

# **Understanding the EU Policy Portfolio: Conceptualising a Dynamic Model of Integration**

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## **ABSTRACT**

This paper suggests that EU's policy portfolio resembles the outcome of interstate bargaining predicted by federalist theory. We conclude that federalist theory, when combined with economic integration theory, is a robust tool for conceptualizing the EU policy portfolio. The result is a dynamic model, which we call 'federal integration'.

## **INTRODUCTION**

The EU's policy portfolio is extensive, with just about every area of public policy featuring in at least some way. It is, furthermore, highly complex, most particularly perhaps in respect of the varying degrees of EU involvement, which range from the extensive – as with, agriculture, fishing, and external trade – to the marginal – as with education, health, and social welfare.

The complexity of the EU's policy portfolio, which only seems to be increasing, poses challenges for students of the European Union. How is the nature of the EU's extensive and complex policy portfolio to be explained? Is there a useful paradigm on which we could draw, and, what might be the variables we could study to enhance our ability to predict the evolution of EU policies and the parameters of EU-member state relations?

## **WHY A TREATY-BASED EXPLANATION IS NOT ENOUGH**

The contents of the EU's treaties might be thought of as being the most useful place to start an examination of why the nature of the EU's policy portfolio is as it is. Do the treaty articles not stipulate what the EU must, can, and cannot do in policy terms? Have not the treaties been quite specific as to future policies not only listing these specifically, but complete with timetables.

Unquestionably, the contents of the treaties are indeed extremely important in helping to explain the nature of the EU's policy responsibilities and activities, and in many cases, anticipated policy development. On the one hand, they can serve to prod the EU's decision-makers into policy action. It is, for example, not possible to understand the focus on economic policies, and more especially market-related policies, or of the special place of the CAP, without reference to treaty goals and stipulations. This prodding impact of the treaties has been especially effective when there has been a treaty-specified timetable for action – as with the customs union (which the EEC Treaty stipulated had to be created within 10-12 years), the SEM programme (which the Single European Act specified must be enacted by the end of December 1992), and EMU (which the Maastricht Treaty required must come into force in its third – single currency – phase by no later than January 1999).

On the other hand, whilst the treaties do not actually exclude action by the EU in any policy area, treaty provisions can make it very difficult to pursue. So, for example, the treaty requirement that EU-wide laws in such policy areas as taxation and defence can only be made if the governments of all member states agree to the contents of these laws has been a key reason why there has been but limited policy development in these sensitive areas.

But, important though treaty content is, by itself it provides only the most partial of guides to what the EU does in policy terms. There are four main reasons for this. First, the reasons for the nature of the contents of the treaties need to be explained. Why, for example, has there always been such a strong focus on market-related policies? Why have policies such as research and foreign and security policy come to be given treaty recognition? And why are such policy areas as health and education given only limited and narrow treaty recognition?

Second, several of what are now amongst the most important of the EU's policies had no specific treaty base in the early stages of their development. So, there were no articles in the Founding Treaties covering the likes of environmental and foreign policies, but this did not prevent these policies being actively developed from the early 1970s. It is true that as new policies have emerged and assumed important positions in the portfolio they have been given treaty recognition via the rounds of treaty reform that have occurred every five years or so since the mid-1980s. But whilst this process of treaty recognition has certainly played a part in shaping the nature of subsequent policy evolution, it has not, as environmental and foreign policies show, of itself been the original driving process behind the evolution: these policy areas were given treaty recognition because they already were receiving considerable policy attention.

Third, not only has the lack of an explicit treaty base not prevented policies from being developed at EU level, but the existence of a treaty base has not ensured that they have been developed. The clearest example of this is seen with transport policy, in respect of which Article 74 of the EEC Treaty said certain objectives – mainly relating to cross-border transport – should be pursued ‘within the framework of a common transport policy’. No such policy has been developed.

Fourth, where there is a treaty base for a policy area, it usually does little more than set out a few guiding principles in the most general of terms. On the bases of these principles, it is up to the EU's decision-makers to develop specific policies – and there is usually the potential for them to do so in many different ways and at many different speeds.

So, it is necessary to look beyond the treaties to explain the nature of the EU's evolving policy portfolio.

## **POLITICAL INTEGRATION THEORY**

There are well-established different theoretical perspectives seeking to provide an answer to our question. Macro-level theories—following the concept of grand theory—would include the usual dyad of neo-functionalism and intergovernmentalism. Each theory is based on different assumptions. Spillover, the dynamic element of neo-functionalism, which rests in large part on success in particular policy areas resulting in policy learning and policy transfer to other policy areas, operates in significant measure via the political actions of supranational and non-governmental actors. Intergovernmentalism's emphasis on the centrality of the state and on continued EU cooperation being a function of cost-benefit calculations by national governments leaves little doubt that policy is an outcome of member state bargaining.

A key point for many of those who view intergovernmentalism in its various forms as over-stating the policy-making dominance of national governments is that intergovernmentalism concentrates too much on the formal and final stages of decision-making. If, it is argued, attention is concentrated too much on the final decision-taking stage then an intergovernmentalist perspective is almost inevitable because national governments – operating in either the European Council or the Council of Ministers – are bound to be seen as the key actors because important final policy decisions are always taken by them and in their name (usually in co-decision with the EP when legislation is being made). But if the horizon is broadened to embrace the whole process of decision-making – which runs from policy agenda-setting through to policy evaluation – then, it is argued, the roles and policy influences of many policy actors in addition to national governments must be recognised. Moreover, it is also argued that intergovernmentalism pays too little attention to

informal integration and the constraints that such integration imposes on the formal decision-makers. For example, Wincott (1995) suggests that the SEM programme and the accompanying SEA that gave it legal force, which Moravcsik suggests were the outcome of negotiations between national actors, are in important respects better viewed as the formalisation by national governments of what had been happening in practice for some time.

Sandholtz and Stone Sweet, 1998 offer a rebranded neo-functionalism to develop a theory in which '[t]ransnational exchange provokes supranational organizations to make rules designed to facilitate and to regulate the development of transnational society' (25). In seeking to answer the question why integration proceeds faster and further in some policy areas than in others they 'look to variation in the levels of cross-border interactions and in the consequent need for supranational coordination and rules' (14).

Sandholtz and Stone Sweet (14) ask: *Why does integration proceed faster or farther in some policy areas than in others?* They tell us 'where the intensity and value of cross-national transactions are relatively low, the demand for EC-level coordination of rules and dispute resolution will be correspondingly low'. Example: The EU approaches supranationalism in the internal market because intra-EU trade and investment has grown steadily since the founding of the EEC. 'In contrast, there are few societal transactions that are impeded by the absence of a common foreign and security policy'.

But is a lack of 'societal transactions' an accurate explanation for an effete ESDP? Defense spending is an area of enormous importance to key economic actors, some of which are pan-European (even transatlantic) if not in ownership, then in joint ventures and collaborative contracting. So although ESDP is a national and

international (NATO) responsibility, trans-European corporate mergers and the European Defence Agency's (EDA) goal to Europeanise defence contract bidding would begin to create, under transactionalist theory, a more supranational policy. But can we realistically expect that transactionalist behaviour would be the impetus for a supranational defence policy in democratic systems where foreign policy is an important factor in political party competition in domestic elections? Additionally, polling results of the Standard Eurobarometer consistently indicate widespread support among citizens of member states for a European foreign and defence policy.

So, as this brief discussion shows, there are apparent holes and weaknesses in grand theory as explanatory devices of the EU's policy portfolio. So, too, are there weaknesses in meso-theories such as policy networks and institutionalism which, to be fair, are typically employed primarily to identify actors and the nature of their interactions, rather than to explain policy development in an overall perspective. Such theories do reveal something about the nature of specific policies, but have not been especially useful in explaining and predicting evolution of the overall nature of the EU's policy portfolio.

## **DEVELOPING AN ALTERNATIVE APPROACH: FEDERAL INTEGRATION THEORY**

If there are limitations with the usefulness of established mainstream theoretical work in explaining the nature of the policy portfolio, how then is extensiveness and complexity to be explained? While the market continues to be at the centre of European integration, political scientists sometimes ignore the economic logic driving integration. As long ago as the early 1960s the economist Bela Balassa observed that economic integration is both 'a process and a state of affairs': when member states choose the path of economic integration, economic determinism comes into play,

carrying the member states toward a ‘point of no return’ when economic dependence (and interdependence) in one policy area triggers economic coordination and interdependence in another. The remedy for the unanticipated side effects of integration is still more integration and an inextricable web of economic relations.

Economic integration theory, however, is not equipped to fully explain the political dimension of integration. This is where political integration theories come to the fore in assisting the ferreting out of the political and societal factors that condition and shape European integration despite the economic ‘logic’ of integration. We argue that EU policy-making processes and outcomes closely resemble the interstate bargaining predicted by federalist theory (rather than the intergovernmental bargaining of sovereign countries). We conclude that federalist theory, when combined with economic integration theory, is a robust tool for conceptualizing the EU policy portfolio. The result is a dynamic model, which we call ‘federal integration’.

## **FEDERAL THEORY**

Most of the competing explanations of European integration share a common starting point: that there is no analogue to the EU in the constellation of nation-states. The EU thus has a ‘*sui generis*’ status or, to quote European Commission President, Jose Barroso (2007), is ‘an unidentified political object’. If it is the case that the EU is an unidentified political object, established well-tested theories of state- and policy-building might appear to offer little in the way of explanatory power in the study of European policy development. But, as EU scholarship has increasingly recognised, the EU in important respects is not unique and has followed certain recognisable paths. One of these paths is arguably a federalist.



Federal theory offers another possibility for both conceptualising and predicting the evolution of the EU's policy portfolio. Scholars have long noted that the EU has federal characteristics, though most have stopped short of describing it as a federal system. But could it be that the same sort of 'intergovernmental' bargaining that takes place between different levels of government in federal systems, which over time has resulted in a general movement of policy-making powers to the centre, is much the same in substance and process as that found among EU member states? As was reported to one of the authors, for instance, after Slovenia joined the EU, members of the Slovenian government were observing (paraphrasing), 'We thought the difficulty in governing Yugoslavia lay in its ethnic composition, but the same sort of exasperating disputes and perpetual interstate bargaining that plagued Yugoslavia exist in the EU!'

Pinder (1968, 1993) and Sbragia (1992, 1993) were among the early proponents of the usefulness of federal theory in understanding the evolution of the EU. Why did they and others find it useful and why is federalist theory continuing to attract attention from at least some students of European integration? According to Burgess (2004: 25-6) 'Federalism seeks to explain political integration...as a conscious and perfectly rational goal of European national states that continue to pursue their national interests in a world of turbulent international change'. Sbragia (2007: 9) has recently commented that '...thinking of the EU as fitting within a comparative US-EU framework helps make it less 'unique' and more susceptible to the 'normal' questions of comparative politics'. And beyond EU specialists, Vincent Ostrom (1987), a major federalist theorist, who advanced the influential 'compound republic theory', has suggested its relevance for 'fashioning the institutions of government for a European community and for a European society more generally'

and a ‘useful theoretical apparatus...to think through problems and make an independent assessment of appropriate ways for addressing the problems of contemporary Europe (p. 9).’ And there are scholars—such as Kelemen (2001) who, in his study of social and environmental regulation in the EU, concludes that ‘the EU’s regulatory regime functions as a federal state’ (160)—see the EU as being quite distinctly federal, at least in some respects. Nevertheless, scholars who are sympathetic to a federalist approach are reluctant to explain EU policy-making and policy development *in toto* with federalist theory. Rather, the EU is seen as having federal ‘features’. So, for example, while Keleman (2001: 160) proposes a ‘theory of regulatory federalism’, he explicitly limits the theory to ‘regulation and (the theory) does not claim that the EU is a “federal state” in some larger sense’.

So too do we take a qualified approach here. We do not suggest that the EU is a fully-blown federal system, but we do suggest that federalist theory is an excellent paradigm to examine and explain EU policies and policy development. The learning that has taken place within federalist systems and the timing of the federalisation of politics, then, can be an invaluable guide in charting and predicting the EU’s course. This is because the EU: 1) meets the prerequisites for federalism; 2) exhibits policy-making responsibilities common to federal systems; 3) follows a similar historical development to that of federal systems.

### **Prerequisites of Federalism**

The term ‘federal’ is derived from the Latin ‘foederis’, suggesting a league or alliance among equals to act jointly in defined policy areas. Precisely what this means in practice has been much debated by scholars, with some taking a strict and indeed restrictive view and others being more flexible and being prepared to regard a range of political systems as being essentially federal in nature. Scholars, in other words,

vary in the particular prerequisites of federalism that they identify. For example, in his classic text on federalism, Wheare (1953) included amongst his prerequisites that the regional level units should share a need for a common defence and that there should have been some political association of the regional units prior to their federal union. These are prerequisites with which many scholars would not agree.

But though scholars of federalism disagree on specifics, most would subscribe to the view that there is a list of features that are at the core of federal systems. Prominent amongst these features are the following: two levels of government – one central and one regional – exercise power and authority over the same people in the same territory; in the ‘division of labour’ between the two levels, neither the central nor the regional government is subordinate; each level has a sphere of significant independent policy activity; each level is sanctioned in a federal constitution and is protected by it; neither the central nor the regional levels can abolish the other; both levels have direct power over the citizens; and there is the availability of a federal capital whose location is acceptable to potential divides within the federation. Brussels, interestingly, lies in the centre of a fault line between Romance- and Germanic-speaking Europe, just as Washington, D.C. was placed near the fault line of free North and slave-holding South and Bern a fault line between Protestants and Catholics.

There is not space in this paper to go through each of these features and systematically apply them to the EU. But even the most rudimentary understanding of how the EU is structured and operates shows it to display most, if not all, of the core federal features to a marked degree. To be sure, it might be argued that, for example, the EU’s budgetary arrangements – which puts the main responsibility for determining the size of what is a relatively very small budget mainly in the hands of

the member state governments – tilts the policy balance towards the regional level, but the EU is no different here from the fledgling years of all modern federations. But, whilst there may be characteristics of the EU that might make it less than a full federal system, that does not disqualify the usefulness of a federalist approach when trying to understand the nature of the EU's policy portfolio.

### **Policy-making Responsibilities**

In the previous section, it was suggested that the EU meets the essential prerequisites of federalism. This section explores whether the EU meets the second test of exhibiting policy-making responsibilities that are common to other federal systems.

What is the division of policy responsibilities in federal systems? Virtually all analysts have observed a similar pattern to Watts (1996) who, in an exhaustive comparison of the locus of policy in federations, showed that in most federations, foreign policy, defence, the functioning of macro-economic and monetary policies, major taxing powers, and inter-regional transportation are the responsibility of the federal government, while education, health services, social services and labour (unemployment insurance, income security, pensions), maintenance of law and security, and supervision of local governments are usually assigned to the regional level governments. However, within this general framework, there is wide variation in terms of the distribution of powers and functions. Corporate taxation, for instance, is a concurrent power in the U.S., but exclusively federal in Switzerland.

On the basis of this pattern it might be concluded that the EU falls some way short of meeting the federal model because at the central level its powers are relatively weak in respect of the policy responsibilities identified by Watts and others as being federal in character. But, whilst this observation may indeed mean that the EU is not federal in a classical sense, it is undeniably the case that the EU level does

exercise a very wide range of policy responsibilities, both on an exclusive and shared basis (see Table 1).

**Table 1: The Varying Extent of EU Policy Involvement**

<b>Extensive EU involvement</b>	<b>Considerable EU involvement</b>	<b>Policy responsibilities shared between the EU and the member states</b>	<b>Limited EU policy involvement</b>	<b>Virtually no EU policy involvement</b>
★ External trade	★ Market regulation	★ Regional	★ Health	★ Housing
★ Agriculture		★ Competition	★ Education	★ Domestic crime
★ Fishing		★ Industry	★ Defence	
★ Monetary (for euro members only)		★ Foreign	★ Social welfare	
		★ Environment	★ Civil Liberties	
		★ Equal opportunities		
		★ Working conditions		
		★ Consumer protection		
		★ Movement across external borders		
		★ Macroeconomic		
		★ Energy		
		★ Transport		
		★ Cross-border crime		

*Source:* Adapted from Nugent (2006: 388)

Furthermore, if general rules can be deduced to ascertain the most efficient level at which policy is enacted and implemented, then federalism can afford to be flexible in the assignment of policy responsibilities. On this basis, the EU's division of policy responsibilities, which reflects aspects of both public choice and liberal visions of the optimal level for where public policy should be made and implemented, can be seen as making sense. It can be so seen not least because of the heterogeneity of the EU's population, which means that relatively few goods are perceived as being collective in nature. Hence, social welfare, corporate taxation, corporate law, education, and unemployment policy properly reside at the member state rather than the (federal) EU level.

But though the EU may not be a pure federal system in policy responsibility terms, over the years it can be said to have been moving in a federal direction as it has assumed increasing roles in such classic federal-level policy areas as economic, monetary, foreign, defence, and citizenship policy areas. Moreover, in so doing it is reflecting the ‘federalism’ of citizens who, according to *Eurobarometer* findings, are increasingly lining up in a federalist manner and are revealing a federal conception in attitudes toward the role of the EU and members states in key policy areas. As Table 2 shows, in response to the question ‘For each of the following areas, do you think decisions should be taken by Nationality (Government), or jointly within the EU?’ a

**Table 2: Attitudes toward Policy Cooperation**

<b>Policy Area</b>	<b>National Government Only</b>	<b>Jointly with the EU</b>
Fighting Terrorism	16%	81%
Scientific and Technological Research	24%	71%
Protecting the Environment	28%	69%
Defence and Foreign Affairs	33%	62%
Energy	35%	61%
Support for Regions Facing Economic Difficulties	35%	60%
Fighting Crime	38%	60%
Immigration	37%	59%
Competition	34%	57%
Agriculture & Fisheries	45%	50%
Consumer Protection	48%	48%
Economy	50%	46%
Transport	51%	45%
Fighting Unemployment	58%	39%
Educational System	64%	33%
Health & Social Welfare	66%	31%
Taxation	68%	28%
Pensions	72%	25%

Source: Standard Eurobarometer (2007), No. 67

clear majority favoured 'jointly with the EU' in fighting terrorism, scientific and technological research, protecting the environment, and defence and foreign affairs. On the other hand, Europeans feel that the educational system, health & social welfare, taxation, and pensions are national responsibilities. These results demonstrate that on major governmental policy responsibilities, Europeans tend to think in terms of cooperative federalism. This would strongly suggest that Europeans do not act as if the EU as an IO, but are responding as if the EU is a federal state.

### **The Federal-Making Process**

Our third variable is 'process'—the idea that the EU is a federal system in the making. Haas and Schmitter (1964: 710) wrote that the integration process 'must show evidence of increased politicization, of shifting expectations, of adaptation by the actors to a new process of mutual accommodation'. Having established that the EU meets the first two tests of the applicability of federalist theory to European integration, in general and the policy portfolio in particular, a final test remains: Are there similarities in the EU's federal experience with modern federalist states?

Burgess (2004, 25) writes that:

When we focus upon European integration, the empirical context looms particularly large because it has transcended the familiar level of the nation state to the level of an unknown "ever closer union among the peoples of Europe" that currently includes intergovernmental, supranational, federal, confederal, and functional elements. This hybrid Europe, with its complex institutions, structures, and procedures that defy precise definition and categorization in conventional political science terms, is widely deemed today to be moving toward that *finalité politique* that looks increasingly like a federal destination. Step by step, in piecemeal, incremental fashion, the European Community has evolved into the EU, which is now on the threshold of a constitutional and political Europe that is nothing less than a federal Europe, but not necessarily a federal state as we know it.

Burgess captures the political dynamic of integration as a *federal process*, which is very close to Elazar's notion of 'thinking federal'. The process is critical to taking us from the snapshot notion of political integration to the dynamic or process approach. Indeed, a principal stumbling block in the application of federal theory to understand European integration in general, and the EU's policy portfolio in particular, presupposes that European integration follows a well-trod path of modern (federal) state-building. Proving this is largely an empirical matter that is predicated on three rather distinct notions of 'federalism' in the European integration literature—the federal 'idea', constitutional federalism, and the federal process. The federal idea—which involves such questions as the building of dual nationalities (European and nation-state) and institutional reform (bi-cameralism with a directly-elected Council constituted along the lines of the German *Bundesrat* or the U.S. Senate)—is an interesting literature, but inappropriately normative for policy studies. Constitutional federalism (cf. Dicey 1915—federalism as a legal compact) is best framed in legal studies, typically as an examination of the evolution of the *acquis communautaire* through case exegesis of ECJ rulings.

An inquiry of the federal *process*, on the other hand, should offer insight into the evolution and location of the policy portfolio. Friedrich (1968: 7) argues that any definition of federalism 'should not be seen only as a static pattern or design, characterized by a particular and precisely fixed division of powers between governmental levels'. Rather, to fully comprehend federalism, it must be understood as a *dynamic process*. Zines (1991, 101) reminds us that 'If the history of federations teaches anything about the making and the life of constitutions, it is that the predictability sought from form yields to spontaneity and inventiveness in practice.'



If one views European integration as a federalising *process*, the dynamic element of time is introduced to the inquiry. This brings us to our final test of whether federal theory is appropriate to understanding the EU policy portfolio by comparing the EU with that of modern federalist states. When European integration is examined as a dynamic process in the continuum between confederation and unitary organisation, the limitations of intergovernmentalism, neo-functionalism, and critical political economy as explanations of European integration become obvious: not only can they be somewhat static, but they are divorced from theories of nation-state formation and territorial organization.

An important aspect of the dynamic process nature of federalism is the way in which the amending feature of federal constitutions coupled with judicial review combine to form two powerful built-in mechanisms for change. Austria, Canada, India, and the U.S. have supreme courts; Belgium, Germany, and Spain (which political geographers often classified as federal) have constitutional courts; and, Switzerland has a tribunal. The Swiss case is unique in that the tribunal's power is limited to judicial review of cantonal laws: the validity of federal laws is put to citizen referendum, taking on the role of 'adjudicating umpire' (Watts 1996, 92 & 93). In addressing the issue of the role of the federal courts in the federal process, Watts (1996, 93) writes:

The question is sometimes raised whether federation as a form of government results ultimately in rule by judges rather than by elected representatives. There is some element of truth in this and it is reinforced where the judges also interpret a set of fundamental individual and collective rights in the constitution. This has sometimes led to the advocacy of the popular election or recall of judges, although that has not yet been applied to the most senior constitutional court in any federation.

Indeed, the ECJ is often cited as a federalising institution in the EU. Zines, for example (1991: 102), has argued that many of the problems that the ECJ has been

called upon to adjudicate are similar to those once presented to the federal courts in Australia, Canada, and the United States in their formative years. The ECJ's early rulings established the primacy of EU laws, signalling that the treaties would be dealt with not as international agreements between independent signatories but as a European (federal) constitution. The ECJ mirrors the experience of the federal courts in the British-created federations such as ruling on concurrent powers, the reserve powers of the state, the necessary and proper notion (implied powers), and expanding the size of the commercial market. Goldstein (2001: 16-17) concludes that 'In effect, the ECJ transformed this international treaty into a higher-law constitution and thus transformed the EC into a nascent federated policy'

Nevertheless, one can only go so far by citing the federalising dynamic of the ECJ. So while Stone Sweet (2000: 1) argues that the ECJ 'has fashioned a kind of supranational constitution, and this law binds governments and the parliaments they control,' one must be careful to delineate the substantive difference in the cases that the ECJ is permitted to hear (the single market) and those that have appeared before, for instance, the U.S. Supreme Court since its inception. The ECJ has not dealt with slavery, land claims of an indigenous people, school prayer, abortion, affirmative action, flag burning, homosexual relations, the right to counsel, and the hundreds of other civil liberties and civil rights cases that have shaped American federalism. Even here, however, the ECJ's reach is expected to expand with the annexation of the *Charter of Fundamental Rights* to the Lisbon Treaty, with the ECJ signalling as long ago as the Nice Treaty that the Charter embodied rights that had increasingly come to resemble a body of European common law. In sum, while the ECJ's adjudication has been exercised mainly on single market-related issues (much of the U.S. Supreme Court's docket in the 18<sup>th</sup> and 19<sup>th</sup> Centuries), US federal courts have ruled on the

constitutionality of state laws, federal laws, and executive orders, disputes between the states, and on all aspects of governmental power including the single market, civil rights, and civil liberties.

Governing in federal systems is very much a matter of bargaining and compromise among constituent units. As the lesson of American federalism especially illustrates, the tendency of people to look to shift policy to a higher level of government in time of crisis, as happened in the abandonment of the Articles of Confederation for the U.S. Constitution, is well established. The EU is no exception to this pattern as demonstrated by the Europeanisation of food safety policy and in the current Commission proposals drawn from the de Larosière Report (2009) on financial regulation.

If we return to the notion of federalism as the most geographically expressive form of government, we could conjecture that perhaps the experience of the 20<sup>th</sup> Century European civil wars produced a Europe of realists who understood very well that they did not need to *like* each other in order to profit from a quasi-federal arrangement. Federalism, then, as Friedrich (1968, 7) argues, might best be viewed as ‘the *process* (emphasis added) of federalizing a political community’.

In conclusion, federalism offers an intergovernmental perspective, but one grounded in a vastly different perception of ‘intergovernmental’. Utilising federal theory, designing studies to explore the bargaining of member states within a federal state paradigm produces far different policy predictions than a theory that presupposes member states operating in an anarchic international system.

Federal theory, however, lacks an important ingredient to understanding and making predictions about the evolution of the EU policy portfolio. This is because

concentrating as it does on intergovernmental bargaining, it does not address the issues which draw together and increasingly bind constituent units.

Indeed, in the earliest years of integration studies, scholars recognised that both economic and political factors were usually important in stimulating integrative processes, though they did not always agree on their relative importance. So, for example, Bela Balassa, the author of modern economic integration theory, noted in the early 1960s:

In some political circles the economic aspects are deliberately minimized and the plan for economic integration is regarded merely as a pawn in the play of political forces. Such a view unduly neglects the economic expediency of the proposal. Even if political motives did have primary importance, this would not mean that the economist should not examine the relevant economic comparison, although the formation of the United States was primarily the result of political considerations, nobody would deny the economic importance of its establishment (Balassa: 1961: 7)

Also in the early 1960s, Haas and Schmitter (1964: 705) asked: ‘Does the economic integration of a group of nations automatically trigger political unity? Or are these two processes quite distinct, requiring deliberate political steps because purely economic arrangements are generally inadequate for ushering in political unity?’ They advanced the thesis that ‘under modern conditions, the relationship between economic and political union had best be treated as a continuum’ meaning that ‘definite political implications can be associated with most movements toward economic integration even when the chief actors themselves do not entertain such notions at the time of adopting their new constitutive charter’ (707).

However, notwithstanding such early recognitions of the importance of looking at both political and economic factors in integration models, over the years discipline-based approaches have tended to prevail. So, for the most part, political scientists do not emphasize the many economic factors constraining political

decisions while economists have tended to play down the significance of political variables. This impermeableness of theories can be explained partly by the different instruments political scientists and economists utilize in scholarly inquiry, but also by the questions they pose. Economists tend to focus mainly on seeking to establish the optimum conditions for achieving economic efficiency, while political scientists investigate the underlying power relations among member states, their agents, and societal actors. So while these two branches of inquiry have contributed significantly to our understanding of European economic and political integration, there has been an insufficient attempt to develop explanatory models that blend both the economic and political components of European integration. This is problematic for the study of EU policies and policy-making because it is not readily apparent at which level—regional, national, or supranational—policy should be created and implemented. A paradigm developed to explain the evolution of the EU policy portfolio needs to take into account of both the economic efficiency and political feasibility of a policy dilemma.

Illustrative of this point is the recurring debate among EU and national policy-makers over the appropriate governmental level to locate corporate taxation policy. Some national leaders (led by France and Germany), citing a ‘race to the bottom’, advocate the Europeanisation of corporate tax policy. Other member states (particularly Ireland, the U.K., the Czech Republic, and the Baltic Tigers) insist that corporate tax policy should remain under the sole jurisdiction of national governments. Economists focus on the extent to which governmental tax policy disrupts efficient markets. Political scientists, on the other hand, examine actor motives (among national policy-makers, European policy-makers, and interest groups), the decision-making processes (e.g. Open Market Coordination or EU

legislation?), power relations (e.g the Commission and Parliament versus the Council), and the policy outcome in the context of supranationalism and intergovernmentalism. Whether a uniform (European) corporate taxation policy is a necessary ingredient in a federal Europe, however, is left unanswered by these modes of analyses.

## ECONOMIC INTEGRATION THEORY

Writing in the early 1960s, the Hungarian economist Bela Balassa proposed a theory of economic integration. According to his evolutionary model (depicted in Table 3) European integration would proceed via a predictable path of stages marked by increased integration. Within each successive stage, more policies would be decided upon and implemented at the European level.

**Table 3: Balassa's Theoretical Evolution of Political and Economic Integration**

	Removal of Internal Tariffs	Common External Tariff	Free Flow of Capital and Labor	Harmonization of Social & Economic Policy	Single Common Currency	Political Integration
Free Trade Area	X					
Customs Union	X	X				
Common Market	X	X	X			
Economic Union	X	X	X	X		
Economic Federalism	X	X	X	X	X	
Political Union	X	X	X	X	X	X

Balassa's approach was thus very much deterministic. We can consider its usefulness in the EU context by briefly looking at the stages he identified.

## **Free Trade Area and Customs Union**

In the EEC the creation of a free trade area and a customs union were not treated as separate integrative stages, as in Balassa's model, but were, in accordance with Article 23 (1) of the EEC Treaty, developed simultaneously:

*The Community shall be based upon a customs union which shall cover all trade in goods and which shall involve the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect, and the adoption of a common customs tariff in their relations with third countries.*

This telescoping of the creation of a free trade with a customs union is the main reason the UK did not become a founding EEC member and created the rival European Free Trade Association (EFTA). The UK realised that a customs union would have much wider integrative implications that it was prepared to accept. The EEC's founders, by contrast – who were fully informed by historical knowledge that customs duties have been enormously important as a catalyst for closer union among contiguous independent states – broadly welcomed the prospect of further integrative developments.

Free trade in goods and the customs union were both achieved (for the most part) by 1968, in accordance with the timelines set out in the Treaty of Rome. The customs union was a particularly significant integrative step because it necessitated a much higher level of cooperation and agreement among its members than do free trade areas. This is so because the common external tariff (CET) that the customs union required, dictated that the EEC must have also a common external trading policy; otherwise, a CET would break down immediately if the governments of states that were subject to it were at liberty to negotiate their own terms of trade with third countries. The EU's common external trading policy – which is formally called the Common Commercial Policy (CCP) – is the most integrated of all EU policies and of

the several EU policies that are preceded by the word ‘common’ (as in *Common Agricultural Policy* and *Common Fisheries Policy*) is the one that is closest to truly being completely common: it involves the Commission acting on behalf of all member states in trade negotiations with third countries and in multilateral trade forums, though with its negotiating positions being based on mandates that are approved by the Council of Ministers and with all final ‘deals’ requiring Council approval.

The existence of the customs union has also been integrative in its impact on the policy portfolio in that it quickly played an important part – and indeed still does – in stimulating member to seek cooperation, and indeed integration, in other spheres of external relations. If the EU can be a single and powerful actor in international trade negotiations, why cannot it also be one in respect of the likes of environmental, transport and foreign policies?

### **Common Market**

The common market adds the abolition of restrictions on factor movements (capital and labour) to the restrictions on trade in goods and services which were abolished in the first stage of economic integration. The goal of the Single European Market (SEM) is attainment of the four freedoms identified in the Treaty of Rome: freedom of movement of goods, services, people, and capital. A fifth factor, entrepreneurship, is not mentioned in the Treaty of Rome, but the EU has addressed the mobility of this factor primarily in its policies promoting freedom of establishment. The common market is the EU’s signature achievement, and clearly has been important in promoting advance in such key market-related policy areas as environmental and social policy.



## **Economic Union**

This phase of integration, somewhat incongruously labelled ‘economic union’ by Balassa, involves the harmonisation of certain key economic policies (primarily employment policy and policies in some productive sectors such as agriculture and fishing), social welfare policies (pensions, healthcare), the health and well-being of citizens (consumer protection, environment, cohesion), and regional policy. Many of these are not mutually exclusive; for instance, social cohesion policy is tied to regions whose eligibility is determined by economic measures. We hinted in the previous section that as more variables are brought into the equation, pressure builds for integration in other areas. Neo-functionalists would attribute this phenomenon to policy learning, but economists such as Balassa would see this as an inexorable outcome of free trade, which shows that closer economic growth can advance such economic desirables as growth and wealth.

Applying this stage of Balassa’s model to current EU policy realities, Table 1 shows that the picture is very mixed. So, for example, regional, labour (working conditions, equal opportunities), and health and well-being (consumer protection and environmental) policies are shared between the EU and the member states, while the EU has limited policy competence in health and social welfare. Agriculture and fisheries are the most integrated sectoral policies.

A particularly interesting policy area in this context of considering the usefulness of economic theory to help explain the nature of the EU’s policy portfolio is regional policy. One of the more consistent concerns about European integration has been the existence of regional disparities as measured by labour productivity and per capita income. Common markets need to be concerned about regional disparities

because free movement of factors might, in a combination of ways: 1) disproportionately benefit wealthy regions by inducing labour and capital to flow towards agglomerated industry; 2) disproportionately benefit poorer regions by – largely in response to wage differentials – increasing demand for the underdeveloped regions’ products, attracting capital and labour, and encouraging the relocation of plants (Balassa 1961: 204). Concerns about the near certainty that some poorer regions would find it difficult to compete in an integrated market, played an important part in the creation in the 1970s of the European Regional Development Fund (ERDF).

### **Economic Federalism**

This fifth phase of Balassa’s economic integration model is equivalent to ‘fiscal and monetary federalism’. Balassa (1961) indicated that as integration proceeded and interdependencies developed an increasing number of policies would have to be dealt with in a coordinated manner. At a minimum ‘in the face of integrated commodity and factor markets, it is necessary to have accord on basic goals, understanding the evaluation of current trends, agreement on the strategy applied, and reciprocal consideration given to the repercussions of any unilateral action in the field of monetary and fiscal policy on the economies of partner countries. These common objectives are likely to include full employment, price stability, balance-of-payments equilibrium, and growth’ (p. 268). Most observers would agree the growth objective – much of which is embodied in the Lisbon Strategy – has become central to EU policy thinking and planning.

Writing about fiscal and monetary federalism, Balassa believed that both fiscal and monetary union would need to proceed simultaneously. ‘Concerted action’

cannot be restricted to, for example, the monetary field ‘partly because integration impairs the effectiveness of unilateral fiscal measures, too, and partly because the combined application of monetary and fiscal policy is likely to be more effective than the employment of only one of these policies’ (Balassa, 1961: 270). Clearly there has been only a very partial such joint movement forward in the EU: the instruments of fiscal union are very weak and cannot be used in a Keynesian fashion to smooth out cycles in the European economy: there is an integrated monetary system, but it does not include, and has no foreseeable prospect of including, all EU member states. Arguably, both of these weaknesses have resulted in very damaging policy consequences.

### **Political Union**

Political Union is quite simply a federal system. Quite what is to be understood by a federal system has already been considered in the paper, so suffice it to restate here that though the EU may not be fully federal – it does not, for example, have a European police authority, a European army, or a constitution – it is much more federal in character than is often recognised.

In Balassan terms, political unions emerge gradually in response to a build-up of inter-connected factors. So, for example, an ostensibly economic goal—free movement of labour—cannot neatly fall into the common market phase because people cross borders not only to work and to tour, but to engage in illegal activities, to escape arrest and prosecution for crimes, and to take advantage of more porous borders to enter the EU without the proper entry visa. Accordingly, the virtual complete dismantling of internal borders in the EU – especially for Schengen countries – has opened up a need for a wide range of common justice and home

affairs policies. And, naturally, an expanding policy portfolio requires an increasingly strong political system, which since the mid-1980s has been brought about in each successive round of EU treaty-making.

## **APPLYING A FEDERAL INTEGRATION APPROACH: THE CURRENT FINANCIAL MELTDOWN**

We have argued that the steadily expanding and increasingly differentiated nature of the EU's policy portfolio can be understood with a model that combines economic integration theory and federal theory. Our position is that federalism describes, informs, and explains EU policy-making in two ways: 1) in terms of the bargaining that takes place between member states within what is in many key respects a federalist system (rather than an anarchic state system); and 2) by historical comparison of similar circumstances confronting federal systems, and their respective policy outcomes. Understanding is further advanced by linking the federalist approach to the Balassa economic model which lays out a sequencing of integration policies.

It seems to us that the recent developments at the EU level in respect of tightening up financial regulation in the wake of the credit crisis provides such an instance of how economic theory can help to explain this coupled with federal experience in constructing such a regulatory system. As in any federal arrangement, member states will enjoy competitive advantages, or seek to gain wealth even if this is and likely to be at the expense of their partner states. This is inevitable behaviour, and, indeed seen by free market liberals as a desirable feature of federalism. The point here is that the free movement of capital initiated in the common market phase

had to depend upon the quality of the national regulation in other member states. Naturally, this is a recurring problem when actions taken by companies in one member state negatively affect the economies of others. Meanwhile, member states hosting these companies prefer to maintain regulatory control rather than surrender it to the central authority, while free market liberals prefer national regulation so as to enable the financial industry to vote with it feet.

An analysis of European financial market regulation can draw upon the many interesting parallels between the EU and the US in respect of the regulatory role of Washington, and increasingly that of Brussels. While some of the impetus for regulation can be seen as institutional opportunism, especially on the part of the Commission, it can also be understood as the optimal level through which governments can tackle market failure, and as Barosso himself has suggested in a series of press conferences and releases beginning in the fall of 2008, the internal market is the bedrock of European integration. This is a classic illustration of Balassa's argument: to preserve the internal market (prevent a relapse into national protectionism), the EU would need to agree to financial regulation, and, thus move beyond negative to positive integration.

The de Larosière Group (2009), a high-level reflection group chaired by the former governor of the Bank of France and managing director of the IMF, was convened at the request of the Commission, and charged with examining the cause of the financial crisis, and propose recommendations for developing a more effective system of financial supervision. The de Larosière Group proposed increased supervision at both the macro- and micro-levels. To improve macro-level prudential supervision, the Group recommended replacing the Banking Supervision Committee (BSC) of the European Central Bank (ECB) with a new committee called the

European Systemic Risk Council (ESRC). The ESFS would be a decentralised network comprised of:

- existing national supervisors who would continue to carry-out day-to-day supervision;
- three new European Authorities would be set up with the role coordinate the application of supervisory standards and guarantee strong cooperation between the national supervisors;
- Colleges of supervisors would be set up for all major cross-border institutions.

The **Supervisory Colleges** would be responsible for supervising all major cross-border financial firms in the EU by 2009. This might encompass at least 50 financial institutions having a significant market share in another member state.

The current 'Level Three' Lamfussey Committees [the three voluntary standards-setting bodies in Europe: the Committee of European Banking Supervisors (CEBS), CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) and Committee of European Security Regulators (CESR)] would in the first stage take on supervisory powers (2009-2010), and, in the second stage (2011-2012) become **European Authorities** (EU regulatory agencies) for each of the major financial sectors: a European Banking Authority (EBA), a European Insurance Authority (EIA) and a European Securities Authority (ESA). The Authorities would advise the Commission on regulatory and other issues, defining overall supervisory policies, convergence of supervisory rules and practices, financial stability. Quoting from the de Larosière Group's Report:

Authorities would have the following key-competences:

- i) legally binding mediation between national supervisors;
- ii) adoption of binding supervisory standards;
- iii) adoption of binding technical decisions applicable to individual financial institutions;
- iv) oversight and coordination of colleges of supervisors;
- v) designation, where needed, of group supervisors;

- vi) licensing and supervision of specific EU-wide institutions (e.g. Credit Rating Agencies, and post-trading infrastructures);
- vii) binding cooperation with the ESRC to ensure adequate macro-prudential supervision. (National supervisory authorities should continue to be fully responsible for the day-to-day supervision of firms.)
- viii) licensing and direct supervision of some specific EU-Wide institutions, such as Credit Rating Agencies and post-trading infrastructures.

The Authorities would also enjoy the highest degree of independence vis-à-vis the European institutions, which would not interfere in the internal processes and decisions of the Authorities. However, the Authorities would be accountable to the Council, the European Parliament and the Commission and report formally to these three institutions on a frequent basis. The Authorities would be managed by a board comprised of the chairs of the national supervisory authorities. The chairpersons and director generals of the Authorities should be full-time independent professionals. The Authorities would have their own autonomous budget, commensurate with their responsibilities.

The report's recommendations were endorsed by the Commission on March 4, but the Commission signalled that its legislative proposals would call for immediate creation of the European Authorities, bypassing the supervisory stage. EcoFin, however, at its April Prague meeting, decided to strengthen and transform the Lamfalussy Level 3 Committees into new bodies with a specific legal framework, but signalled that discussions would need to continue with the goals of achieving compromise in advance of the June European Council Summit: (*translation*—there is opposition among some member states to regulatory bodies).

How can our model be brought to bear on this unfolding policy issue?

The Balassa model would predict that if the integration model was proceeding through the stages he identified that a firm regulatory financial system would already be in place. Clearly no such system is in place, and the reason for that lies in the differences between the member states that have not been possible to resolve in the context of federal-type negotiations: for example, the UK has consistently resisted

EU-level financial regulation because of its different style of corporate capitalism, its competitive advantage in delivering innovative financial instruments, and its more laissez faire conception and practice of capitalism. Federal theory, however, will guide us in the different preferences of member states and how these preferences will play out in the bargaining over proposed legislation. States with comparative advantage in the development of innovative financial instruments – those with a more laissez faire conception of capitalism and those that stand to gain business by offering lax regulation – will be less inclined to accept what would undoubtedly be far more intrusive regulation of financial markets.

Economic theory, would predict that this mismatch between the current stage of economic integration and the lack of a regulatory framework for financial services would result in considerable economic difficulties, much as the mismatch between monetary and fiscal integration has become an increasing problem within the Eurozone. Bringing the mismatch into line will depend upon the willingness of the federal partners to realize that compromise is necessary for the larger success of the federal project: a willingness that is always more likely to emerge in crisis situations.

The frustration of Europe's weak and uncoordinated response to the financial meltdown as compared to the robust response in the US (particularly galling given that Europeans lay much of the blame for the crisis to lax US regulation) has been reflected in commentary and analysis over the past couple of months, with various proposals such as floating of European bonds that would give the EU some ability to employ fiscal measures to tackle the crisis on a European level. At the same time, powerhouse Germany is naturally reluctant to stimulate its economy when it will benefit Italians and French, whose products Germans will purchase. Hence, the EU finds itself in a fiscal trap—the EU budget too small to make an appreciable



difference in stimulating the economy and member states reluctant to borrow money to stimulate their national economies because they cannot ensure that stimulation will benefit their residents. The competition policy rules (witness the Commission's request of the governments of France, Italy, Spain, and Sweden to explain their auto company bailouts) offer little room for manoeuvre, or, at least require member states to explain the national emergencies which would permit the suspension or lightening of competition rules.

Another advantage of the federal integration model for understanding the evolution of and the component elements of the EU policy portfolio is its comparative value. For example, what regulatory policies have federal states elsewhere been able to adopt that provide some measure of protection in their internal markets? These policies may be next in line for EU decision makers to adopt so as to be able to protect the integrity of and further develop the internal market.

## **CONCLUSION**

Notwithstanding its usefulness, Balassa's model is first and foremost a theory of economic integration. It predicts that once member states choose the path of economic integration, economic determinism comes into play, carrying members toward a point of no return with economic dependence in one area triggering the necessity for economic integration in another. The game of 'chicken' member states are playing in the current financial crisis—stalling of stimulus packages—and the prisoners' dilemma—bailouts of automobile companies that are member state based in name and identity only—attest to the ineffectiveness of competitive game playing in the inextricable web of European economic relations that defies unravelling by economists and seasoned policy-makers. Standing in the eye of this financial

meltdown, it is reasonable to conclude that there is something to the notion of entangled economic linkages, where a decision to integrate in one area carries with it unanticipated side effects that are remedied only through further integration.

Yet despite the seemingly inexorable nature of economic integration and the usefulness of the economic model in helping to explain the nature of the EU's policy portfolio, politics has a way of derailing 'rational' policy. In spite of the unfinished common market project – as witnessed for example, by the ways in which energy, transportation, and services are all still largely operating under national rules and enjoying domestic protection – most member states 'jumped' a stage when they formed the eurozone (economic federalism). Similarly, the EU's substantive policy in the field of justice and home affairs (political union) leapfrogged corporate taxation (economic federalism). At its most simplest, the key relationships in this federalist system are that federal level institutions of different sorts, but including what are commonly-referred to in the EU context as supranationalist institutions do much to set the framework of policy discussions and negotiations, but the ultimate decisions are taken by the constituent units.

Thus, though it is very valuable as an explanatory device, Balassan economic integration theory is not equipped to fully explain the way in which national and EU policy-makers and societal actors have conditioned and shaped the integration process. For a more rounded account we need to combine federal integration with Balassa's model of economic integration. This conceptual model that combines the theories of economic integration and federalism enables us to chart the EU policy portfolio dynamically: hence '*federal integration*'.

We are suggesting that the bargaining between the constituent governmental units (the member states in the EU context) is actually much more resonant of the

nature of the bargaining process in federal systems than has been recognized. Further, Balassa's economic integration theory is very useful in helping to explain at least why some issues come to be considered to require policy action at the EU level.

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