit of the EU is not a bug but a feature. The effort of this thesis will be to address shortcomings in the assertion that the EU as a regulatory state is a legitimate and functional means of supra-national governance. Majone's regulatory state thesis, like all of the aforementioned arguments over the democracy deficit, is a means of producing legitimate rule within Europe. This legitimizing framework will be referred to as the Majone framework. Majone contends that so long as specific actors produce specific policy, then the EU as a regulatory state does not require democratization in order to be legitimate. Furthermore, Majone contends that not only is the regulatory state a legitimate form of supra-national governance, it is also the most effective means of producing policy. There are two important parts to the Majone framework. The first is a normative claim and a second is an empirical claim. The normative claim derives from the legitimizing power of non-majoritarian rule. The purpose of this thesis is to test the empirical implication that the

¹³ See Scharpf (1994) pgs. 219-242; Scharpf (1996a), pgs. 136-155; Scharpf (1996b) p. 15-40.

¹⁴ See Moravcsik (1998a), (1998b), (2002), (2003), (2004) and Majone (1993a), (1993b), (1994), (1996), (1997), (1998), (2000), (2002a) and (2002b).

¹⁵ See Majone (1994) for a full treatment of the Majone regulatory thesis.

regulatory state is functional while also being legitimate. I will test this functionally assertion by using the Global Financial Crisis (GFC) and the Greek Sovereign Debt Crisis (SDC) as empirical tests. For that purpose, this thesis will operate under the assumption that Majone's normative claim is correct.

The first chapter of this thesis is devoted to Majone's explanation of his regulatory state thesis. Here, the argument for the legitimacy and desirability of non-majoritarian rule rather than majoritarian rule will be spelled out. The second chapter is an explanation of the GFC and the SDC. These two crises are used to put the Majone framework into an empirical context exposing its functional limitations at addressing the demands of increased European integration. Chapter three analyzes the empirical implications rose by the GFC and the SDC by highlighting the functionality flaws of the regulatory state. This analysis results with the suggestion that the EU is faced with the dilemma between choosing a legitimate yet dysfunctional government or an illegitimate yet functional government. As this is not a desirable choice, chapter four endeavors to reform Majone's non-majoritarian legitimizing framework so that it is more functional. It is possible to make the EU more functional within Majone's legitimizing framework but this product could prove to have other undesirable effects casting doubt on its long-term sustainability. In this light, this thesis ends with a discussion over the nebulous nature of the EU and suggests that the inability to adequately define what it is and what it should become is a fundamental problem. The democracy deficit debate is essentially a European identity crisis writ large. This fundamental disagreement is the antecedent to all other disagreements over legitimate political power in Europe. As a consequence, finding a balance between a EU that is both functional and legitimate cannot occur until the EU and its purpose are better defined and agreed upon.

2 THE MAJONE FRAMEWORK

2.1 From a Positive State to a Regulatory State

During the nineteenth century, Henri de Saint-Simon, a wild-eyed idealist in his day, envisioned that society would transform itself into a government of experts. Fueled on the vogue promise of Newtonian mechanics' affect on social order, Saint-Simon figured that science and reason would produce and necessitate a new ruling elite. According to Saint-Simon, "the government of man will be replaced by the administration of things," and these administrators "qualified by their superior talents," would replace the traditional political actor whose leadership is wrought from self-interest and ignorance with the rational and skilled expert.¹⁶

While a complete actualization of Saint-Simon's vision has not come to pass, one can see vestiges of the "rule by skilled elites" premise in today's governments in the form of regulatory bodies that rely upon the expertise of individuals to govern the complexities of modern societies. Majone favors the basic notion that there are some sectors of governance whose stewardship is best delegated to regulators over politicians and has chronicled what he believes is a steady shift in that direction. This shift can be seen in the reduced role for the positive state and a corresponding increase in the role of the regulatory state.

According to Majone, the positive state is characterized by its intervention and was the hallmark of post-WWII European democracies. During this period, the positive states of Europe attached themselves to redistributive, tax and spend policies of the so-called

¹⁶ For a full treatment of Saint-Simon's ideology see *Letters from an Inhabitant of Geneva to His Contemporaries 1803*. Quotations attributed to Saint-Simon taken from Siedentop (2000) p. 32 and Hewett (2008).

“Keynesian Welfare State” era. Governments of this era sought to control and regulate their societies by nationalizing key markets and industries. Intervention by this means failed, however, and “in one country after another, publicly owned firms came under fire for failing to achieve their social as well as their economic objectives; for their lack of accountability; and for their tendency to be captured by politicians and trade unions.”¹⁷

The failures of the positive state in Europe has been exacerbated by globalization, economic integration, and the EU, where member states’ ability to tax and spend (or borrow) has been considerably hamstrung by law. Since the late 1970s European governments have accordingly been forced to reject and change their traditional modes of governance and adopt reform in the shape of privatization, liberalization, welfare reform, and deregulation¹⁸. Rule making rather than redistribution has therefore become the emerging prominent form of policy; and the technocratic expert rather than the elected politician has become the most important actor.

With this transition into delegated rule making, a question of legitimacy emerges. If a government’s legitimacy is still to be judged upon its democratic structure then a regulatory state where key policy makers are insulated from the democratic process can be found wanting. Majone responds to this charge with a thesis that pivots the discussion away from democracy as the preferred source of legitimacy. Instead, Majone highlights failures with the majoritarian democratic process and argues that these failures represent the true wounds to EU legitimacy. Majone’s thesis can be distilled down to three essential points: the first relates to the accountability dilemma of majoritarian rule; the second relates to the tyranny of the majority over the minority; and the third relates to a change in standard setting that places a premium on effectiveness over democracy for legitimacy. Each of these above points will be explored in the following sections.

¹⁷ Majone (1996) pgs. 11-23.

¹⁸ Majone (1997) p.143, for explains on deregulation.

2.2 The Accountability Dilemma of Majoritarian Democracy

There is a reason why policy makers choose to delegate their power. Some advance cognitive factors such as the dearth of competence and expertise among legislative bodies to convene on complex issues.¹⁹ Others advance a blame-avoidance theory where policy makers wish to avoid the consequences of policy failures by spreading the guilt around and thus dampening their responsibility.²⁰ Majone sees merit with both explanations but concludes that for the EU, the need to achieve credible policy outcomes has been a primary motivator for the rise of the regulatory state.

Democratic policymaking has a credibility problem.²¹ The *pro tempore* nature of democratic lawmaking means that these lawmakers are under time constraints to pass policy.²² Once a policy objective is initiated, there is nothing to prevent a successive legislature from changing policy in another direction. Because politicians have an interest to seek re-election, they are not necessarily motivated to consider long-term policy interests of the polity over their own short-term interest of re-election. As a result, long-term policy commitments are difficult. Majone defines this as the accountability dilemma. The accountability dilemma exemplifies the demarcation lines separating the political actors of majoritarian democratic procedure from the technocratic expert of delegated regulatory regimes. “[I]n seeking re-election, legislators engage in advertising and position-taking rather than in serious policy-making, or they design laws with numerous opportunities to help particular constituencies. In either case, re-election pressures have serious consequences for the quality of legislation.”²³

Within a nation-state, credibility issues can be subdued by the coercive power of the state, but as Majone points out, this is not possible to do outside national borders and is

¹⁹ McCubbins and Page (1987) pgs. 409-25.

²⁰ Fiorina (1981) p. 33-36, at 47.

²¹ See Kydland and Prescott (1997) for the value of fixed rules over discretion.

²² Linz (1998).

²³ Majone (1996) p. 291.

particularly not feasible for the EU. As nation-states become increasingly integrated and laws are established in response to this interconnectedness, it becomes all the more important to establish credible policy. Foreign governments and international economic actors who must plan their strategies on a forecast of long-term thinking will only respond to credible policy.

2.3 The Tyranny of the Majority over the Minority

The second point to be discussed, the tyranny of the majority over the minority, has many facets to it and plays a central part in Majone's thesis. The concept of a "tyranny of the majority" has its roots in American political thinking, in particular with James Madison.²⁴ Majone employs this concept to distinguish two distinct forms of democracy. Majone characterizes the first form as a radical concept of extreme majority rule where a populist, unitary, and centralized government rules upon all manners of public life. On the contrary, "the alternative, or 'Madisonian', model aims to share, disperse, delegate and limit power. The over-riding goal is to protect minorities from the 'tyranny of the majority', and the judicial, executive and administrative functions from representative assemblies and from fickle mass opinion."²⁵

If the reader is convinced of these two models of democracy and, more importantly, that the regulatory state falls within the Madisonian model (for it is absolutely incompatible with the former model), then legitimacy through democratic means isn't completely off the table. Approaching legitimacy from this angle, however, does come with a requirement for procedural legitimacy—democratically enacted agencies with clearly defined legal authority and objectives; decisions follow from formal rules and public participation; decisions must also be justified, transparent and open to judicial review—that, according to Majone, isn't difficult to realize. Majone is a particular fan of the US

²⁴ For classical statements of this concept, Majone points readers in the direction of Federalist papers numbers 48, 49, and 71.

²⁵ Majone (1997) p. 159.

Administrative Procedures Act (APA) and believes that a similar structure could be used in Europe.

An additional requirement, and a very important one at that, is a limit to the kind of policy decisions the EU as a regulatory state can make. Majone's response to this requirement is the argument that regulatory policy outcomes be Pareto-optimal. Pareto-optimality, or Pareto-efficiency, is a concept named after an Italian economist, Vilfredo Pareto, who sought to define an outcome that made one or more individuals better off without making any other individual worse off. Pareto optimality is critical to Majone's framework of a legitimate regulatory state as it isn't merely a desired characteristic—it is a requisite, defining characteristic. This characteristic has considerable implications for the EU as a regulatory state for it limits the types of policy decisions the EU can make and still be considered legitimate within Majone's framework. Namely, policy outcomes need to be Pareto-optimal.²⁶

Majoritarian rule, on the other hand, does not seek Pareto-optimal outcomes. On the contrary, the effect of majoritarian rule is zero-sum where majorities are the “winners” and the minorities are the “losers”. While a democratically governed nation-state can legitimately involve itself into zero-sum outcomes, the EU does not have that possibility. The EU as a regulatory state must instead concern itself with functions of government control that result in positive-sum outcomes. What sort of functions does that leave the EU? Majone identifies three essential functions of government control: income redistribution, macroeconomic stabilization, and market regulation. The first two are functions of a positive state and the last one is a function of the regulatory state. As a result, the EU must shy away from involvement in redistributive or macroeconomic policies and instead deal primarily with matters of market correction where Pareto-optimal outcomes are possible.²⁷

More than being necessary, this requirement is also practical for addressing the realities of strained European integration where deep cleavages divide the polity. According to

²⁶ Majone (1997) pgs, 140-141.

²⁷ Majone (1996) pgs. 162.

Arend Lijphart, non-majoritarian democracy is better suited for plural societies in which people are sharply divided along a number of important lines.²⁸ In such a circumstance, the fear of the “tyranny of the majority” is more problematic. The EU should, therefore, shield itself from the populism of the majoritarian democratic model and instead embrace the Madisonian, non-majoritarian model.²⁹

2.4 Standard Setting

Lastly, Majone returns the question of legitimate governance to a fundamental level. This thesis started with an assumption that legitimacy is a product of democratic structures. It is important to note that this is indeed just that, an assumption. Majone makes the distinction between standard-setting and standard-using. Standard-setting is a process by which people deliberate and propose standards upon which a proposal is to be judged. Standard-using is the actual task of measuring dimensions of performance against set standards.³⁰ According to Majone, we are currently in the standard-setting stage and should therefore refrain from using standard-using until an accepted standard exists. The problem with those who advocate that the EU suffers from a democratic deficit is that they jump the gun by using a standard before anything has been set. According to Majone the current debate tends to use majoritarian standards when it shouldn't. Instead Majone believes we should be using non-majoritarian standards.³¹

It is here where Majone's position takes a confusing turn. His rejection of a majoritarian set of standards for a non-majoritarian set is not the search for an alternative approach to democratic legitimacy. As discussed above, Majone's vision of a non-majoritarian democracy is formulated by an understanding of a Madisonian democracy where his particularly attraction is to the more extreme antidemocratic element. As a result, Majone is not asking that the reader be convinced by the democratic quality of his non-majoritarian premise, quite the contrary. What Majone is really proposing, though it is

²⁸ Lijphart (1984).

²⁹ Majone (1996) pg. 286.

³⁰ Majone (1998) p. 5.

³¹ Majone (1996) p. 7.

obfuscated, is that there is a struggle between the democratic standards based on majoritarianism and the standards of efficacy based on the non-majoritarian regulatory state. The EU is more efficient with its democracy deficit than it would be without it. If the democracy deficit were to be lessened, the EU would become less effective. This is the new standard upon which the legitimacy of the EU should be judged, not on democracy, but its effectiveness.

2.5 Conclusion

A fair assessment of the EU as a regulatory state thesis shows that Majone's conclusion follows logically from his premise. One must therefore either accept his conclusion or reject his premise. A rejection of the premise could follow by a simple repudiation of the normative assumptions. For instance, if one is from the outset unconvinced of the legitimacy of anything short of full political integration backed by a democratically structured federal European State, then any argument to the contrary, or arguments against the efficiency of non-majoritarian rule will fall on deaf ears. Perhaps a better approach, and a more useful one, is to at least nominally accept all of Majone's normative assumptions and instead examine his thesis on empirical grounds for while justifications for his thesis are largely normative (non-majoritarian rule is better than majoritarian rule at the EU level), they are also dependent on empirical criteria (efficiency) that besets the real world. This thesis will therefore operate under the assumption that the Majone framework is legitimate. If the theoretical framework can be shown to not be simpatico with actual reality, then the value of the framework would be considerably hamstrung in its applicability to real world European governance.

There are a number of critiques already that point out some of the weaknesses with Majone's thesis when it comes to his framework's plausibility of working outside of a theoretical context and in the real world. Much of Majone's framework hinges upon the ability of the regulatory state to find Pareto-optimal solutions. There are some studies that suggest it does not. Friedman and Rogowski have argued that private producers for domestic markets are losers from the liberalization of trade in a single

market.³² Others have raised similar critiques arguing that the EU consistently engages in policy that produces winners and losers.³³ Another relevant critique of Majone comes from Scharpf who argues that a separation between negative and positive integration is not possible.³⁴ These authors suggest that the Majone framework is already not a viable governance strategy due to an existing contradiction within the union itself that does not allow for absolute Pareto-optimal policy. While this thesis is aware of these criticisms, it is going to operate under the same assumption that the Majone framework operates under: that the regulatory state can and must produce Pareto-optimal policy. With this in mind, the effort of this thesis is to examine the applicability of Majone's thesis to European governance through the prism of the GFC that started in 2007 and reached a climax in 2010 with the SDC when Greece nearly defaulted on their loan obligations. These two events tested the mettle of the European integration project and have exposed, in some part, the nature of the beast in areas that used to be purely conjecture. The following chapter will examine the events leading up to the crises and the actions taken in response.

³² Friedman and Rogowski (1996).

³³ See Joerges (1999), Pierson and Leibfried (1995).

³⁴ Scharpf (1996b).

3 THE GLOBAL FINANCIAL CRISIS AND THE SOVEREIGN DEBT CRISIS

3.1 The Global Financial Crisis

The affects of the GFC on the EU had its origins in the United States when in 2006 the subprime crisis saw a rapid reversal in the prices of the US housing sector. Many factors collided ultimately resulting in the drying up of credit. With the well dry, the financial sector was in crisis. The problem hit a tipping point in September 2008 with the default of Lehman Brothers. Lenders became reluctant to issue credit and the cogs of the mighty American financial machine came to a screeching halt. Businesses and hedgefunds engaged in “fire sales” in the effort to deleverage and decrease their risk. These effects quickly spread from Wall Street to Main Street as John Q Public began to feel the sting of the crisis and the looming recession.³⁵

Meanwhile in Europe, in the age before the downfall of Lehman Brothers, EU financial systems were starting to become affected with some institutions showing solvency problems, but there was no evidence that these troubles were significantly problematic trans-nationally.³⁶ However, later in 2008 and into 2009, lack of confidence increased and major cross-border banks began to notice severe solvency shortages.³⁷ The first bank to be rescued was the Belgo-Dutch bank Fortis. Soon after Belgium, France and Luxembourg intervened to rescue the Belgo-French bank Dexia. What followed was a series of national initiatives to guarantee banks. Calls for coordination at the EU level began but the European governments failed initially to come to a consensus when they

³⁵ The New York Times (2009).

³⁶ ECB (2009).

³⁷ Financial Services Authority (2009).

met in early October 2008 short of a general commitment that “negative spill-over effects should be avoided.”³⁸

The situation worsened and an emergency summit was convened on 12 October, 2008 for all of the heads of states of the Eurozone. The result of this was the Paris Declaration, a plan of action endorsed by the EU countries to tackle the crisis through cooperation and a resolved commitment to provide liquidity via the central bank, a recapitalization of banking institutions, and a guarantee for bank borrowing backed by public funds. With the absence of an *ex ante* framework, the EU governments gathered to organize an *ad hoc* approach to solving the crisis in an *ex post* fashion. This framework included a number of significant Commission documents designed to negate spillover effects.³⁹ By the summer of 2009, the Commission had approved a total of over three and a half trillion Euros to stabilize faltering financial institutions. As a result of this action, many have assessed that the rapid and unified response by the EU quelled what could have been a truly devastating state of affairs.⁴⁰

With the fire put out and what seemed to be the worst behind them, attention of the EU was shifted away from crisis management to questions of diagnosis and prevention: what happened, why did it happen, how did it happen, and what could be done to make sure it would not happen again. Even with the bulk of the crisis in the rearview mirror, it was not clear on what must be done in the future as positions continued to vary on the best course of action. What was more obvious was that the cause of the GFC was due in large part to regulatory failure. According to Cukierman, “The most glaring regulatory failures are the rise of an unregulated shadow banking system, the existence of compensation packages that encourage excessive risk taking behavior, the too-big-to-

³⁸ Council of the European Union (2008) pg. 1.

³⁹ See Communication from the Commission on “The Application of the State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis”, OJ C 270, 5.10.2008; Communication from the Commission on “The Recapitalization of Financial Institutions in the Current Financial Crisis: Limitation of the Aid to the Minimum Necessary and Safeguards against undue distortions of Competition”, OJ C 10, 15.1.2009; Communication from the Commission on “The Treatment of Impaired Assets in the Community Banking Sector”, OJ C 72, 26.3.2009.

⁴⁰ Pisani-Ferry and Sapir (2010).

fail problem, procyclicality in the behavior of financial institutions, and moral hazard problems in the rating agencies sector.”⁴¹ Others pointed to an overly expansive monetary policy ⁴², a global savings glut⁴³, and inadequate regulating of financial institutions.⁴⁴

For the EU, reaction to the failure of regulation is often a call for the formalization of increased cooperation amongst nations in the form of centralized powers for oversight and enforcement. For instance, the Larosiere Report 2009 has called for a number of reforms that would strip regulatory authority from the national level and give it to the EU level. Included in the proposed reforms is the creation of the "European Systemic Risk Council" (ESRC) to be chaired by the European Central Bank president. Its duties would be to establish a risk warning system, with coordination with the Economic and Financial Committee that could take action when local supervisory action is deemed to be inadequate. The Report also calls for detailed criteria for burden sharing during a crisis so it is clear for whom the responsibility lies in the event of the need for cross-border bailouts. An additional agency, the “European System of Financial Supervisors” (ESFS), would be an independent and decentralized regulatory body tasked with day-to-day supervision and would be involved intimately with all major cross-border institutions.⁴⁵

Another centralized approach suggests the formation of a European banking resolution authority.⁴⁶ In the USA, the Federal Deposit Insurance Corporation (FDIC) is in charge of resolving major banking crisis but the EU does not have an equal regulatory body. The consequence of this absence is that there is no pan-European authority that can step in to dismantle or reorganize failing companies that pose a systemic risk to the union’s financial system. According to Dewatripont et al, the GFC has shown that national authorities have no other option but to default to a strategy of bailouts creating a threat of moral hazard. They suggest a model that establishes a single resolution authority

⁴¹ Cukierman (2010) pg. 2.

⁴² Taylor (2009).

⁴³ Bernanke (2005).

⁴⁴ Roubini (2008).

⁴⁵ Larosiere (2009).

⁴⁶ Strauss-Kahn (2010).

that would be responsible for crisis resolution. This authority would coexist with the European Commission who would be responsible for regulating competition in state aid control.⁴⁷ However, in order for this model to be viable, the resolution authority must have access to public funds. Exactly how these funds are to be raised and the implications over its governance and its effect on the financial sector remains an open question.

Even before the GFC, there have been many who raised concerns over the lack of an *ex ante* framework to establish roles and responsibilities in the event of a crisis. Leading up to the GFC, the EU had no clear guidelines for how to handle liquidity or how the function of a EU lender-of-last-resort would work.⁴⁸ On the solvency side there was a clear lack of protocol for the resolution of cross-border banking crisis and fiscal border-sharing mechanisms.⁴⁹ Despite these concerns, the EU was able to formulate a cooperative strategy on the fly to dampen negative effects of the GFC. While this is good news, it doesn't necessarily bode well as a long-term strategy. Once EU wide action was taken it was quick and decisive, but it also came not a moment too soon. The stirrings of the GFC started years before the European heads of state met in October 2008 with clear signs of insolvent European banks in 2007. With a regulatory framework in place the situation may never have reached a boiling point, as proactive action would have gone into effect early. Consider also that the most complicated pan-European action involved only three countries, all of which have had a history of cooperation. Would the situation be different if more countries were involved, especially if those countries had no previous cooperative history? It seems a realistic assumption, considering the trend of European financial integration, that the next time a crisis like this occurs it will look far more similar to the situation in the USA. After all, the EU "single passport" policy that enables companies established in one member state to provide services in all of the other member states practically guarantees that the need

⁴⁷ Dewatripont, Nguyen, Praet, and Sapir (2010).

⁴⁸ Prati and Schinasi (1998), (1999); Schinasi and Teixeira (2006); Nieto and Schinasi (2007).

⁴⁹ Goodhart (2004); Goodhart and Schoenmaker (2006) pgs. 34-57; Mayes, Nieto and Wall (2008).

to bail out a Too-Big-To-Fail (TBTF) is not a question of if, but when.⁵⁰ In light of this forecast, it seems prudent that serious consideration and discussion continue over the formation of an ex ante framework to govern the course of action when the next crisis hits.

With the GFC as a backdrop, European leaders formulated the Europe 2020 Strategy.⁵¹ It succeeds the Lisbon Strategy of the 2000-2010 period and spells out both their vision for a brighter tomorrow and the means to achieve it. Largely building off the Lisbon Strategy of 2005, the 2020 strategy focuses on sustainable growth through competition, lowering unemployment, investment in both education and R&D, as well as a commitment to green energy in light of fears over climate change. However, in the midst of drafting the 2020 Strategy, Europe's attention became quickly diverted away from the GFC when it became clear that the Greek economy was perilously close to defaulting. By March 2010, when European Commission President Jose Manuel Barroso pleaded with Eurozone countries to provide Greece with aid packages and support mechanisms, it became alarmingly clear that the GFC was just the start of Europe's worries.

3.2 The Sovereign Debt Crisis

The story of the Greek default and the SDC starts at the beginning when the European Monetary Union (EMU) was first established. Since the formation of the EU in 1957, there had been voices advocating the need for a common currency. By the time of the Maastricht Treaty in 1992, the goal of a universal currency became "the most important in the history of the European Community."⁵² Once the decision was made in 1999 to fully implement the Euro, the dream to see a unified Europe under a common monetary policy and a single market was realized. Unlike other monetary unions, though, the EMU was formed with no unified fiscal union. As a tip of the hat to national sovereignty, matters of fiscal policy were to remain within the jealously guarded

⁵⁰ Bulter (2009).

⁵¹ European Commission (2010).

⁵² Caravelis (1994) p. 1.

domain of the member state. This presented some unique challenges. Under the optimal currency area (OCA) theory, states in a monetary union should have relatively homogenous economies. Within the EMU, varying levels of economic development exist with a clear distinction between the core economies of Germany and France, and the peripheral economies of the PIGS (Portugal, Italy, Greece, Spain). The marginal cost of an OCA has a positive slope meaning that as a monetary union adds more economies, especially heterogeneous economies, the marginal costs also go up. If too many diverse economies are added, the increase in costs can outweigh any benefits. The stability of the monetary union is therefore dependant upon the stability of each economy. But without the ability to manage fiscal policy, a rather important shortcoming emerges in the ability to govern the EMU. The EMU's answer to this is the Stability and Growth Pact (SGP).

The SGP's legal foundation derives from a Council Resolution and two Council Regulations.⁵³ Members are under a strict obligation to keep their deficit spending south of 3%, which is meant to prevent excess borrowing to manage national finances.⁵⁴ Members must also keep their government debt from passing 60% of their GDP. Adherence to these standards is designed to ensure the growth and stability of the EMU in the absence of a centralized fiscal authority allowing both the benefits of a common currency and the protection from intervention into macroeconomic policy making. To ensure the integrity of the SGP, the Commission was tasked with the duty to regulate the terms and give the authority to levy fines on member states that failed to live up to their duties. The SGP was especially important for Germany who thought it essential that a mechanism was in place to regulate price stability.⁵⁵ Price stability protects from

⁵³ Resolution of the European Council on the Stability and Growth Pact (Amsterdam, 17 June 1997) [Official Journal C 236 of 02.08.1997]; Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies; Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure [Official Journal L 209 of 2 August 1997].

⁵⁴ This fiscal obligation starts from Article 104 of the Maastricht Treaty and later clarified and sped up by Council Regulation No. 1467/97.

⁵⁵ See Article 105 of the Maastricht Treaty: 1. *The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to*

inflation and sends a reassuring message to investors that a volatile exchange market will not compromise their investment.

The SGP has proved anemic and incapable of protecting the EMU from the ravages of excessive public spending. How could the Eurozone, after showing so much promise in its early years, fall from grace in a little more than a decade? The terms of the SGP suffered a severe lapse of regulatory control. The Commission exhibited complacency during the middle of the 2000s when the Eurozone was experiencing growth and the Euro took a respected place alongside the world's top currency. Trade within the Eurozone increased and members' ability to borrow money at a relatively low interest enabled countries like Greece, who saw 4% growth during this time, to stimulate their economies. Due to political and social pressures in Greece, the government borrowed heavily to sustain services and increase public sector jobs in the effort to curry political favor.⁵⁶ Through a number of underhanded agreements with a multitude of banks, Greece cooked their books to make it seem as if their deficit numbers were lower than they really were.⁵⁷ A considerable amount of blame should be placed on the Greek government for their malfeasance and their assiduous attempts to disguise it. That being said, even their "cooked" numbers were outside the SGP parameters. Soon after the Papandreou government came to power, it was revealed that the Greek deficit, first believed to be an already high 3.7 percent, was in fact a staggering 12.5 percent. It became clear that not only was the Greek Government living outside its means, it had been doing so for many years with nary a reaction from the EU.

With a deficit in the stratosphere (there have been estimates putting the true deficit as high as 13.6 percent⁵⁸) and government debt totaling over 120 percent of the GDP⁵⁹, the next step was to figure out how to move forward. Without an *ex ante* framework in

contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 3a.

⁵⁶ Kathimerini (2010).

⁵⁷ ABC News (2010).

⁵⁸ Bloomberg (2010).

⁵⁹ Forelle (2010).

place, the EU had to once again resort to ad hoc coordination. As opposed to their swift response to the GFC, reaction to the SDC was considerably more delayed. The delay was principally in part due to a lack of vision on what should be done. The proposition of bailing out Greece in light of their reckless spending left a bitter gall in many European mouths but the prospect of leaving them to wither on the vine was considered by many to be even more undesirable. Despite the Greek economy amounting to only 3 percent of the Eurozone's GDP, many feared that a default would trigger a catastrophic destabilization throughout the entire EMU. Greece had been borrowing from banks throughout the Eurozone, but they were not the only ones to take advantage of cheap interest. European banks had "funneled \$2.5 trillion into the five shakiest Eurozone economies: Greece, Ireland, Belgium, Portugal and Spain" with no clear plan for repayment.⁶⁰ The fear many had was that should a Greek default occur, a substantial number of private banks throughout Europe would not be able to take the hit. With many of these banks residing in "at risk" countries such as Spain, a failure of these banks could take down the economies of the peripheral countries, which could in turn take down the economies of the core countries, which would result in the destruction of the currency and the EMU. After so many decades of unification and integration, the irony is that in the end it was the interconnectedness that put the Eurozone at risk. United they stand; united they fall.

While this reality would seem to limit their options, there was one significant legal roadblock. During the Maastricht deliberations, the Germans insisted on a no bailout clause.⁶¹ The Germans were worried, and with good reason, that the non-disciplined economies to the south may in time seek assistance from them. They wanted it made clear that entrance into the Eurozone meant each member state had a responsibility to keep their financial house in order. This would minimize moral hazard and collective

⁶⁰ Theil (2010).

⁶¹ Maastricht Treaty, Article 104b.1: *The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.*

action problems.⁶² They had apparently underestimated the extent of integration's effect and by May 2010 Eurozone governments, despite the no bail-out clause⁶³, came to an agreement on a bailout package for Greece. This 110 billion euro rescue package included assistance from the International Monetary Fund (IMF) and demands implementation of severe austerity measures.

Like the GFC before it, the SDC has raised a number of questions revolving around what went wrong and what must change. The EU's vision to the future can be seen in the 2020 strategy where a commitment to growth includes ensuring the quality and sustainability of public finances and addressing macroeconomic imbalances. A realization of this strategy has arrived in part via the European Financial Stability Facility (EFSF)⁶⁴, a new special purpose vehicle designed to preserve financial stability in Europe by providing necessary funds to economies in crisis throughout the EU. More needs to be done, however, in addressing the root failure of the SDC. After all, something must be terribly wrong when a possible Greek default can pose such a huge risk to the entire Eurozone. The most obvious failure is that of the SGP.⁶⁵ This failure raises concerns over a lack of transparency and regulatory enforcement, and an inability of the SGP to stimulate growth and promote competitiveness in the periphery economies.

3.3 The Stability and Growth Pact

To better understand where and how the SGP fell short, it is important to first understand how it was intended to function. The primary responsibility of the SGP is to constrain excessive fiscal spending by members of the EMU and smooth the impact of

⁶² Brown Brothers Harriman FX Report (2010) p. 15.

⁶³ Article 103a.2 provides some flexibility by adding the language: *Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, acting by a qualified majority on a proposal from the Commission, may grant, under certain conditions, Community financial assistance to the Member State concerned.*

⁶⁴ Regulation (EU) No 407/2010 of the Council of 11 May 2010 establishing a European financial stabilization mechanism.

⁶⁵ Papaioannou (2010).

asymmetric shocks on real output and inflation in the absence of a centralized fiscal authority.⁶⁶ At the time of its formation it was a remarkable feat of policy coordination and before the lead up to the SDC, a casual observer could be excused for believing that it was successful in its mission. Hindsight, however, shows that problems had been present long before the crisis.

The SGP has two means of enforcement; the first can be described as a preventative arm and the other can be described as a corrective arm.⁶⁷ The preventative arm employs soft tactics that includes a survey of self-submitted Stability and Convergence Programs, which is a description of a country's fiscal objectives and their plans to achieve their objectives. Should something be awry, the Commission and the ECOFIN Council has the ability to make it public and put public pressure on poorly performing countries.⁶⁸ The corrective arm is stricter and employs formal enforcement to ensure fiscal discipline. Countries with excessive deficits are obliged to resolve it within a year. If the Council is of the opinion that sufficient progress has not been made, they may give notice to the offending country. If after 10 months the member state is still non-compliant, sanctions can be levied by the issuance of a non-interest-bearing deposit or fines.⁶⁹ All of the above measures are not automatic but open to the discretion of the Council.

Greece was hit hard by the GFC, but even before the crisis they had the highest deficit of any other member country. Their public spending and wage growth outpaced productivity making their economy uncompetitive. While Greece has exceeded the 3 and 60 percent deficit and debt cap for nearly every year since their introduction in the EMU, the Council never imposed any fines or sanctions on them. In fact, the Council decided to abrogate the Excessive Deficit Procedure (EDP) for Greece in 2007 despite its high deficit. The situation in Portugal is very similar. They have also seen high

⁶⁶ See also Article 104 of the Maastricht Treaty where it says: "Member States shall avoid excessive deficits."

⁶⁷ Fliipek and Schreiber (2010) section II.2.

⁶⁸ The preventative arm for surveillance and of budgetary positions is enshrined in Council Regulation (EC) No 1466/97.

⁶⁹ The corrective arm outlining the EDP is enshrined in Council Regulation (EC) No 1467/97.

deficit and public debt numbers in excess of the 3 and 60 limit. They also did not receive any fines or sanctions. Does this point to a fundamental flaw in regulatory enforcement? Perhaps, but to suggest that the failure of the SGP was primarily due to a lack of enforcement may ignore another significant issue.

In contrast to Greece and Portugal, Spain and Ireland have been top performers under the SGP criteria but have also been devastated by the GFC. This suggests that, “seemingly sustainable public finances are not enough to promote the necessary level of economic health and stability in a currency union.”⁷⁰ What all of the failing countries in the EMU show is a lack of savings during the boom times to have something to fall back on during the lean times, and a drop in competitiveness in the sector of trade goods.⁷¹ Traditionally, an economy that loses its competitiveness can devalue by lowering the cost of its goods in relation to foreign goods so their imports decrease and their exports increase. The power to impose competitive measures for the Eurozone rests with the European Central Bank (ECB) giving very little room for Greece, whose options are limited—primarily to wage cuts—to maneuver.⁷² Fostering competitiveness, especially for the PIGS, is therefore very important for long-term stability and growth and something that the SGP within the current EU framework has not been able to achieve. That being said, there is a broad consensus that fiscal rules do tend to improve fiscal discipline.⁷³ A prudent way forward for the EMU would therefore involve an interest to ensure fiscal discipline, prudential savings, and a commitment to increase competition as a path to sustainable growth.

⁷⁰ Fliipek and Schreiber (2010) section III.1.

⁷¹ Fliipek and Schreiber (2010) section III.2.

⁷² It is also important to consider that Greece’s competitiveness outside the EMU is lackluster. Increased competitiveness would have to include trade to more markets outside of Europe.

⁷³ von Hagen and Harden (1995) pgs.771-79; Gleich (2003); Flic and Scartascini (2004).

4 THE FAILURE OF THE REGULATORY STATE

The above overview of the GFC and the SDC has raised a number of questions on the state of regulation within the EU and how it relates to the Majone framework of the EU as a regulatory state outlined in the first chapter. This thesis has distilled the essence of Majone's argument into the following three core points: first, it provides for better policy credibility over majoritarian rule; second, it lessens the negative effects of the tyranny of the majority by reaching outcomes that are Pareto-optimal; and finally, it is more effective and better suited to the needs and realities of the EU over majoritarian rule. Majone's primary focus is to provide a framework that legitimizes EU supra-national governance. At the same time, Majone assumes that this legitimizing framework is also functional. Events that have since transpired seem to cloud the issue. There are two elements to consider, the first is the legitimizing power of the framework and the second is its functionality. This thesis continues to work under the assumption that the regulatory state is legitimate. The task is therefore to see whether or not the actions and proposed reforms outlined in chapter two are within the legitimizing parameters of Majone's framework. If they fall outside the parameters, then they are illegitimate. Their illegitimacy aside, if it so happens that these actions were done out of necessity, then this raises concerns over the functionality of legitimate power to effectively deal with the crises. It is clear that the regulatory state failed in profound ways. The question is whether that failure is a consequence of legitimate power's inability to effectively govern due to a fundamental flaw in the framework or whether the framework is functionally sound, and its failures can be resolved by reform within the parameters of legitimate power. In order to answer this question, this chapter will analyze the nature of the EU, the relationship the Majone framework has to this nature, and finally to what extent the actions taken in response to the GFC and the SDC as well as the proposed reforms are legitimate.

4.1 What is the EU?

The venerable English statesman Winston Churchill, during a number of speeches on European integration in the 1940s, coined the term “United States of Europe” as a vision of what Europe could become. Others have invoked the image of a European federal state including Jean Monnet and Robert Schuman who described the Coal and Steel Community, the predecessor of the EU, as a first step in “laying the foundations of a European federation.”⁷⁴ The EU is not a federated state, however. Instead it is an amalgam of varying structures—part supra-national, part trans-national, and part international—representing more of a confederation than anything else.

The result of the EU in its present form is the product of two competing tensions. On one hand is the need to centralize competence at a European level to be able to handle issues that are intrinsically pan-European and best handled by a European body. On the other hand, there is the need to guard against unnecessary intrusion by a centralized authority into areas that are instinctively national and best handled at the local level. Where one draws the line between what is national and what is European is not always an easy prospect. This challenge is exacerbated by the competing interests of the Pollyannaish-integrators and the Euro-skeptics whose views of the EU and what it should look like are diametrically opposed. The end product is something of a compromise—part European, part national, the sum of which fails to become a whole.

4.1.1 The Majone Framework and the EU

This vision of the EU is exemplified by European integration into a single market and the formation of the EMU. The logic of economic integration, since the formation of the Coal and Steel Community, has always been that globalization is an unstoppable

⁷⁴ Wistrich (1994) pg.vii.

force and proper coordination is not only necessary but it is also desirable if done correctly. Opening markets appears to have validated this premise as Europe has benefited as a whole through the freeing of trade. Members to the monetary union also have seen remarkable success, the effects of the two crises notwithstanding. However, for all of the advancement economic integration has produced in Europe, its political integration by comparison has been considerably stunted. European nations want all of the benefits of integration without the undue cost of dissolving national sovereignty.⁷⁵ What results is a product of European compromise—a single market with an EMU, but no unified fiscal authority.

This division of competences works quite well within the Majone framework. The three types of government control Majone isolates are income redistribution, macroeconomic stabilization, and market regulation. Of these, the regulatory state can only legitimately engage in market regulation. Taxation, borrowing, wealth redistribution, government programs, in short all issues related to positive rule must remain within the nation-state. Does EU economic integration pass muster? While the SGP places limits on how much a member state in the EMU can spend and borrow, it does not dictate fiscal policy or determine the social direction a member state would like to go. The ECB is a mere organ dedicated to price stability, a function of market correction, which is not designed to interfere with national policy. In many ways, the ECB is the epitome of a Majone regulatory institution: it is independent, insulated from politics, and engages in Pareto-optimal rule making. Keeping this in mind, what would happen if the EU started to shy away, even a little bit, from its role as a regulator and began to touch policy areas traditionally dedicated to the states? Would it still be legitimate?

4.1.2 Is the Majone Framework Flexible?

It is not clear to what extent the EU can engage in a bit of wiggle-room within this framework and still be considered legitimate. After all, the EU itself does have a budget collected ultimately from European citizens and used, or redistributed, via

⁷⁵ Rohrscheider (2002).

decisions made in Brussels and not through the member states. Would this be an example of wealth redistribution by an unelected body worthy of disdain and shouts of “no taxation without representation”? Not according to Majone as the EU budget is so small compared to its GDP (1.3 percent), it is simply not enough to matter.⁷⁶ At what point would it begin to matter, though—2 percent, 5 percent, or 7 percent? The same can be asked of the SGP. The introduction of the SGP was met with backlash by some who saw it as an intrusion into national sovereignty. Some propose that this backlash could set back European integration by decades.⁷⁷ At what point could the terms of the pact, or its enforcement, be considered to significantly affect fiscal policy to an extent that it no longer could be considered legitimate within the framework? And finally, what would happen to the legitimacy of the ECB if it became a bank-of-last-resort or engaged in other minor acts of redistribution?

It seems fair to characterize the Majone framework as not being completely absolute in its terms. If it were, the EU budget would not be permissible no matter how small; and the SGP, where it limits state freedom in macroeconomic affairs, albeit with the lightest of hands, would similarly be inconsistent under an absolute interpretation. That being the case, it is also fair to say that the Majone framework should not be construed to be a flexible organ. Majone’s thesis extols the benefits of non-majoritarian rule. In addition, it argues for giving a wide berth to traditional majoritarian rule-making to enhance legitimacy. By becoming more majoritarian, the EU would thusly lose the benefits of nonmajoritarian rule and become less legitimate. Any amount of straying into majoritarian rule making would therefore serve no purpose within the framework. This thesis asked the question to what extent rule making could stray into majoritarian policy and still be legitimate. The answer seems to be: if one were to ask such a question they would be missing the whole point of the framework.

4.2 Undesirable and Illegitimate Reaction to the GFC and the SDC

⁷⁶ Majone (1998) p. 10.

⁷⁷ Alesina (2008).

With the understanding that the Majone framework is not to be construed as being overly flexible in the desirability or legitimacy of increased majoritarian rule making at the European level, the European response to the crises and many of the proposed reforms to coordinate and centralize EU policy would therefore have to be seen as being both undesirable and illegitimate. This is due to the introduction of macroeconomic and wealth redistribution policies enacted to stem the effects of the GFC and the SDC.

4.2.1 Undesirable and Illegitimate Reaction to the GFC

The threat that the GFC posed to Europe was a systemic or macro risk coupled with what has been termed the too-big-to-fail problem. When small financial institutions fail, the effects are negligible to society. The societal costs involved with the failure of large financial institutions, however, are significant. In order to prevent the systemic risk associated with the failure of a large financial institution, a government can step in and bail out the failing financial institution. A bailout comes with its own costs, however, as public money must be used to keep a failing financial institution afloat. Whenever the negative social costs of a failed financial institution outweigh the cost of a bailout, then that financial institution is TBTF. The TBTF problem is a result of a realization that a TBTF institution knows that they are TBTF. This realization incentivizes a TBTF institution to engage in excessive risk as they know that they have “a get out of jail free card”. This puts governmental authorities between a rock and a hard place: they either must bailout a TBTF institution and thereby encourage bad behavior in the future or not respond and be faced with the severe crisis of confidence in financial markets. This problem is especially complicated in the EU where there is no clear framework on how to deal with pan-European TBTF institutions.

The slow creep of financial integration has confronted the EU with the trilemma of financial supervision.⁷⁸ There is a fundamental incompatibility between integration, financial stability and independent national supervision. Before the GFC, it was hoped

⁷⁸ Schoenmaker and Oosterloo (2007).

that a decentralized approach to regulatory oversight would be sufficient so long as there was adequate coordination amongst the many national supervisors. It is now clear that these modes of coordination were not sophisticated enough to match the level of integration of European financial institutions and Pan-European banks.

Without a framework in place for a EU response to a banking crisis, the primary responsibility for regulatory oversight and bailing out a failing bank would default to what it had always been, the authorities of the country the failing bank resides in. If a TBTF institution showed signs of failing, it would be a national prerogative. The GFC has shown that Europe is far more integrated than this strictly national approach would allow. Fortis and Dexia in particular are emblematic that banks are becoming less national and more European as they are situated in more than one country. When one country by itself cannot resolve a failing bank or if the consequences of a failed bank significantly affect more than one country, it becomes a European issue. Without a framework in place, the EU was forced to develop the *ad hoc* response outlined in chapter two. The result is increased coordination and enhanced centralized oversight that strains the boundaries of legitimacy and desirability under Majone's framework.

Increased and formalized cooperation is not in and of itself a violation of the Majone framework. In fact, some of the reforms proposed in the Larosiere report that advocate for centralized oversight are in line with the tenets of the regulatory state. Where these reforms stray are when they advocate a centralized system of action whereby a EU institution is in charge of providing security to pan-European banks. Of the many reforms discussed, the most obvious reform is to formalize the ECB as a lender-of-last-resort. It is common for central banks to act as a lender-of-last-resort essentially providing reassurance that there is a safety net for institutions in need of liquidity. It is a fitting role for the ECB to step in and play the part of a pan-European lender-of-last-resort when the systemic risk posed by a failing institution is not controllable by one country alone⁷⁹. The funds required to fill this role, however, must ultimately come from somewhere and because the issuance of these loans are by definition to the most at risk institutions, this can make a lender-of-last-resort more of a distributor of liquidity

⁷⁹ Walter and Bergheim (2008).

that may or may not see a return. When one adds the threat of moral hazard from the TBTF problem, an ECB as a lender-of-last-resort could become the *de facto* redistributors of European capital to risk prone institutions.

Realizing the threat of moral hazard that would confront the ECB as a lender-of-last-resort, some have advocated a system whereby European TBTF institutions would be subject to a special tax.⁸⁰ The purpose of this tax would be to lessen the burden on the taxpayer for the future costs associated with bailouts. Taxation, however, is not a function of the regulatory state and would therefore violate the Majone framework. Another proposal is to put limits on the extent of leverage a TBTF can engage in. This reform is equally undesirable per Majone as it proposes to dictate not only macroeconomic policy but also microeconomic policy, something that is reserved for the member state. There is also the possibility to create a European FDIC. A European resolution authority like the FDIC would give the EU more options when dealing with a failing institution than just a straight bailout. While that may be less of an offense to the Majone framework than an outright EU sponsored bailout, it still would require public funds and would therefore be an act of redistribution.⁸¹ The extent to which these reforms may or may not be effective in dealing with the financial integration problems Europe is facing is immaterial at the moment. The single criterion is to consider if a reform engages in behavior outside the prescribed role of the regulatory state. When it comes to providing liquidity to failing financial institutions, none of the discussed reforms are consistent with the role of a regulatory state.

It is important to mention here, though, that there actually was not any EU backed bailout of banks. All the public money used to stabilize failing financial institutions came from national sources. The EU was used as a vehicle of *ad hoc* coordination to facilitate cross-boundary stabilization. Accordingly, the primary criticisms over the reaction to the GFC in how it conflicts with the role of the regulatory state are fixed on proposed reforms that would formalize action at the EU level resulting in either macroeconomic intrusion or wealth redistribution. However, this may be splitting hairs.

⁸⁰ Cukierman (2010) pg.4 section 2.3.1.

⁸¹ Dewatripont, Nguyen, Praet, and Sapir (2010).

Is there much of a difference between EU backed action and EU backed coordination in terms of its desirability? While EU backed coordination in a regulatory state is more desirable than EU backed action, it does not mean that all levels of coordination are desirable. In some ways the distinction between the EU coordinating a response to a crisis and executing a response could become a distinction with no difference. This thesis does not pretend to have an answer for this question and therefore leaves it open for future discussion.

4.2.2 Undesirable and Illegitimate Reaction to the SDC

The SDC, like the GFC that preceded it, posed a potential catastrophic risk of destabilization throughout Europe. Only this time it was not a problem created by the excessive risks of a TBTF, it was the excessive spending by one of the member states to the EMU. Despite the prohibition enshrined in Maastricht against a bailout of a member country, the Eurozone nevertheless coordinated a bailout package totaling 110 billion euro in available assistance for Greece. While it can be argued that EU institutions in response to the GFC largely did not deviate from their pre-existing roles (though they might have gone beyond their pre-existing script⁸²), the same cannot be said of the way the EU handled the SDC. Much of this is because there was never a plan in place to deal with the eventuality of state default in the first place. If anything, the bailout prohibition would seemingly signify that the plan was “no plan”. The SGP was devised to control fiscal behavior of all the EMU member states. If for some reason a state did find itself in risk of default, the reasonable assumption would be that it would not receive any help. This is not what happened. On behalf of failed regulatory control and unforeseen consequences of integration, it was decided by the powers-that-be in Europe that Greece, much like the bailed-out banks that preceded it, was too-big-to-fail. While the EU taking on the task of bank bailouts stretches the boundaries of the role of the regulatory state, their response to the SDC breaks these boundaries altogether.

⁸² Pisani-Ferry and Sapir (2010) p. 366.

It is well outside the bailiwick of the EU and the EMU to engage in coordinating a rescue package for member states at risk of defaulting on their loans. Not only is it outside their preexisting legal authority, as a function of a regulatory state it is both undesirable and illegitimate. It is equally undesirable and illegitimate for a regulatory state to impose the kind of strict austerity measures that Greece has been hit with. Within the Majone framework, the EU is not supposed to involve itself in the macroeconomic affairs of the many states. The austerity measures forced upon Greece demanding tighter fiscal control, though arguably necessary, is precisely the sort of macroeconomic intervention the EU must abstain from.

It is not merely the response on behalf of the EU and EMU members to the situation in Greece that strains legitimate governmental action under a regulatory state, it is also by the way the discussion has advanced regarding increased coordination of fiscal policy. In chapter two, this thesis isolated two fundamental shortcomings with the SGP that directly lead to the SDC. The first was the failure of regulation. The primary responsibility of the SGP was to keep deficit spending and high public debt to a minimum. Despite Greece and many other EMU members violating the terms of the SGP, there was no action taken on the part of the regulatory bodies to bring them to heel. Despite the fact that enforcement measures were available to the EU, these measures were not employed and in the particular case of Greece, the Council actually made the conscious choice to abrogate the EDP. The second shortcoming is the evidence that points to non-competitiveness as a leading cause of countries becoming “at risk”. With the general inability to compete, countries like Greece have not been able to grow sustainably. By not saving during the fat times, Greece had nothing to fall back on during the lean times when the GFC hit. This has pointed to a critical problem with the EMU: non-competitive countries spending like there is no tomorrow have a huge negative impact on all of the other countries of the Eurozone. Whether via ineffectual policy by the SGP or the result of disastrous national spending policy (or both), it does not appear that the current framework is working. It is tempting to advocate for stricter coordination of fiscal policy and more means by which members of the EMU can intervene if and when another member engages in risky fiscal behavior. It must be cautioned, however, that unified fiscal policy is not something the regulatory state can legitimately engage in. It is even more illegitimate for the regulatory state to

use legal force to enforce the terms of a unified fiscal policy in a particular member state.

4.3 The Credibility Crisis Without an *Ex Ante* Framework

One of the most attractive aspects of non-majoritarian rule, according to Majone, is that regulatory bodies, which are insulated from political influences, are better at producing credible policy. In the abstract, this is generally true but there appears to be a rather significant deviation when one considers the empirical implications rose by the GFC and the SDC. The regulatory structure in place before the GFC relied on the ability of national supervisors to coordinate with one another in the event of a crisis. There never existed a European playbook detailing roles and responsibilities of EU authorities or even an outline or a battle plan on how to execute national coordination. This absence of an *ex ante* framework necessitated the *ad hoc* coordination outlined in chapter two. The situation revolving around the SDC was even more tenuous as not only was there no *ex ante* framework on how to go about developing a bailout of a state in the EMU, if anything the assumption was that there never would arise an occasion where a bailout would become necessary. Nevertheless, a bailout did occur as a result of another bout of improvised coordination. These two responses suggest that, ironically enough, the regulatory state did not produce credible policy.

The essence of credible policy making is that the law should not only be clear but predictable and its applicability not prone to change in the foreseeable future. Another important element of credible policy is that it is sophisticated, or capable enough, to deal with the situational realities of the behavior it aims to govern. This sophistication element is key because the clarity and predictability of policy making is all for naught if the policy itself is not capable of doing what it is designed to do. This was the principal flaw with the policy in place to deal with the possibility of a financial crisis like the one seen in the GFC. Because standing policy was ineffectual, European leaders had no choice but to create new policy on the fly to effectively deal with the crisis. While this *ad hoc* reaction to events appears to have worked to solve the immediate issues brought about by the crisis, as a long term strategy for dealing with future crises it leaves a lot to

be desired. The absence of a framework to deal with the SDC can also be described as not having sophisticated enough policy to deal with a potential crisis. While the circumstances are different in that the absence of a policy framework for handling the potentiality of a member state defaulting on their loan obligations was done intentionally, this intention did not factor in the possibility that inaction in this regard could prove cataclysmic for the entire EMU. As such, it can be seen that the regulatory state failed to produce credible policy due a lack of sophisticated policy.

The ad hoc approach to crisis management is also the antithesis to credible policy making because it is unpredictable. While the ad hoc approach to the GFC was sufficient and timely enough—if only barely so—the undesirability of this sort of haphazard coordination as a long-term strategy for crisis management is due to the fact that it does not produce credible policy. Without a framework, there is no indication that the EU, given a future crisis, will behave in the same way. With a workable framework in place, actors will be able to base important decisions throughout all stages of a crisis on what they know the government will do. Without a framework, these actors must base these important decisions in a cloud of uncertainty and hastiness, potentially making crisis situations even worse. Many of the proposed reforms that have been discussed in this thesis could likely aid in this regard. For instance, the formalization of the ECB as a lender-of-last-resort would give assurance to large cross-boundary institutions that a last gap option is available should the risk they engage in prove to be overreaching. This assurance benefits not only the at-risk institution but also the plethora of secondary actors as well including debt holders, stockholders, national governments, and many others. The formation of a European resolution authority would provide similar assurance to secondary actors that in case of default, a systematic regime of restructuring and resolution of assets would assure at least a marginal return to investors.

The lack of a framework for dealing with another potential SDC is even more problematic to credible policy. The political will of the European citizen to bailout Greece was very weak. Couple this reluctance with the understanding that the EMU was never envisaged to be faced with the dilemma of bailing out a member country; it was reasonable to have assumed that a bailout would never have occurred. In contrast

to the GFC response, which was swift and decisive, the vacillating response to the SDC was cumbersome, protracted and characterized by the controversial implications surrounding the events. For instance, the indecisive action was not only predicated on the dilemma proposed by whether to bailout Greece or not on behalf of the EMU member states, pride also had a stake. The IMF approached the EU early in the process but their offers for assistance were not accepted, at least initially. It was, after all, an embarrassing affair for the EMU. If IMF assistance were accepted early on, it would have been an admission that the Eurozone had serious problems that it was not able to resolve itself. Unfortunately it appears the old adage *pride cometh before the fall* is true at least in this case as IMF assistance was eventually used in addition to European funds. The added misfortune is that according to some, had the IMF been brought in early, a European funded bailout never would have been necessary. If so, the inaction by the EU early on in the process may have made the situation in Greece even worse or harder to resolve.

All of these factors produced an uncertain environment. No one could have predicted whether or not the EU would have reacted, and if they did, no one could know what that reaction would look like. The present situation is altogether worse because the cost of inaction has proved damaging. Per Maastricht, bailouts are still not supposed to happen. However, now that a bailout has occurred, there is a possibility that it might happen again. The “if”, “when”, and “how” as well as under what circumstances another bailout would arise are pure conjecture. Under this environment, the only constant seems to be that inaction and indecision are inevitable. The Eurozone would be better served by making its position clear, one way or the other, on what would happen in the event of another SDC. By developing an unambiguous framework outlining exact roles and responsibilities, the Eurozone can save itself from the ravages of inaction and indecision in the future.

4.4 Conclusion

This analysis suggests that the Majone framework cannot legitimize the response by the EU to the GFC and the SDC. Furthermore, it also strongly suggests that the framework

suffers a functionality deficit. This raises a potentially worrisome state of affairs for the effectiveness of the EU as a regulatory state. Is it possible that the limits of the regulatory state make it too feeble to deal with the problems facing an integrated Europe? If truly effective control over integration and crisis management or crisis prevention means that the EU must involve itself into the macroeconomic decisions of the member states or open itself to facilitate the rescue of states or financial institutions at risk of default via the redistribution of funds, then this type of governmental power cannot find legitimacy through the Majone framework. If this premise is indeed correct, then it stands to reason that the EU may have the difficult decision of choosing between an illegitimate but functional government, or a legitimate but dysfunctional government. This underlining premise will be analyzed in the next chapter.

5 SOLVING THE FUNCTIONALITY DILEMMA

The effort of this thesis to this point has been to critique the EU as a regulatory state, not on normative grounds, but on its functionality. It has largely been assumed that the regulatory state is an effective means of supra-national governance. This thesis has tested that assumption by applying the empirical implications of the GFC and the SDC. These findings suggest that the regulatory state is not as functional as previously assumed. The responses to the GFC and the SDC have not conformed to the designated role the regulatory state can legitimately engage itself in. If one presumes that these illegitimate responses were necessary and no conceivable legitimate action could have forestalled the effects of the two crises or could have prevented them from occurring, then it can be said that the regulatory state in its current form suffers from a functionality deficit. This deficit is exacerbated by the absence of credible policy. Many of the suggested reforms would go a long way towards creating credible policy, however, it would not be legitimate. This is the exemplification of the dilemma of the choice between an illegitimate but functional government, or a legitimate but dysfunctional government.

In this final chapter, the principle aim will be to find a way around this undesirable dilemma. In order to do so, I will attempt to rework the Majone framework so that it produces a regulatory state that is both legitimate and functional. Through the course of this endeavor, I will dissect Majone's thesis even further, identifying the genesis of his framework's legitimizing power and then apply it to a better functioning system. The resulting rework would help give more functionality to the framework while preserving its legitimacy but does so at a cost. In time, these costs could prove to be just as undesirable as the dilemma over functionality vs. legitimacy. This analysis suggests

that the regulatory state thesis is not sustainable as a governing system and raises additional questions on the future of Europe.

5.1 Of the Origins of Legitimacy

Many authors have advocated that the only way to have legitimate political authority is via democracy. Democracy as a concept, however, is not universally accepted. To some, the tenacity of a flawed paradigm that equates democracy with majoritarian rule neglects the non-majoritarian model as another means of democracy.⁸³ In this respect, a non-majoritarian model of democracy can provide democratic legitimacy just as much as the majoritarian model can. Majone embraces the non-majoritarian model over the majoritarian model and builds his entire thesis upon the normative assumption that the non-majoritarian model legitimizes political power. This thesis has worked under this assumption. Now, Majone's vision of non-majoritarian democracy will be scrutinized to isolate the essential legitimizing characteristics of non-majoritarian rule and determine if they are indeed legitimizing.

The basic principle of non-majoritarian democracy is that the majority is not privileged to rule absolutely. Their political power is constrained in the interest of the minority. Protection against majority rule is instituted via a constitutional system where governmental powers are checked and individual rights are granted. In such a system, the government is constitutionally constrained as minority rights guarantee that there are some areas that governmental authority cannot tread. To use the nuclear example of this—consider a country with a constitutional democracy where slavery is considered a violation of a person's fundamental rights, if a majority decided one day that they wanted to institute a system of slavery, that majority would not be able to. When the two come into conflict, the need to protect the right of the individual is more important than prevailing democratic desire. Majone and others describe this constrained system of democracy as Madisonian.⁸⁴

⁸³ Lijphart (1991) p. 483-494.

⁸⁴ See for instance Dahl (1950).

Majone takes the concept of Madisonian democracy and runs with it. By making an assertion that the Madisonian model of non-majoritarian democracy is legitimate, Majone extends a line of rationalization that bestows legitimacy to all forms of non-majoritarian rule. In particular, Majone uses the Madisonian model as a foundation for regulatory state legitimacy where rule making is delegated to non-political actors. This extension of the Madisonian model focuses more on the anti-democratic elements of the Madisonian design making for a slight perversion of true Madisonian democracy. For example, Madisonian democracy is the product of a tension between two conflicting desires of Madison: on one hand he wanted to protect against the tyranny of the majority while on the other he wanted a democracy that would respond to the wishes of the people. For Majone, he suffers not from a similar tension preferring outright the anti-democratic element (or as he characterizes it, the non-majoritarian element) to the democratic element (or the majoritarian element). This overt preference excludes the other side of the coin and therefore does not produce something akin to Madisonian democracy but rather something that perennially over represents minority interests over majority interest.

Majone's treatment of the tyranny of the majority is abstract when it is meant to be specific. In a democracy, there is nothing intrinsically wrong when the majority gets their way. To legitimately abstain from the majority's will, there must be an overwhelming and specified reason for protecting minority interest. For Madison, these reasons arise when the majority seeks either to trample upon the rights of the individual or to circumvent the authorities afforded to it under the constitution.⁸⁵ Majone's embrace of the tyranny of the majority rationale fails to isolate a specific protection for the minority. Instead, the prevailing interest worthy of protection is the perceived benefits associated with delegated rule-making and is therefore left to the discretion of the regulator. The regulator in this role assumes a function similar to that of the Court: an independent, politically removed governmental organ responsible for the protection of minority interest in a polity. A significant distinction being that a regulator's

⁸⁵ A problem of the tyranny of the majority can also manifest when a majority bloc and a minority bloc becomes institutionalized over many voting cycles. The antidote for this, according to Madison, is to have a large republic where factions are numerous and fluid. This particular problem is not as relevant to this thesis.

function derives not from a constitution but from the direction determined by either a legislative or executive branch of government. As a result, the regulator, unlike the Court, is not necessarily apolitical. Furthermore, whereby the Court passes judgment protecting minority interest within the enumeration of law, the regulator produces policy within its mandate. The authority and legitimacy of the Court, therefore, derives from the law. The authority and legitimacy of the regulator, however, is passed down to it from another branch of government.⁸⁶

This is not a desirable approach at obtaining legitimacy but this approach must also be weighed with the alternative. For Majone, and others, the prospect of majority rule within the EU is undesirable.⁸⁷ When one considers the rather significantly stratified identities within the EU that are fragmented along linguistic, national, cultural, religious, and historical lines, the argument against majority rule is convincing. This leaves two undesirable options. To guard against the ill effects of majoritarianism in a plural society, a veto system could be devised requiring unanimity before any law could be passed.⁸⁸ By giving a veto to every party, a unanimous vote would reflect a generally shared opinion. This “least common denominator” would ensure that policy would at the very least not be parasitic to any of the parties. This is in fact what Pareto-optimality is all about. If coordination of the EU via the regulatory state can live up to the Hippocratic oath of “first do no harm,” then the added benefits associated with regulation seem to make it a better option than majority rule. This does not make Majone’s non-majoritarian argument for legitimacy desirable; it makes it the least offensive. As such, it is as legitimate as the EU can currently get. This rationalization is the product of the analysis in chapter 1.1.3 regarding the new standard of legitimacy that Majone proposes: the regulatory state is legitimate not because it is democratic, but because it is the most effective and least offensive means of EU governance. This thesis accepts Majone’s new standard with the understanding that it may not be ideal, but it is better than the alternative.

⁸⁶ For disagreement with this level of delegation, see McNamara (2002).

⁸⁷ Lijphart (1984).

⁸⁸ Bellamy (2010).

5.2 A Better Functioning Framework

The above analysis over the origins of regulatory state legitimacy gives increased insight to the importance of governmental roles. It is imperative that the regulatory state does not engage in matters of macroeconomics or redistribution. These are not Pareto-optimal solutions and are therefore not legitimate. This proves to considerably constrain what the regulatory state can do. The EU must therefore make do with the tools at its disposal. The question chapter three left with was to what extent the limited tools available to the EU as a regulatory state were sufficient for meeting the demands of integration. This analysis suggests that integration has created demands that a regulatory state cannot resolve legitimately. Before credence can be given to this conclusion, however, one must first consider if the failure of the regulatory state during the GFC and the SDC was due not to a lack of tools, but of poor execution.

5.2.1 A failure of Execution

Even the best-laid plan will fail if the execution is poor. Chapter two has highlighted integral areas where regulation failed opening up the possibility that reform of the framework may not be needed if it can be argued convincingly that the failure of regulation was due to poor execution. There is some merit to this possibility.⁸⁹ This thesis has discussed research that shows fiscal responsibility is very closely related to healthy economies. The SGP was envisaged to be the key coordination tool to ensure that the economies of the EMU did not excessively spend. If the SGP succeeded in enforcing fiscal responsibility amongst the EMU economies, then Greece may never have come close to default. EMU regulators did not exhaust, or even entertain, the remedies available to them. Perhaps it is this lack of execution that failed and not the SGP?

This thesis cannot give a definitive answer one way or the other as it is impossible to fully predict how events might have been different. It seems reasonable that better

⁸⁹ Pisani-Ferry (2010).

execution would certainly not have made the situation worse, but it is hard to say how significantly it could have improved it. This thesis has also argued that fiscal discipline in itself is not necessarily indicative whether or not an economy is secure.⁹⁰ Stable growth via a competitive economy and the need to be able to build reserves during the prosperous time of the financial cycle are just as important. As the SGP does not seek to regulate this, no amount of better enforcement of the SGP would do a thing. Even if one contends that tighter fiscal policy could have prevented the SDC, one must consider then the argument that the SGP, in its current form, is simply not strong enough to guarantee it. Even if the EMU had exhausted all of its remedies, they still would not have had the authority to stop Greece from spending. Research shows that fiscal rules are only effective when backed by consequences.⁹¹ Unless the consequence is severe enough, instituting rules for fiscal behavior is a hollow act. Unfortunately, instituting severe punishment starts to approach upon the macroeconomic sovereignty of states, making what potentially could be effective reform illegitimate.

5.2.2 An Alternative View: Inaction is Better than Action

One must also consider the veracity of the doomsday scenario so many assumed would result if nothing were done. Governmental action in the GFC was justified on the understanding that inaction would have made for an even worse situation. While many of the world's governments reacted within this premise, there are many voices that argue against governmental intervention into the financial markets. This argument is that while there may be a deep recession in the short run as liquidity dries up and economies come to a halt, the market will quickly come back stronger and healthier than before. Governmental intervention might keep an economy from hitting rock bottom, but its recovery is sluggish and artificial. From this view of the market, events like the GFC can be good and necessary thing as they purge what is wrong with an economy (e.g. companies that engage in overly risky behavior). By not letting poorly managed institutions fail, however, a government encourages moral hazard and in a

⁹⁰ See sections 2.3 and 3.2.2.

⁹¹ Alesina (2010).

sense is not solving a crisis, but delaying it. In this way, the doomsday scenario is overhyped.

A similar argument had been made over the situation in Greece. While EU action was predicated upon the fear of what would result from a Greek default, not everyone believes that fear was warranted.⁹² According to this alternative view, the bailout of Greece was not necessary to save the Euro from collapse. On the contrary, allowing Greece to default would have been the best option for strengthening the Eurozone. While investors would have lost money, the currency itself would have been unaffected. This alternative view also advocates that the fear of contagion is misplaced. The possibility of spillover effects is entirely self-inflicted and could easily be resolved if it were made clear that no bailouts would occur. Included in this is the contention that there was an overstatement over the systemic risk associated with the Greek's financial situation. If so, this alternative view suggests that not only was EU action not necessary but also it probably did more harm than good.

It is beyond the scope of this thesis to speak authoritatively to the veracity of either the major view or the alternative view. This distinction is nevertheless quite significant. Depending upon one's view, the EU must either swiftly formalize a number of centralized mechanisms of oversight and action in order to effectively manage the growing complexity of European integration, or it must instead do the opposite by leaving member states to their own devices and holding them to account for failures resulting from poor fiscal management. This has dramatic implications for the regulatory state. If the alternative view is correct, then very little stress is put upon the regulatory state to expand outside of its legitimate parameters. If, however, the majority view is correct, then the regulatory state is in the precarious position of needing to change, resulting in the dilemma of legitimacy vs. functionality. In the following section, this thesis will assume the premise of the majority view. The purpose for the reworking of the Majone framework is to find a regulatory state that is as functional as possible while still being legitimate. Therefore, if the alternative view

⁹² Cochrane (2010).

is correct, then nothing is really lost. However, if the majority view is correct, then the EU will benefit from a better functioning framework.

5.2.3 The Majone Framework Revised

The first step to a revision of the Majone framework is to fix its credibility issues. One of the key benefits of the regulatory state is that it produces credible policy, the fact that it has not demonstrates that reform is clearly needed. The primary cause of the current accountability dilemma is the absence of an *ex ante* framework for the handling of a future financial and/or sovereign debt crises. An immediate fix could be to assure that a future bailout of a country within Europe will not occur again. Legally, this may require a reworking of the language in Maastricht where the possibility of a bailout can be justified under Article 103a.2 that reads:

Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, acting by a qualified majority on a proposal from the Commission, may grant, under certain conditions, Community financial assistance to the Member State concerned.

By making it understood that “exceptional occurrences beyond its control” does not extend to self-inflicted occurrences (e.g. excessive public debt and deficit spending), EMU members will know that EU bailouts are clearly prohibited under the law. This will guard against moral hazard problems while ensuring credible policy.

The downside to this is what happens in the event of another sovereign debt crisis. The best the EU can do is exhaust all possible preventative measures at its disposal. More effective regulation under the SGP could help. Included in this is an effective system of surveillance and transparency. While the SGP may not be capable at preventing another sovereign debt crisis by itself, ensuring fiscal responsibility will help. In addition, the goals outlined in the 2020 strategy are a good beginning for long-term competitive economies, though these goals are not fully adequate. It is plausible that a

commitment to education, R&D, and employment are worthwhile endeavors and would help the EU economy. However, the 2020 strategy is a reaction to the GFC and does not factor in the issues raised by the SDC. As the 2020 strategy is largely a reiteration of the earlier Lisbon goals, before the EU should go ahead with the 2020 strategy, it is wise that it should first discuss how and why the Lisbon strategy failed.⁹³ This discussion might yield what the EU's core problems are. As the 2020 strategy stands now, EU countries are faced with a trilemma: reducing the public deficit, investing in going green, and preserving the welfare state and public services.⁹⁴ It is difficult to imagine that many countries, especially countries with underperforming economies, would be able to meet all of these objectives. A commitment to competitiveness is important, but it may be worthwhile to return to the drawing board.

In the end, any plans to improve competitiveness must ultimately be honored by each country. It would be illegitimate for the EU to actively involve itself in the macroeconomic policies of its member states. This opens up the possibility that some may not live up to their obligations. In such a circumstance, the EU must be prepared to let countries face the music. While this very well could result in poor conditions for the country in default, the EU at large can find ways to insulate itself from negative spillovers.

From a certain perspective, the SDC is a fiction. In essence, the SDC is just a continuation of the GFC. The argument that has been proffered over the need to bailout Greece was due to the destabilizing inevitability of a Greek default. This destabilization would occur on behalf of a domino effect of banks throughout Europe holding Greek credit that would go under because they would not be able to withstand the shock of a Greek default. If so, a Greek default is not a sovereign debt issue, it is a financial liquidity and solvency issue. By allowing Greece to default, the EU could have instead turned its attention to the European banks just as they had done during the GFC. The only crisis the EU needs to worry about then is how to handle the systemic effects of a TBTF. By allowing overextended countries to default, the regulatory state

⁹³ Bonggardt and Torres (2010).

⁹⁴ Pochet (2010).

can devote their attention to coordinating reaction to important pan-European banks saving themselves from the temptation to impose needless illegitimate bailouts.

Treating a sovereign debt situation as a financial crisis gives increased functionality to the regulatory state while maintaining its legitimacy. The response to the GFC has shown that the EU can react decisively and effectively. The EU would be better served if a framework were instituted formalizing this decisive and effect reaction to the GFC. This would take the guesswork out of how coordination will ensue in the future. So long as the regulatory state acts as a vehicle of coordination whereby the states for whom the failing financial institutions reside come together to do a bailout and not the EU, than the regulatory state can maintain its legitimacy. This is essentially what transpired during the GFC. The key for the EU is to devise a sophisticated coordination mechanism. The arrival of another financial crisis in Europe is only a matter of time and when it arrives, the level of integration and increase of pan-European banks will make the next attempt at coordination harder.

This approach is not perfect. By not allowing the EU to step into the role of a centralized European source for bailouts, coordination amongst the member states must work. If it does not work, then Europe would have to bear the brunt of a financial collapse. Additionally, by allowing member states to default, the EU must accept the possible negative consequences associated with a failed economy. As situations would inevitably deteriorate in the defaulted state, many citizens of the defaulted state would invariably move elsewhere in Europe in the search for jobs and securities. This could put strain on all of the other member states. If such migration proved overly stressful on the other member states, it is conceivable that political will could turn against Europe's single passport policy. Additionally, the defaulted state might very well be forced out of the monetary union perhaps followed by an expulsion of the union itself. These series of events could ultimately unravel the EU itself, as states within the union would be motivated to institute policies of protectionism via a reinstatement of national currency or departure from the EU.

5.3 What is the EU?

The EU is an interesting study for legal scholars. Its formation has resulted in a number of discussions over what its legal institutions should look like and what their competencies should be. Above all, the EU is a reminder that the question over legitimate political power is a living discussion. The arguments on the EU's democracy deficit exemplify the relevance of this discussion. The arguments on the EU's democracy deficit also exemplify a major disconnect among academics, lawyers, politicians, and European citizens. Majone contends that the EU is still in the standard setting stage of establishing a criterion over how legitimate power is to be judge. All of the arguments over the EU's democracy deficit debate represent a preconceived standard based upon a preconceived view of what the EU should be. This is the key disconnect, not everyone agrees on what the EU is, or more importantly, what it should become.

The current state of affairs in the EU is that there is deep financial integration via the single market and a common currency but there is no comparable political integration. European citizens are still skeptical over EU institutions preferring instead to be governed by national bodies.⁹⁵ While some have responded to the GFC and the SDC as a call for European republicanism, there does not seem to be many European citizens willing to take the next step into a United States of Europe.⁹⁶ Advocates for a European republic had hoped that political and social integration in Europe would catch up to its financial integration. Some assumed that once Europe joined together under the EU and later with the EMU, full integration was inevitable. The GFC and the SDC have cast serious doubt on the inevitability of European integration along political and social lines. Instead, the wisdom of European integration itself, to the extent that it has expanded, is under scrutiny. Many currently question the introduction of countries like Greece into the union in the first place. Furthermore, the formation of the Eurozone with many diverse economies, which is inconsistent with the OCA theory, looks foolhardy in retrospect. This realization has encouraged some to call for Germany to

⁹⁵ Rohrschneider (2002).

⁹⁶ Colligon (2010).

exit the Euro and go back to the Mark.⁹⁷ Others have proposed a dual currency union with one Euro for the core economies and another for the periphery economies.⁹⁸ The two crises have refueled a debate that has been around since the beginning: no one agrees on what the EU is or what it should be. There is no unified vision; there is no unified design.

This crisis of observation is similar to the old fable of the blind man and the elephant. As the story goes, each blind man feels a separate body part of the elephant (e.g. a leg, an ear, a trunk, etc.) and concludes that particular part they felt constitutes what an elephant is. Blind to the totality of its parts, each of the blind men argues over what they believe to be an elephant. They are both right and wrong at the same time. Europe, like the blind men, does not share a single version of what the EU looks like. Is it a federation, is it a confederation, is it a democracy, is it a financial union, is it a political union, or is it a regulatory state? How can anyone agree on a standard of legitimate political power when no one can first agree on which part or parts define the EU? It is difficult to say whether the blind men of Europe will ever be able to agree on what their elephant looks like. The old fable itself does not offer any assurances. While some versions end with resolution, others do not suggesting the debate will continue for sometime to come. Considering the implications brought about by the GFC and the SDC, one is apt to assume that Europe will continue to deliberate over what their future should look like. If so, their search for the elephant, like the blind men in the poem by John Godfrey Saxe, is ongoing:

And so these men of Indostan
Disputed loud and long,
Each in his own opinion
Exceeding stiff and strong,
Though each was partly in the right,
And all were in the wrong!
So oft in theologic wars,

⁹⁷ Ipsos pool showing majority of Germans want the return of the deutschemark: The Sydney Morning Herald (2010).

⁹⁸ Arghyrou and Tsoukalas (2010).

The disputants, I ween,
Rail on in utter ignorance
Of what each other mean,
And prate about an Elephant
Not one of them has seen!

6 CONCLUSION

This thesis has sought to advance legal scholarly discussion over legitimate political power within the European Union. As jurists, it is necessary to consider the legitimate ramifications of the institution of legal institutions at the supra national level. The debate over legitimate political power in Europe, or the lack thereof, is commonly referred to as the European Union's democracy deficit. There are a myriad of voices in this debate. Some argue for increased democratization of European institutions while others argue against it. One of the more technocratic voices arguing against democratization is that of Giandomenico Majone. Majone contends that the European Union is a regulatory state and can be legitimized by a non-majoritarian standard. This alternative standard severely constricts the sort of policy the European Union can legitimately engage in. According to Majone, the regulatory state only involves itself in matters of market regulation. It must leave macroeconomic regulation and wealth redistribution to the member states. The wake of the Global Financial Crisis and the Greek Sovereign Debt Crisis has put strain on these limitations. This thesis has outlined the response to these two crises and many proposed reforms and has found that the regulatory state may not be capable of meeting the demands of European integration. The heart of the Majone regulatory state thesis is a legitimizing framework. It is merely assumed that it is also functional. The two recent European crises cast doubt on this assumption. This suggests that Europe may have the undesirable dilemma of choosing between 1) a functional yet illegitimate government whereby a democratically deficient centralized body involves itself in wealth redistribution and member state macroeconomics, or 2) a legitimate yet dysfunctional government whereby the needs of integration are not met by capable policy, the effects of which could prove damaging.

Considering the undesirability of forced political and social unification via the democratization of European legal institutions due to the deep cleavages among member states and Europeans, this thesis agrees with Majone that legitimacy through a non-majoritarian framework is the best option. The task is then to make this legitimate political authority as functional as possible at meeting the demands of European integration. This thesis has endeavored to do that by proposing reforms that are both legitimate and functional. In the end, though, the nebulous nature of the European Union prevents the formation of long-term legitimate and functional reform. Before Europe can advance its legal institutions to meet the next financial crisis, it must first resolve its identity crisis.

This conclusion mirrors in part some of the other criticisms levied upon Majone concerning the feasible distinction between negative and positive integration within Europe. With the two crises still relatively young at the time of this writing, time and further research will continue to shed more light on the ability of the regulatory state to effectively and legitimately create law. Accordingly, this thesis in no way speaks conclusively on the future of European regulatory rule or the European Union's democracy deficit. What this thesis does ultimately suggest is that the two crises have given a renewed perspective upon which to judge many of the long standing theories. Hopefully this will invite more discussion and research over the legitimate rule of law in Europe.

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