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Abstract. Three topics of a European constitution are discussed. First, basic arguments from constitutional political economy that aim at restricting representatives' potential misuse of powers in a European Union with extended competencies are summarized. Since a European *demos* does not yet exist, an extension of competencies of the European Parliament is not sufficient in order to legitimate political decisions at the EU level. The introduction of elements of direct democracy in the European constitution would shape the creation of such a *demos* and lead to a stronger control of the European legislature and executive. Second, the introduction of direct democracy in the European constitution is proposed in order to reduce the European democratic deficit. Third, the creation of a European federation requires a more transparent assignment of competencies and rules to resolve conflicts between different centers of power. A European federation should be organized according to the principles of competitive federalism.

Keywords: European Constitutional Convention, Bill of Rights, Separation of Powers, Competitive Federalism, Referendums, European *demos*.

JEL Classification: D78.

1. Introduction

The EU is in the process of giving itself a constitution.[1] The document entitled ‚*Draft Treaty Establishing a Constitution for Europe*' has been agreed upon by the European Constitutional Convention on 10 July 2003 and proceeded to the Italian Presidency on 18 July 2003.[2] The draft has not found the consent of the European heads of state at the intergovernmental conference in Brussels on 13 December 2003, but member states continue the negotiations in 2004. In case the Constitutional Draft is not adopted by the

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1. There is a controversy among European legal scholars as to whether a European Constitution already exists. Although the European Treaties and directives take precedence over national laws and contain many of the usual constitutional contents, their constitutional character is denied for example by the German Constitutional Court (*BVerfG* 89, 1993) or *Grimm* (1994), a former judge of that Court, because the EU lacks a European identity. Whether this shortcoming is coped with by the Constitutional Draft must be questioned as well. At least, however, it is politically considered to be a constitutional draft.

2. See http://european-convention.eu.int/docs/Treaty/cv00850.de03.pdf.

member states of the EU, some countries, in particular France and Germany, think about establishing a closer union among smaller groups of states such that a Europe of variable geometry results.[3] The Constitutional Draft resembles the existing Treaties as well as the Bill of Rights in one document, but additionally contains several changes or new provisions aiming at a deepening of European integration.

Such a deepening of political integration is however controversial. There have for example been discussions about the weighting of votes in the Council of Ministers which have led to the failure of the negotiations at the Brussels summit. Art. I-24 of the Constitutional Draft establishes new criteria for majority voting in the Council according to which a simple majority of member states and three fifths of the population (represented by the heads of state) of the Union shall suffice to enact policies that are not subject to the unanimity requirement. This procedure is supposed to start in 2009. The weighting of votes shall then be dropped. Poland and Spain have strongly objected against this new procedure by arguing that the large member states could dominate the smaller states if the weighting of votes were dropped. It can be expected that the new double majority proposal will indeed enhance the number of minimum winning coalitions in the qualified majority procedure at the EU level such that smaller member states have reduced blocking abilities. The EU's ability to act would however be increased.

Another controversial topic in the political discussion accompanying the constitutional process is found in a newly created President of the European Council who could be elected for a five years' term at maximum. He or she is supposed to represent the EU in foreign affairs, but also to help accelerating decision-making processes at the EU level. This proposal is called the 'double hat' solution because the President of the European Council competes with the Commission President, but also with the supposedly created EU minister of foreign affairs in several respects. Political economists disagree as to whether this or, more generally, which governance model at all is useful for a European executive. *Berglöf et al.* (2003) and *Tabellini* (2003a) prefer a presidential model with an elected Commission president who also presides the European Council. The latter would become more effective without reducing the position of the Commission in the balance of powers. The *European Constitutional Group* (2003) supports the double hat solution though with a shorter term of the President of the European Council, while *Vaubel* (2003) is generally skeptical about the European Constitutional Draft.

The debates illustrate the fundamental problem that the Convention has faced by formulating the Constitutional Draft and the heads of state will face in their decision about the future shape of the EU: Europe has to decide whether the final goal of European integration should be a federation or a confederation. *Blankart* and *Mueller* (2003) discuss the consequences of this choice for political decision-making procedures in the EU. If member states wanted to establish a confederation, the Council, or the European Council respectively, should be the main decision-making body of the EU. The single nation states would then be members of such a treaty. In addition, several competencies

3. In an article in the German newspaper Frankfurter Allgemeine Zeitung on 20 December 2003 with the title *Die Lehren von Brüssel* (p. 9), the French minister of external affairs, Dominique de Villepin, suggests to continue the constitutional process as a kind of further integration between France and Germany which will establish a nucleus that is open for the other member states.

the EU currently possesses would necessarily need to be returned to the member states. If a federation were the final goal of European integration, legislative and executive powers should be adequately assigned and a certain governance systems be chosen among, e.g., presidential or parliamentary, single chamber or two chamber systems. In that case, European citizens would be the members of the constitutional treaty. The (European) Council could not keep its current decision-making powers in a federation, but could play a role as the second chamber of parliament.

Still, the EU is far from being a federation. However, its current competencies considerably exceed those of a confederation. In addition, much speaks in favor of the EU developing towards a federation despite all irritation that follows the failure of the Brussels summit in 2003. The predominant goal since the Treaty of Rome is an ever stronger integration. Moreover, the Commission, the European Parliament and the European Court of Justice have incentives to achieve a fully fledged political integration in Europe, because it increases their competencies and hence their political powers.[4] If the EU is indeed developing towards a federation, it is necessary to consciously and actively decide upon a European state and its future institutions. A considerable concentration of powers at the EU level must be restricted by safeguarding mechanisms that help to prevent the center from abusing its powers. A further creeping centralization of competencies in the EU that leads to a high concentration of powers at the European level, without establishing effective mechanisms of democratic control entails unacceptable risks. It would thus be advantageous to centralize certain competencies to the EU level, like, e.g., defense or internal security policy, and additionally create political decision-making procedures which legitimate and control central European policies much more strongly than today. This new set of rules should also contain procedures to assign and transfer competencies to different levels of government as well as to resolve conflicts in the EU.

In that respect, it is very much telling that mainly the competencies of the current and future European executive as well as the decision-making procedures in the Council are hotly debated. It appears to be of secondary importance whether and how the democratic deficit of the EU is resolved.[5] This is not even seriously attempted by the Constitutional Draft. The extension of decision-making powers of the European Parliament

4. Even if several more recent decisions of the Court provide evidence against its integration promoting role, the overwhelming evidence up to now speaks in favor of that interpretation. See *Voigt* (2003). The U.S. history also indicates that the U.S. Supreme Court decided in favor of centralization of competencies in cases of doubt. The Anti-Federalists were fully aware of such a development: „*The judicial power will operate to effect, in the most certain, but yet silent and imperceptible manner, what is evidently the tendency of the constitution - I mean, an entire subversion of the legislative, executive and judicial powers of the individual states. Every adjudication of the supreme court, on any question that may arise upon the nature and extent of the general government, will affect the limits of the state jurisdiction. In proportion as the former enlarge the exercise of their powers, will that of the latter be restricted.*“ (Antifederalist #11 of 31st January 1788, in *Ketcham* (1986)).

5. For a discussion of the democratic deficit see *Boyce* (1993), *Abromeit* (1998, 4) and *Hug* (2002, 8). The democratic deficit does not only consist in the difficulties of refusing re-election of the Council as the main decision-making body. The Council composition is only changed indirectly in national elections and via national government changes. The core of the democratic deficit consists moreover in the lack of influence of EU citizens on policy outcomes at the EU level.

(that is included in the Constitutional Draft) will not increase the legitimacy of political decisions at the EU level. In a decision on the compatibility of the Maastricht Treaty with the German Basic Law, the German Constitutional Court argued in 1993 that the EU decisions lack a comparable legitimacy to political decisions at the German Federal level as established by Art. 38 GG (Basic Law) because of the non-existence of a European public, a European *demos*. *Grimm* (1994) contends that the existence of such a European identity would be *the* major step to turn the Treaties into a constitution. *Abromeit* (1998, 32) calls this argument the '*no-demos thesis*': A constitution is democratic only if it is based on a collective entity, like a ‚people' or a ‚nation' that has a common culture, common traditions and experiences, in short: a common identity, the conscience of being ‚European'. Even if decision-making powers of the European Parliament are extended by the European constitution, its majority decisions will not legitimate European policies because of the lacking *demos*.[6]

In this paper, the thought experiment is made that the EU will finally be a federation. Such a deepening of political integration in Europe is not evaluated positively or negatively. The functional preconditions of a European federation are also not legally elaborated. The analysis is focused instead on two central propositions on a future European constitution which ensure that political decisions of the European federation follow citizens' preferences. In *Section 2* basic arguments from constitutional political economy are summarized that argue for a restriction of decision-making powers in general. Means for reducing the democratic deficit in the EU are discussed in *Section 3*. Based on the arguments concerning the lack of a European *demos* mentioned above, it is argued in a more detailed fashion that an extension of the powers of the European Parliament will not suffice to resolve the democratic deficit. Instead, elements of direct democracy in a European constitution may help to create a European *demos*. Moreover, referendums and initiatives allow for a stronger control of the European legislature and executive than could be achieved in the current institutional environment. The introduction of direct democratic institutions in the EU constitution is thus the first proposal on the European federation that is formulated in this paper. Following the proposal by *Feld* and *Kirchgässner* (2003) the introduction of a mandatory constitutional referendum as well as constitutional and legislative initiatives in the European constitution are discussed. In *Section 4,* competitive federalism is considered as the second proposal for the future European federation. Concluding remarks follow in *Section 5*.

2. Why does the EU need a constitution?

Constitutional political economy has interpreted a constitution as an (implicit or explicit) contract between individuals that provides them with an insurance against expropriations by other individuals (*Buchanan* 1975). By rejecting any organic normative justifications of the state, like the divine right of kings or natural law, political legitimacy can be derived from an initial contract as a foundation of the law and the state

6. The German Constitutional Court added that European policy will only be legitimate if the German Parliament can withhold considerable decision-making competencies. See *BVerfG* 89, 1993, 155-213.

(*Höffe* 1999, pp. 48). In a Hobbesian initial situation, individuals are free to do what they want to because they are not restricted by other individuals', nor by state coercion. Without the state, selfish individuals have however incentives to expropriate their fellow citizens or even to threaten their lives. *Buchanan* (1975, 12) describes this problem in the following way: "*The issue is one of defining limits, and anarchy works only to the extent that limits among persons are either implicitly accepted by all or are imposed and enforced by some authority.*" If individuals do not want to rely on the implicit acceptance of their privacy by others, they will voluntarily subordinate to the law and to a coercive power, the state, that enforces the law, because it entails mutual benefits as compared to anarchy. Individual conflicts are resolved by an impartial third party such that individual property rights are secured to the largest possible extent. In addition, this newly created state helps to organize and enforce individual co-operation in the provision of collective goods that are as well to the mutual benefit of a large number of individuals in a polity. The state helps to overcome free riding and to solve social dilemmas. The blueprint for such a voluntary agreement is found in a basic initial contract.

The early contractarians, *Hobbes*, *Locke*, *Rousseau* and *Kant,* in recent times also *Rawls* (1971) interpret the contractarian reconstruction of the state as a thought experiment according to which it turns out to what set of political rules individuals could potentially agree. *Wicksell* (1896), *Buchanan* (1975, pp. 147) or *Buchanan* and *Tullock* (1962, 96) emphasize the importance of a real and practical agreement of the citizens subordinating to a constitution. An explicit agreement is necessary because the state has itself incentives to exploit citizens and behave as a Leviathan. From that point of view, an *indispensable* need for constitutional rules follows that prevent the state, and the politicians, bureaucrats (and interest groups) that constitute it, from abusing their powers. The design of constitutions should be such that bad and incompetent governments can be prevented from doing too much harm.[7] "*The passions of men will not conform to the dictates of reason and justice without constraint*" (*Hamilton*, Federalist No. 15, quoted according to *Hamilton*, *Madison* and *Jay* 1787/1788, 110). The government must subordinate itself to the rule of law. Checks and balances laid down in the constitution help to create sufficient political competition such that dominant positions of specific centers of power in a polity cannot emerge.

The constitutional discussion in the EU is far from the Hobbesian initial situation. The individualistic starting point of the contractarians does however allow to evaluate the European Constitutional Draft at basic principles. Three institutions are particularly suited to restrict the state authority such that it is forced to respect basic individual rights, does not assume illegitimately concentrated powers and considers the interests of the highest possible number of individuals in a jurisdiction (*Höffe* 1999, Chap. 4). These institutions are the rule of law, the separation of powers and democracy. The rule of law must be secured by high requirements for changes of fundamental rights and by an independent judiciary. Rights which can be changed arbitrarily cannot be interpreted as basic rights (*Buchanan* 1975, p. 106). They could be secured by first requiring that a revision must not lead to a change in the substance of their contents (eternity clause). Or,

7. See *Hume* (1741); *Popper* (1945); *Buchanan* (1975).

the change of fundamental rights may be restricted by higher majority requirements such as (quasi-) unanimity in parliament or a qualified majority in a referendum. There is hence a trade off between the principle of democracy (with lower majority requirements than unanimity) and the rule of law. Unanimity prevents the suppression of structural (ethnic, religious, racial) minorities. However, fundamental rights are also relative rights (*Hayek* 1979, p. 416). The *habeas corpus* right has a lower value in countries with high levels of terrorism than in those without terrorism (*Mueller* 1996, pp. 216).

Moreover, any potential rules might not qualify as fundamental rights. The EU's Charter of Fundamental Rights which the Convention proposes for acceptance by the European Council does not exclusively follow the requirements of a catalogue of fundamental rights. *Mueller* (2003, pp. 23) argues that several of these rights are not fundamental, are contradictory or redundant, or simply comments on certain issues. For example, Art. II-35 of the Charter proposes a high level of health protection and Art. II-37 as well as Art. II-38 propose high levels of environmental and consumer protection. Art. II-33 offers families social protection. It is highly questionable whether these are fundamental rights and how they can be guaranteed. A contradiction can be found with respect to discrimination. According to Art. II-21, each discrimination because of sex (and 16 other criteria) should be prevented. Art. II-23 Paragraph 1 proposes equality of men and women which may already have been obtained under Art. II-21. However, Art. II-23 Paragraph 2 explicitly allows for discrimination in favor of the underrepresented sex. Is discrimination prohibited or allowed for?

Less contested than the definition of fundamental rights is the requirement of an independent judiciary which is supposed to protect citizens from offenses by the state. Independence of the judiciary additionally signals that the government of a country subordinates to the rule of law which is a credible commitment of the state to respect private property rights. The protection of private property rights is a precondition for private investment in human and physical capital and hence positively contributes to economic growth. Finally, judicial independence is an element of the separation of powers and enhances the competition between centers of power. Art. I-28 as well as Art. III-258 to Art. III-289 of the Constitutional Draft strengthen the legal independence of the European Court of Justice.[8] It may however be criticized that judges are appointed for a three years' term only with a potential renewal because this procedure provides incentives to judges to behave friendly to governments of particular member states. Art. III-262 of the Constitutional Draft attempts at reducing these incentives by requiring that judges can only be appointed after consulting a council that consists of former judges of the ECJ, members of national highest courts and reputed legal scholars. Instead of a mere consultation, it would have been desirable to establish stronger restrictions, like,

8. *Feld* and *Voigt* (2003) provide systematic evidence for the impact of judicial independence on economic growth by constructing a *de jure* and a *de facto* indicator. Whereas the *de jure* indicator of judicial independence is obtained from the constitutional and legal provisions of single countries, the *de facto* indicator captures actual independence. In this data set, the EU is at the 57th rank from 106 countries in the case of *de jure*, but at the 1st rank in the case of *de facto* independence.

e.g., the ability of that council to postpone an appointment or to require the member states to nominate alternative candidates in cases of dispute.

Separation of powers considerably enhances political competition in a state. As government and parliaments consist of individuals that are continuously tempted to misuse their powers, a cautious treatment of the concentration of powers requires the separation of powers to different institutions by the constitution. *Montesquieu* (1748, 586) hence proposes to establish the legislature, the executive and the judiciary in such a way to keep each other effectively in check: *„Tout serait perdu si le même homme, ou le même corps des principaux, ou des nobles, ou du peuple, exerçaient ces trois pouvoirs: celui de faire des lois, celui d'exécuter des résolutions publiques, et celui de juger les crimes ou les différents des particuliers."* Because of the separation of powers a mutual control of decisions of each institution is possible.[9] *Laffont* (2000, chap. 3) formally shows that this leads to a reduction of corruption and abuse of powers. The information disadvantage of citizens as compared to politicians is reduced by the separation of powers. *Persson*, *Roland* and *Tabellini* (1997) additionally show that the separation of powers is more effective in presidential than in parliamentary systems because the possibilities of the legislature and the executive to collude are higher in the latter.[10]

These thoughts about the separation of powers strongly contradict the proposal by *Bodin* (1576) to ensure the sovereignty and ability to act of a government. The requirement of more effective decision-making procedures at the EU level originates from the premise of sovereignty. It is frequently underlined that neither the Council nor the Parliament will be able to take decisions after the next round of enlargement of the EU (*Tabellini* 2003a). The Constitutional Draft considers these criticisms and attempts at establishing more effective decision-making procedures. As mentioned in the introduction, Art. I-24 of the Constitutional Draft requires a double majority of the member states and three fifths of the population of the European Union for qualified majority decisions in the Council. The additional criterion of a qualified majority of the weighted votes of the Council members as established by the Nice Treaty shall be dropped by 2009. The same holds with respect to EU budgetary procedures. According to Art. III-310 of the Constitutional Draft, the current distinction between compulsory and non-compulsory spending shall be abolished. *Tabellini* (2003a) and *Vaubel* (2003) correctly criticize that both changes will potentially enhance the legislative activities of the EU and entail a further centralization of competencies in the EU. *Hayek* (1979, p. 429) argued that it is not the sovereignty of the government, but the restrictions imposed upon it that constitute the main purpose of a constitution. The changes in the decision-making procedures entailed by the Constitutional Draft are hence only acceptable if they are met at least by an increased ability of citizens to control European politics.

An increase of control could be obtained by a stronger separation of powers in the EU. Currently, an imbalance of powers to the disadvantage of the Parliament exists.

9. Aside the separation of powers between state centers of power, the separation between the state and the private society plays a crucial role which is however not further discussed in this paper.

10. The advantages and disadvantages of two chamber systems are however controversial. See *Levmore* (1992), *Mueller* (1996, chap. 13) and *Blankart* and *Mueller* (2002). The latter find two chambers systems problematic after a discussion of the high blocking abilities of the German Bundesrat.

While the Commission has agenda setting power, the Council, in many cases even the heads of states in the European Council take the most important decisions at the EU level. The Parliament has a co-decision power in less important policy areas. Even though its position in the budgetary procedure, but also in the legislative process will be increased by the Constitutional Draft such that the aforementioned process of the development of the EU towards a federation is not interrupted, the Parliament will have too little ability to effectively control and sanction European policies.

A stronger separation of powers in the EU would be important as citizens' ability to control representatives at the EU level is considerably low. First, the current delegation of decision-making powers to the Council of Ministers undermines their control possibilities. Each head of state or of government can easily argue that unpopular measures were necessary because of compromises taken at the EU level. It is not necessarily unreasonable to enforce unpopular measures at home via European institutions. It does however entail the danger that national governments abuse EU decisions to realize their own personal objectives instead of following citizens' preferences and spread the resulting costs over the whole populace. Second, the European Parliament has incentives to attract additional competencies in order to increase its own decision-making powers and will thus not object against a further centralization in the EU such that the discretion of the European and the national executives will further increase. Third, the European peoples lack a European identity. They perceive themselves as Italians or French, but not as European. This has important consequences for the ability to control governments in the EU because the media will not be induced to exert its control to the same extent as it does at the national level.[11] This is the main reason why the EU needs a constitution: The control of decision-making bodies at the EU level must be increased and the democratic deficit must be reduced. Today, the EU shapes a big majority of legislative decisions of its member countries without such a control. This is unacceptable.

The lacking European identity and the own narrow interest to increase its competencies render it impossible to resolve the democratic deficit by giving more powers to the European Parliament. A sufficient control of political decisions at the EU level will only be achieved by establishing direct democratic instruments in the EU constitution. They provide incentives to citizens to become informed about European politics. Referendums and initiatives hence shape the emergence of a European *demos*. Moreover, referendums and initiatives presuppose a lesser extent of cultural and historical agreement than the effective control of European institutions by the European public in a representative democratic system. As direct democracy provides incentives to citizens to gather information about European policies, they start to examine their own narrow individual interests that are still molded by national considerations by comparing it to the positions of citizens from other member states. It is crucial for that outcome that a discussion process is established before European referendums take place. In contrast to

11. In an interview with the *Frankfurter Allgemeine Zeitung,* the former Belgian Prime Minister and Vice President of the Constitutional Convention, Jean-Luc Dehaene, criticized that the work of the Convention is not realized in many EU countries, although its meetings are public and it contains representatives of national governments. See also *„In Europa ist eine neue Alchemie entstanden"*, in: Frankfurter Allgemeine Zeitung No 16, 20. January2003, p 7.

the arguments by *Habermas* and *Derrida* (2003),[12] referendums and initiatives would found a European identity by actively reflecting European political issues instead of stretching the external threat of U.S. hegemony in external affairs.

3. Direct democracy for a European constitution

The arguments for the introduction of direct democratic decision-making procedures at the EU level are hence obtained from a contractarian perspective: A constitution establishes the rules for politics as well as the security mechanisms against an abuse of powers. From that perspective, it is also excluded that those who are supposed to be restricted by these rules have the decision-making powers to change those mechanisms of control and sanctioning. The players should not be allowed to decide upon the rules of the game. In the European context, members of parliament and government representatives should not have been allowed to be members of the Constitutional Convention if they have national or European decision-making powers after the Convention work. Pragmatic reasons may provide arguments to violate such a requirement. This violation must however be cured by a final approval of the Constitutional Treaty by the citizens.

The composition of the EU Convention has followed pragmatic reasons. The Convention has consisted of three former heads of states as the presidency, 15 representatives of national governments, 30 representatives of national parliaments, 16 members of the European Parliament, 2 representatives of the Commission, 13 representatives of governments of the candidate countries, and 26 representatives of the candidate countries' national parliaments. With the probable exception of the presidency, the members of the Convention remain in their former offices. *Vaubel* (2002) correctly argues that the members of the Convention therefore find themselves in a potential conflict of interests between their own personal goals and the fundamental objectives of the constitution. It is hence necessary to institutionally enable European citizens to decide the future European constitution in a mandatory constitutional referendum. As they possess the *competence competence* to change constitutional provisions, a constitutional referendum must be established in the EU constitution. According to an opinion poll by *EOS Gallup Europe* (2003, p. 56), 41 percent of EU citizens currently find that such a referendum is indispensable for the establishment of the European constitution. 45 percent still think that it is useful. EU citizens themselves rationally perceive the necessity of direct democratic decision-making in this case.[13]

Aside the constitutional level, the advantages and disadvantages of referendums and initiatives must be considered as selective control and sanctioning mechanisms for political decisions of legislatures and executives also in day-to-day politics.[14] While ele-

12. See: *Böckenförde* (2003); *Grimm* (2003); *Muschg* (2003); *Starbatty* (2003).

13. Just like a parliamentary decision, such a mandatory constitutional referendum does not only represent a binary decision because an intensive discussion among European citizens will precede it. For the importance of the discussion process for the diffusion of information in direct and representative democracies see *Kirchgässner*, *Feld* and *Savioz* (1999) as well as *Feld* and *Kirchgässner* (2000).

14. The political economy arguments for and against direct democracy have been discussed extensively in the recent literature and are thus only briefly summarized here. See *Gerber* (1999), *Kirchgässner*, *Feld* and *Savioz* (1999), *Feld* and *Kirchgässner* (2000, 2001a, 2003) and *Matsusaka* (2002).

ments of representative democracy on the one hand entail decisions with a higher information content because a division of labor enables representatives to specialize in politics, they increase principal-agent problems and allow representatives in the government and the legislature to follow their own interests to a higher extent on the other hand. Referendums provide citizens with a potential veto of representatives' decisions. Policy proposals that favor special interest groups, or representatives' personal or ideological interests will have difficulties to obtain a majority at the ballots such that proper policies result that are guided by citizens' interests. Initiatives enable citizens to introduce new proposals to the political arena that have been neglected (on purpose or not) by the *classe politique*. Changes in the political preferences of a polity are thus reflected to a larger extent in political outcomes. *Besley* and *Coate* (2000) show in addition that initiatives provide means to unbundle issues that are linked in package deals via logrolling devices whenever they are not in citizens' interests.

Many objections against instruments of direct democracy are brought forward in the literature and in political discussions. A look at theoretical and empirical studies reveals that they are not sufficient to dismiss the option of direct democratic decision-making.[15] This holds first with respect to the contention that ordinary citizens are cognitively unable to judge complex political issues,[16] but second also with respect to the alleged dominance of interest group influence on policy outcomes in direct democracies.[17] Without discussing these issues at length, it should be stated that the empirical studies by *Pommerehne* (1978) for Switzerland and *Gerber* (1999) for the U.S. provide evidence that policy outcomes in jurisdictions with initiatives and referendums are more strongly oriented at citizens' preferences. Interest groups and the ideology of political parties apparently have less influence in direct than in representative democracies such that policy outcomes are also less oriented at the positions of special interests or parties.

Moreover, direct democratic jurisdictions follow a relatively rational economic and fiscal policy according to an abundance of empirical studies. Citizens' cognitive abilities for understanding complex political issues obviously suffice to reject unreasonable and approve reasonable fiscal and economic policies. Studies for Switzerland and the U.S. show that Swiss cantons (and local jurisdictions) with fiscal referendums, and U.S. states with initiatives have – *ceteris paribus* – significantly lower public spending and revenue per capita and also lower public debt per capita.[18] Referendums and initiatives mainly restrict social welfare spending[19] and induce governments to finance their

15. See *Romer* and *Rosenthal* (1979), *Steunenberg* (1992), *Feld* and *Kirchgässner* (2001a), *Matsusaka* (2002) and *Feld* and *Matsusaka* (2003a).

16. See *Matsusaka* (1992), *Kirchgässner*, *Feld* and *Savioz* (1999), *Marino* and *Matsusaka* (2000), *Kessler* (2001), *Matsusaka* and *McCarty* (2001) and *Benz* and *Stutzer* (2003).

17. See *Gerber* (1999) for U.S. evidence and *Longchamp* (1991) as well as *Feld* and *Schaltegger* (2002) for Swiss evidence.

18. See *Matsusaka* (1995, 2000, 2002) and *Kiewiet* and *Szakaly* (1996) for the U.S. and *Feld* and *Kirchgässner* (1999, 2001a, 2001b), *Feld* and *Matsusaka* (2003a), *Schaltegger* (2001) and *Vatter* and *Freitag* (2002) for Switzerland.

19. See *Schaltegger* (2001) and *Vatter* and *Freitag* (2002).

spending to a significantly higher extent by user charges than by broad based taxes.[20] However, this does not necessarily mean that direct democracy is associated with an erosion of the social welfare state. As *Feld*, *Fischer* and *Kirchgässner* (2003) show, direct democratic Swiss cantons redistribute less income if the income gap between the highest and lowest income decile is relatively low and redistribute significantly more income if the income gap between the highest and lowest income decile is relatively high. Income redistribution appears to be more targeted in direct democratic cantons and hence more effective such that less funds are necessary to achieve redistributive goals. *Pommerehne* (1983) and *Barankay* (2002) also provide evidence for a higher efficiency of public service provision in direct democracies. Tax evasion is lower and tax morale higher in direct democratic jurisdictions.[21] They have a – *ceteris paribus* – significantly higher GDP per capita[22] and higher economic growth as compared to representative democratic jurisdictions.[23] Unsurprisingly, citizens in direct democratic jurisdictions are – *ceteris paribus* – more satisfied with their lives as a whole.[24] The empirical evidence overwhelmingly supports the conjecture that an insufficient control of representatives leads to a less reasonable economic policy. It can be expected that these effects are not qualitatively different if referendums and initiatives are used at the EU level. European policy outcomes will be more strongly oriented at citizens' preferences.

All in all, more arguments therefore speak in favor of the inclusion of referendums and initiatives in a future European constitution. Several proposals have been presented in the literature so far.[25] I follow a proposal by *Feld* and *Kirchgässner* (2003) according to which the EU constitution should include the instruments of a mandatory constitutional referendum as well as constitutional and legislative initiatives. Decisions that are approved in a mandatory referendum (and in the founding referendum on the Constitutional Draft) should not be subject to changes by the Commission, nor by the Council, nor the Parliament without requiring additional popular approval. Referendum decisions are hence binding. The European Court of Justice should however have the possibility to assess whether constitutional changes are unconstitutional or not. A constitutional referendum shall be approved if a double qualified majority (two thirds) of the EU citizens and of the (citizens of the) member states support it. Further restrictions are not necessary. In particular, a turnout requirement should not be laid down in the constitution. German historic experiences with turnout requirements provide strong evidence that turnout requirements invite strategic behaviors of certain groups, parties and citizens.

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20. See *Matsusaka* (1995, 2002) for the U.S. and *Feld* and *Matsusaka* (2003b) for Switzerland.

21. See *Pommerehne* and *Weck-Hannemann* (1996), *Pommerehne, Hart* and *Feld* (1997), *Feld* and *Frey* (2002a, 2002b) and *Torgler* (2002).

22. See *Feld* and *Savioz* (1997). The hypothesis of reversed causality is rejected according to the results.

23. See *Freitag* and *Vatter* (2000) for Switzerland and *Blomberg* and *Hess* (2002) for the U.S.

24. See *Frey* and *Stutzer* (2000, 2002).

25. See the survey of the different proposals in *Hug* (2002, chap. 7). A proposal by *Papadopoulos* (2002) is relatively close to ours in several respects.

In addition to the constitutional referendum as an institution of control, citizens should have possibilities to change the constitution by own initiative. A constitutional initiative enables citizens to induce institutional changes at the EU level if they perceive that changed circumstances in European integration require it. For example, a re-assignment of competencies to the national level could be achieved relatively easily by proposing an initiative. EU citizens, the institutions of the EU and of the member states should basically have the possibility to propose a constitutional initiative. The signature requirement should be 5 percent of the electorate. *Matsusaka* (1995) provides empirical evidence for the U.S.-states that initiatives do not have any significant influence on fiscal policy for signature requirements of 10 percent and higher. The signature requirement should thus be lower. The median of signature requirements of U.S. states is 5 percent. When Switzerland introduced a constitutional initiative in 1891, it drafted a signature requirement in absolute terms that was at about 5 percent then as well. Alternatively, the signature requirement could be 15 percent from at least 5 member states, but at least 2 percent of the EU electorate overall.[26]

As in the case of the constitutional referendum, the constitutional initiative is adopted if a double majority of EU citizens' votes and of (the citizens of) the member states approve it. Further restrictions are again not necessary. There should also not be any restrictions in content of a constitutional initiative. Whether a constitutional initiative is constitutional in the area of basic human rights could be judged again by the ECJ before the initiative is decided upon. Constitutional initiatives can be rejected if they are not constitutional. The role of the ECJ as a constitutional court should however be restricted and less active in comparison to the U.S. Supreme Court or the German Federal Constitutional Court.[27] Parliament and government should have the right for a counter-proposal which should be simultaneously decided at the ballots together with the constitutional initiative. In contrast to the proposal for the constitutional initiative, the legislative initiative could already be adopted by a simple majority of votes. All other regulations of the constitutional initiative should apply accordingly to the legislative initiative. The introduction of an optional referendum at the EU level is not suggested because it would too strongly reduce the ability to reach decisions in European politics. An optional referendum would mainly affect EU directives. The important political decisions in Europe are regulated in the future European constitution which already is subject to a mandatory referendum. An optional referendum is hence abundant.

Finally, a fiscal referendum should be considered for introduction in the EU constitution. In Switzerland and among the U.S. states, fiscal referendums are frequently found in addition to the general constitutional or legislative referendums (or initiatives). Fiscal referendums allow for a stronger control of fiscal policies. In the case of manda-

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26. With respect to the time available to collect signatures, the literature does not provide similar insights. A generous regulation appears to be useful however. Even a signature requirement of 2 percent could be very restrictive if only these signatures must be collected within one month.

27. *Hayek* (1960, p. 245) clearly perceived the necessity to restrict judicial indpendence. He argued that the restriction imposed upon the government in pursuing its goals by establishing general principles should anticipate turbulences; judicial review however would require a kind of referendum as a general call of the people to decide upon the general principles in order to complete it.

tory fiscal referendums, new spending projects must be approved by citizens if the spending amount exceeds a certain threshold. Fiscal referendums also exists for issuing debt or changes of tax laws. If the European constitution contained an EU tax, for ex ample a surcharge on national revenues from value added taxes, changes of tax rates and the tax basis would already be subject to the mandatory constitutional referendum. Since the EU should not have any right to issue debt, a fiscal referendum on the revenue side of the budget would not be necessary. At the spending side, a fiscal referendum would be useful if the spending threshold were relatively high in order not to overburden the instrument. Bigger spending projects, like the creation of a new fund, would again require changes of the European constitution. The assignment of new policy responsibilities will generally require constitutional changes in the EU such that a mandatory constitutional referendum may again suffice to impose restrictions on EU spending. However, the EU will continue to develop and might perhaps be able to demand much higher levels of funds. Although this might look like too much speculation with respect to future developments, it might be reasonable to include a fiscal referendum for new spending projects in the EU constitution already today.

Currently, the Constitutional Draft does not include any direct democratic decision-making procedures. Under the title '*Principles of Participatory Democracy*', Art. I-46 only provides for a petition right according to which at least a million EU citizens could invite the Commission to propose legal drafts at the EU level. Detailed regulations should be fixed in a specific law. In order to be considered as direct democratic, the petition right lacks the final and conclusive right of citizens to take binding decisions. If the EU would propose a law or a directive according to that petition proposal that is however finally decided by citizens in a referendum before it could come into force, it would constitute an indirect initiative. Without binding decision by the citizens in politics, the EU will remain a representative democratic polity.

4. Competitive federalism for the European Union

4.1. The fundamental decision between federation or confederation

The fundamental decision between a confederation or a federation is one of the most important issues for European integration. Currently, the EU constitutes a hybrid entity in between both extremes, because EU decisions partly affect EU citizens directly and are partly enacted by the governments of member states. The integration process in the EU is characterized by a centralization trend at least since the Single European Act that has accelerated since the Maastricht Treaty. More and more policy areas are delegated more or less transparently to the EU level. In more and more policy areas, EU member states are forced to coordinate their policies. The EU instructs national parliaments to an increasing extent by formulating directives for European policies without having sufficient democratic legitimacy in its own right. This situation cannot last forever. The EU needs to decide what its final status should be. Either it should give back competencies to the member states and restrict itself to a confederation or it openly opts for centralization of competencies by founding a federation. In the latter case, competencies for

different policy areas should be transparently divided between the EU, the member states and sub-national jurisdictions. Moreover, decision-making procedures including agenda setting power for future assignments of competencies should be clearly defined.

The alternative organization of the EU, having a unitary state like France or the U.K., is not feasible. According to *McKay* (2001), a federation must be distinguished from a unitary state by the constitutional guarantee for a vertical separation of powers between a central (federal) authority and the regional jurisdictions. A European unitary state would imply the abolition of the European nation states by their inclusion in a new Europe. This must remain a utopia (for some, and it is lucky for others) because preferences of the single member countries are so much different that a strong opposition would object against such a proposal. It is remarkable that comparatively big polities, like the EU could become, either have been a federation from the beginning of their historical development, like the U.S., Canada, Australia or India, or entered a decentralization process after a period of coerced standardization by a central authority, like Russia, China, Spain and meanwhile even France. For a unitary state to be sustainable, a considerable homogeneity of citizens' preferences must moreover exist in the EU. As this is currently not the case, such a unitary EU would be rejected by the citizens. The preferences of the Spaniards, the French, the English and the Germans is still so different that a new European solidarity, according to which financial assistance for all EU citizens is provided without acknowledgement of national origin, cannot be expected for the foreseeable future. On the eve of the creation of a Swiss federation, Napoleon is supposed to have had said that Switzerland will be federal or it will never be. Accordingly, it could be said: *Europe will be federal or it will never be*.

4.2. Competitive or cooperative federalism?

If EU member states decide to found a European federation, they can choose between two role models of federalism or combine different elements of them at least. On the one hand, they can organize their relationships in a competitive federalism, on the other hand they could choose a cooperative federalism type of federation. In both extremes, unambiguous assignments of competencies are desirable. In a competitive federalism, far-reaching competencies would remain in the exclusive jurisdiction of the member states. The competencies of the EU would be clearly defined for particular policy areas that it finally decides upon. Even a competitive federalism would not be able to exist without coordination of policies whenever notable spillovers of national policies to other member states exist. Competitive federalism does however not exhibit a significant amount of harmonization of policies at the central level. It is characterized by a diversity of policy solutions. This is different in cooperative federalism. The centralization of competencies is relatively stronger than in competitive federalism. A larger part of policies is harmonized. The coordination of policies of member states is extended towards almost each policy area.

These two stylized ideals of both types of federalism do not exist in reality. Existing federations do not exactly follow any of these ideals, but exhibit different degrees of cooperation between member states and different extents of centralization of policies. There is a steady transition from competitive to cooperative federalism. *McKay* (2001)

classifies the really existing federations with respect to two criteria, the extent of institutional centralization and the degree of regional identity. Accordingly, Switzerland, Canada and the EU have a low degree of centralization and strong regional identities, while the U.S., Germany and Australia (probably also Austria which is not mentioned there) have a high degree of centralization and weak regional identities. Historical manifestations of these federations can be subsumed to the remaining permutations of the criteria. The U.S. are in that second group of countries because McKay contends that it has a high centralization of the party system. In particular with respect to the fiscal constitution, McKay's classification is however contestable. The U.S. states have far reaching fiscal competencies to a similar extent as the Swiss cantons that are both stronger than those of the Canadian provinces. McKay's classification in both groups does therefore not correspond to the economic idea of competitive and cooperative federalism. More strongly oriented at the fiscal competencies of the sub-federal jurisdictions, Canada, Switzerland and the U.S. belong to the group of competitive federalist countries while Australia, Austria and Germany exhibit a cooperative federalism. If the EU develops to a federation without further centralization and harmonization in most policy areas, it will belong to the first group. Given the strong national identities, it is reasonable to organize a future European federation in such a competitive way.

Frequently, competitive federalism in particular with respect to fiscal policies is strongly criticized by a number of arguments.[28] Theoretically, fiscal competition between jurisdictions can lead to negative outcomes if externalities exist or income redistribution is decentralized. For example, positive regional externalities or benefit spillovers might emerge if Dutch tourists use the German highway system, but do not contribute according to their marginal willingness to pay. Congestion externalities will result. Negative regional externalities or cost spillovers exist in the case of tax exporting. It provides incentives for inefficiently high levels of public services because a part of the tax burden to finance these services is paid by residents from other jurisdictions. An example are multinational corporations whose shares are internationally distributed. Because the shareholders of a multinational cannot participate to the same extent in the political process as those of a national corporation, a government has incentives to raise corporate income taxes to inefficiently high levels above the willingness to pay of those shareholders. The costs of public services are externalized.

Fiscal externalities may arise in the tax and subsidy competition for mobile capital. Germany is for example in tax competition with Ireland. If Ireland drops the corporate income tax rate, it attracts German firms. This relocation reduces the tax burden of the Irish residents given a fixed amount of public goods and services because provision costs can be distributed among more taxpayers. However, the relocation increases the tax burden of German residents because less taxpayers have to finance that given amount of German public services. If both countries do not consider the changes in tax burdens in each country when deciding about the level of public services, fiscal externalities arise. This argument does not hold to the same extent if public infrastructure is

28. For an extensive discussion of advantages and disadvantages of fiscal competition and the empirical evidence see Feld (2000a) and Wellisch (2000).

becoming an additional parameter for relocation decisions. Infrastructure is adjusted in the fiscal competition game such that fiscal externalities might finally vanish. An inefficient provision of public services might only result if economies of scale (non-rivalness) in consumption exist, i.e. when the government provides public goods in the Samuelsonian sense (*Sinn* 1997, 2003a). Fiscal competition enforces the benefit principle of taxation such that mobile production factors can only be charged the marginal costs of their use of public goods. Mobile taxpayers do however not contribute to cover the high inframarginal (fixed) costs of public infrastructure. If this were not to lead to an inefficiently low level of public services, the fixed costs must be covered by immobile taxpayers. This can lead to an undesired income distribution.

With respect to personal income redistribution, fiscal competition poses similar problems. Continue the Germany-Ireland example: Germany presumably has a higher progressivity of income taxes and pays higher levels of social transfers than Ireland. Income redistribution is hence more pronounced in Germany than in Ireland. This provides incentives for Irish social welfare recipients to move to Germany because they can expect higher transfer payments. High income earners from Germany – *ceteris paribus* – follow the incentive to emigrate to Ireland. These migration incentives impede the decentralized income redistribution at the national levels. There do not exist many theoretical arguments against this reasoning. A frequently heard argument is that high income and wealthy people have incentives to voluntarily contribute to the social welfare state in order to obtain social peace. The voluntary income redistribution is the higher the more decentralized the organization of income redistribution is because recipients are known or can be more easily identified by contributors. Many observers question whether the funds obtained from voluntary contributions to income redistribution suffice to secure a minimum income of the poor. If income redistribution is considered necessary, the disadvantage of fiscal competition may theoretically be found in the distribution section.

In the political discussion, a frequent argument focuses on regional income positions. It is contended that fiscal competition results in a situation of poor regions becoming poorer and rich regions becoming richer. The more ‘good’ taxpayers reside in a region, the lower the tax burden needs to be to finance a ‘necessary’ amount of infrastructure. Poor regions however need to increase the tax burden to finance such a ‘necessary’ amount of infrastructure. Fiscal competition then perpetuates income differentials and exacerbates the convergence problems of the periphery. Such permanent differences in growth performances will however also prevail if agglomeration economies in central regions exist. The competition between interregionally active firms induces a concentration of industrial activities in economic centers because of an interaction between economies of scale in production, agglomeration economies and diseconomies and transport costs. Economic activity is more concentrated in the center while the periphery has below average economic activity. *Baldwin* and *Krugman* (2000) analyze the impact of tax competition on the economic development of central and peripheral regions under the conditions normally emphasized by economic geography. Agglomeration economies in the centers allow them to a certain extent to levy relatively higher taxes than the periphery without inducing firms to relocate to the periphery with lower taxes.

The periphery has however no other alternative than to attempt at compensating their location disadvantages by levying lower taxes. A strong decrease of tax rates is necessary to compensate for agglomeration advantages of the center. Ireland has followed this policy in the EU during the last decade and has been very successful. Tax harmonization would then be harmful because it would exacerbate the resource differences between center and periphery and easily lead to demands for higher fiscal equalization.

From the perspective of systems competition, personal income redistribution thus appears to be the only area where problems from fiscal competition might emerge. Fiscal externalities are empirically unimportant or at least compensated for by the effects of tax exporting (*Sørensen* 2003). Benefit spillovers can be relatively successfully corrected for by decentralized bargaining arrangements that induce a Coase like solution as an internalization device (*Wellisch* 2000). Experiences from existing federal states like Switzerland or the U.S. support this hypothesis (*Pommerehne* and *Krebs* 1991). By and large the existing empirical evidence suggests that the advantage of fiscal competition can be found in the allocative branch (*Inman* and *Rubinfeld* 1997, *Feld* and *Kirchgässner* 1997, *Feld* 2000a). Fiscal competition increases the efficiency of the public sector.

However, distributive problems need to be taken seriously in a European competitive federalism. If the economic pressure on European welfare states increases because of transfer induced migration from Eastern European countries, the political need to harmonize social systems in Europe will increase as well. The Commission aims at a social union already today. Such a harmonization at presumably high transfer levels will lead to unemployment in the periphery that does not yet obtain the high wages and incomes of the central regions, because social transfers will be higher than wages of low skilled workers in these countries. The convergence process of these regions will be interrupted such that they demand higher grants from the European center to compensate for their loss of competitiveness. A similar process has followed the social union of the East German states after re-unification. *Sinn* (1997, 2003a) therefore suggest to establish a nationality principle in the EU. According to the earlier version of Sinn's proposal, citizens should obtain transfers according to the mandates of their home country for a clearly defined time period, say five years. They should also pay income taxes according to the mandates of their home country. These contributions to and the transfers from a particular welfare state take place independent from the place of residence. Hence the residence principle is replaced by a nationality principle. This proposal is reasonable in several respects because the incentives of migration in order to avoid the rules of income redistribution of the home country are reduced. If the nationality principle holds, the welfare state is not eroded by fiscal competition. However, this strong version of the nationality principle is too far-reaching and neglects the fact that a state then has a too strong ability to exploit citizens by excessive taxation. In such a system, they cannot escape the infringement of Leviathan states.

In the U.S. and in Switzerland, partially successful examples of elements of a nationality principle existed in the recent past. Until 1969, the U.S. states imposed residence requirements on potential welfare recipients according to which they could only obtain welfare payments in a state if they had worked at least two years in the same state in which they applied for social welfare. The residence requirement was declared uncon-

stitutional by the Supreme Court in that year such that evidence for a harmful welfare migration has been provided only after that Supreme Court decision. In Switzerland, a citizenship principle existed until 1979 according to which the places of citizenship were responsible for social welfare of their citizens. Citizenship has been inherited. If the place of residence of a welfare recipient was different from the place of citizenship, he could be forced to move back in the place of citizenship or obtained lower transfer payments than he would have received at the place of residence. The empirical evidence by *Kirchgässner* and *Pommerehne* (1996) and *Feld* (2000b) supports the positive role of the citizenship principle in Switzerland for a sustainable fiscal competition. The proposals by the European Convention to establish a European citizenship (Art. I-8 of the Constitutional Draft) together with non-discrimination (Art. I-4) and the positive right for social protection (Art. II-34) impose strong restrictions on the introduction of a citizenship principle.[29] If the current proposal of the Convention is realized, the ECJ will probably not be able to accept that a Portuguese citizen living in Germany will receive social welfare payments at the Portuguese level only. It is hence necessary to introduce a weak form of the nationality principle explicitly in the EU constitution as a restriction on the inclusive principle of EU citizenship.

The preservation of an effective competitive federalism in Europe is also desirable because competition between member states helps to resolve public choice distortions. The state does not always do what it ought to. Political actors follow their own self-interest and seek to get rents from the political process. If a government of a member country attempts at securing private rents by increasing taxes, taxpayers can avoid excessive taxation by migrating to countries with lower tax burdens. The government cannot increase the tax burden of the mobile factor above the level of migration costs. It therefore has to take the interests of the mobile factors into account. Competitive federalism preserves a realistic possibility of migration. In addition, federalism enables citizens to comparatively evaluate the performances of representatives and hence reduce the information asymmetries in political markets. For example, German voters can compare the performance of the German federal government to that of the French government. If France has a comparably high level and quality of public services under otherwise same conditions, but offers them to lower tax prices than Germany, German voters have incentives to throw the German government out of office at the next election day. The German government will anticipate this threat in its decision to increase tax rates. Federalism does hence not only work through the migration mechanism, but also improves citizens' ability to exert voice in the political process. The government is forced to provide public services at relatively lower costs and at the level desired by citizens.[30] *Sinn's* (2003b) proposal for a nationality principle for a sustainable decentralized income redistribution in the EU should therefore only by applied to social transfers, but not to income taxation in order to prevent the fisc from exploiting taxpay-

29. See *Sinn* (2003b).

30. Similar arguments can be formulated with respect to a secession right of member states. See *Doering* (2000, 2003). A secession right improves minority protection in the EU and increases the competitive pressure on governments. Art. I-59 of the Constitutional Draft explicitly considers a secession right.

ers. *Wissenschaftlicher Beirat beim Bundesministerium der Finanzen* (2001) and meanwhile also *Sinn* (2003c) suggest to apply the nationality principle only to transfers.

With respect to fiscal policy coordination, the Constitutional Draft is relatively cautious. The Convention has not given way to calls for more tax harmonization. Aside the harmonization of indirect taxes which resulted from the completion of the single market, the possibility for tax coordination in direct taxation, in particular company taxation, has been included only with respect to illegal tax fraud in Art. III-63 of the Constitutional Draft. It is the only case for which the unanimity requirement for taxation issues in the Council is softened. The potential exhaustion of this new article will not undermine tax competition between EU member states. The EU is thus still following the principle of competitive federalism in taxation. Further rules that exceed the status quo regulations in fiscal issues are not included in the Constitutional Draft.

4.3. Assignment of competencies and subsidiarity

A federal EU needs clearly assigned competencies to avoid conflicts between the EU level and the member states. The economic theory of federalism provides insights to such a rational assignment of competencies. The EU should provide those public goods and services whose benefits are reaped by all member states. In addition to the common market that meanwhile also includes the common monetary policy, trade policy and European competition policy, external affairs and defense may fall under the jurisdiction of the EU according to a few authors (see, e.g., *Tabellini*, 2003b). Defense is however already internationally coordinated and harmonized in the NATO the priority of which should not be questioned by the EU even if it takes a supplementary role to resolve local conflicts. A stronger coordination of external affairs at the EU level appears to reasonable in order to effectively influence the peaceful living together of people. In the Constitutional Draft, the Convention follows this proposal by creating a European minister of foreign affairs. The provisions for this new institution are problematic because of the potential conflict of competencies between the minister of foreign affairs and the president of the European Council who should represent the EU externally. The assignment of competencies of both institutions in the Constitutional Draft provides insufficient regulation for conflicts, such that the EU constitution needs to be revised in that respect.

In the field of public security, police and the judiciary, the considerably increased globalization of crime and terrorism demands more coordination between member states.[31] Again, the Constitutional Draft correctly considers a coordination in that field. The preferences of member states in public security are however very different, such that a centralization or harmonization of European criminal laws is not useful. Member states should keep their competencies in that field. Several important questions are however not resolved by stating a predominant competence of members states in that field. For example, the Constitutional Draft establishes an origin principle in criminal procedures and in the collection of evidence. European national codes of criminal pro-

31. See the discussion about a European state attorney and the cross border investigations of national police forces according to the Schengen agreement.

cedure differ however widely. An origin principle in criminal procedures implies that a country must accept evidence in an international criminal case that it would have to re ject according to its own code of criminal procedure otherwise. For example, France allows the consideration of witnesses without their personal testimony. The U.K. and Germany do not allow for such a 'witnessing from hearsay' and they might have good reason to do so in light of the potential manipulation of such a testimony by official investigators. According to the origin principle in criminal procedure, evidence is correctly treated as an internationally tradable good. Whether this tradability is restricted or not by the characteristics of that good is however not discussed.

Moreover, the EU should have competencies to correct externalities that affect all member states (*Feld* and *Kirchgässner* 1996). Cross border externalities are not in the jurisdiction of the EU because they could be resolved by negotiations between respective member states. A comprehensive competence of the EU in environmental policy is thus not required. Common agricultural policy and structural as well as industrial policies are not having characteristics of European wide public goods in the conceptual sense and should thus not be in the jurisdiction of the EU. In fact, they are the main policies for which the EU budget pays. In a public choice analysis, *Folkers* (1995) explains their existence by the necessity to compensate potential losers of European integration in particular member states. For political-economic reasons, a re-assignment of competencies in these areas will however be very difficult if not impossible.

The Constitutional Draft achieves considerable progress in the assignment of competencies in the EU. In Art. I-12 to I-17, the exclusive competencies of the EU in monetary policy, trade policy and the customs union are enumerated. The area of common competencies is however too much expanded. On the one hand, there are reasonable common competencies of the EU and the member states with respect to the common market and public security as well as agricultural policy. The latter would at least keep the door open for an increasing role of member states in agricultural policy such that several inefficiencies could be reduced. On the other hand, there are questionable common competencies in social policy, infrastructural policy and so on. Although those provisions reflect the status quo, a reduction of EU influence in these fields would be useful. Particularly the EU competencies in social policy (Art. III-103 to III-112) must be evaluated very critically. Against the background of the above formulated proposal for a weak nationality principle, such EU competencies are neither necessary, nor reasonable. If a nationality principle existed, income redistribution via social security and social policy does not need to be coordinated at the EU level. The constitution should only establish the nationality principle by changing Art. II-34 accordingly (*Sinn* 2003b, 2003c, p. 444). The EU responsibility for employment policy established by Art. I-14 is however a real fall from grace. The sclerotic European (continental) labor markets need deregulation and less union power. European employment policy currently mainly aims at active labor market policy which has proven to be ineffective measured against the goal of improving employment probabilities of the unemployed and too costly at least in Germany. Cracking union power in continental Europe cannot be accomplished by the EU because it requires the political will of member states instead of the EU as a scapegoat for unpopular deregulation. The competition between national labor market institutions

is better suited to trigger a sustainable reform than any coordinating activities of the EU. Competition is key to change labor market outcomes. Collusion and coordination be tween social partners already prevails for way too much time. An EU responsibility for labor market policy instead resembles the assignment of powers to organize collusion. Similarly, the EU should not have competencies in cultural affairs or education. Health policy requires more market than state and hence no European state. In any of these policy, it is unacceptable that the EU is supposed to play a particular role.

The European budget is financed by revenue from tariffs and contributions from member states which are calculated on the basis of national VAT revenue as well as member states' GNP. The contribution system together with the balanced budget requirement for the EU budget have proven successful (*Blankart* and *Kirchner* 2003). However, the second German empire and the young Swiss federation in the 19th century provide evidence that such contribution systems are unstable. If the EU is assigned further competencies, for example in external affairs and security policy, additional finances will be needed that can be covered less and less easily by contributions. For such an eventuality, a reasonable assignment of taxing powers should be considered: *If* the EU had a power to tax, *which* taxation competencies should be assigned to the EU? The economic theory of federalism suggests to assign competencies for progressive income taxes at the highest possible level because of the above-mentioned arguments against decentralized income redistribution (*Biehl* 1985). From a political economy perspective, progressive taxes have a crucial disadvantage however. The central level will not need to decide upon tax increases explicitly, but receives additional tax revenue because of economic growth or bracket creep. Indirect taxes have the advantage that citizens exert a stronger control on tax policy in the EU because additional revenue may only be obtained if tax rates are explicitly increased or tax bases are explicitly broadened. Hence, representatives are forced to justify tax changes in order to get the permission from citizens to levy higher taxes. Such a necessity does not exist in the case of direct progressive taxes. *Kirchgässner* (1994), *Schneider* (1996) and *Feld* and *Kirchgässner* (2003) make such a proposal: If the EU had a power to tax, it should be an indirect tax, for example a surcharge on VAT revenue of member states. The EU will however not need any right to issue debt because it should not have any far reaching competencies in countercyclical macroeconomic policy or in social policy.

The decision-making procedures to change an assignment of competencies appear to be more important than a specific assignment of competencies. The subsidiarity principle of Art. I-9 of the Constitutional Draft (together with the flexibility clause of Art. I-17) is insufficient to clearly define changes in responsibilities in the Union. Although it formulates the basic conjecture that a decentralized provision of public services is advantageous, the basic power to change the assignment of competencies remains in the hands of EU decision-making bodies. The Commission, the Parliament and the ECJ have an inherent interest in extending their competencies and presumably decide in favor of a European responsibility. The member states in the (European) Council on the one hand have incentives to keep their national competencies. On the other hand, logrolling in the Council has frequently led to a centralization to the European level. Logrolling possibilities will be extended after the Constitutional Draft will have been

adopted, because unanimity voting will be less often required and the new qualified majority voting requires lower thresholds for minimum winning coalitions. It can be ex pected that more centralization coalitions will turn out afterwards. Again, Swiss history provides many examples that a coalition of the federal level and the poorer cantons against the rich cantons led to a centralization of social policy (*Sommer* 1978).

Two institutional mechanisms enable a rational weighing as to whether the EU should be assigned a responsibility. First, the *European Constitutional Group* (2003) and *Vaubel* (1996) propose to establish a subsidiarity court comprised of judges from the national highest courts. A subsidiarity court would have incentives to give the EU level relatively little competencies because those judges would deprive themselves of decision-making powers at the national level. It also implies however that they might allow for too little centralization in cases of reasonable changes of responsibilities. Moreover, the subsidiarity court would have difficulties to enforce a re-assignment of competencies to the national level. Second, a centralization of competencies should trigger a mandatory constitutional referendum according to the provisions outlined above. This proposal allows for a greater flexibility and does not require an additional European institution. *Feld*, *Schaltegger* and *Schnellenbach* (2003) indeed provide strong evidence for Switzerland, that fiscal policies is less centralized if citizens can decide in a referendum. These results are corroborated by evidence for the U.S. states (*Matsusaka* 1995, 2002). *Blankart* (2000) emphasizes that the referendum requirement was crucial for Switzerland to centralize less powers than Germany in similar historical situations.

5. Conclusions

The EU has entered the process of giving itself a constitution. This recent development of European integration should obtain much attention by political economists. Even if the failure of the Brussels summit in December 2003 may not be cured by the summits of 2004, the intended deepening of integration between France and Germany in a Europe of flexible integration will need to reply to the same challenges and will require a constitution. Attention is crucial because a constitution with clearly defined rules to restrict state authorities and an unambiguous assignment of competencies is indispensable to protect the rights EU citizens and to secure a sustainable economic development in Europe. The protection of citizens' rights is obtained by establishing basic human rights, an independent judiciary and a separation of powers. Sustainable economic development is triggered by competitive federalism. Whether a European federation is desired or not: The conscious decision for a centralization in certain policy areas is preferable to the creeping centralization that currently prevails in the EU because the latter creates facts that cannot be changed easily in a world with strong political path-dependencies. A creeping centralization will presumably end in a European federation as well, but probably produces less favorable constitutional rules.

It is particularly desirable to ensure competitive federalism in Europe. A harmonization of policies in the sense of a German-style cooperative federalism would require fiscal transfers between central regions and the European periphery to an unprecedented extent. This will be unacceptable to citizens who are still not prepared to redistribute in-

come to a larger extent between member states. In addition, many political economic arguments speak in favor of competitive federalism. Citizens can more easily avoid ex cessive taxation and restrict fiscal policy. Yardstick competition between member states will become more intensive such that the informational disadvantage of citizens is reduced. In order to secure these positive forces of competitive federalism, transfer induced migration must be prevented. A weak nationality principle according to which citizens may obtain welfare payments at the level of their home country for a certain time period independent from the place of residence will reduce transfer induced migration.

Following *Feld* and *Kirchgässner* (2003), a mandatory constitutional referendum as well as a constitutional and a legislative initiative should be included in the EU constitution. The introduction of a fiscal referendum appears to be reasonable in the light of a more powerful EU in the future that demands more financial resources. The democratic foundation of political decisions is a key condition for the acceptance of the EU constitution among citizens. Referendums and initiatives will reduce the democratic deficit in the EU to a much larger extent than increasing competencies for the European Parliament could achieve. Direct democratic institutions allow for a stronger control of representatives at the EU level and help to shape a European identity. Citizens will have increased incentives to discuss European policy issues such that a common understanding of EU policy can develop. In that respect, Switzerland again provides an interesting example. When the Swiss federation was created in 1847, only cantonal *demoi,* but no national *demos* existed. *Hug* (2002, chap. 6) provides evidence that direct democracy shaped the emergence of a Swiss identity. He also warns however to expect too much from direct democracy in that respect. Too little is known about the mechanisms that induce citizens to examine their own narrow individual interests that are still molded by regional considerations in favor of a new national identity. Instead, national interests might be reinforced at the EU level if direct democratic institutions are available. European integration might be postponed for a longer time. The democratic deficit in the EU is nonetheless unacceptable. It is thus time to develop a European democratic culture.

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