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The EU-Member State Relationship as a Principal-Agent Problem

by

Endre Orbán*

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Abstract

Ever since the European Union came into existence many theories have addressed the state of European integration. This paper tries to offer a further interpretation building on the principal-agent concept. The basic idea is expressed by the dilemma whether the EU should exclusively be seen as an agent of the Member States, or the situation is much more complex. The paper is going to detect three types of agency relationships within the European Union, and presents legal and political solutions of the founding treaties which aim to tackle the agency issues. Furthermore, the study analyzes two fundamental causes for the complexity of the European Union – Member State relationship. One of them are the shortcomings of the EU bureaucracy; the other cause – postulating the European Union as a value community – seems to have its current engine in Central Europe, namely in Hungary and Poland.

Key-words

European integration, value community, interest community, principal-agent problem

1. Introduction

Many theories of integration (see Azoulai and Dehousse 2012: 354) have been developed in order to describe the structure and the evolution of the European Union[I] and many of them focus on the federal aspect of the European Union's structure (Burgess 2006: 226; Schütze 2009: 346; Millet 2012: 53). The roots of the issue have a long history. The measure of the integration on a virtual scale, having two extremes (intergovernmentalism *versus* federalism), has been debated for quite some time (e.g. Bickerton 2012; Van Middelaar 2013: 181). Lately, new centripetal forces such as the Brexit or the emergence of populist politics (Corrias 2016: 6. Müller 2016) keep the debate on the agenda.

It has been an evergreen topic and it can be recognized either as a competence debate (Craig 2004: 323) among the different levels of the integration, or as the question of power balance among various European institutions. Accordingly, it has an essential relevance which institution becomes the dominant player in different periods of the integration, such as the European Parliament having a federalist character, or the inter-governmentalist European Council. In this regard it is important that institutions of the European Union should not be treated as a whole. While the Council and the European Council can be evaluated as the playground of the inter-governmental debates, the Commission and the Parliament play an important role in the relationship structure concerning the EU and Member States. In this regard, the Court of Justice of the European Union [CJEU] has to be taken totally apart as it plays the arbiter role in between the Member States, between the institutions and between the Member States and other EU institutions in both directions, too.

In the background of the *sui generis* nature of the EU there is a relevant pair of concepts which might be interpreted as two different visions or paradigms:[II] the European Union as an *interest community* and its perception as a *value community* (Bogdandy 2019). Can one say that the EU is on the way from the former to the latter? Or, is it already in the latter phase? Or, is this only an artificial binary code as the values and the interests are interrelated from the very beginning? The aim of this paper is to keep analytically apart the two concepts in order to illustrate a paradigmatic shift in the EU-Member State relationship. Therefore, the paper

operates first with the concept of interest community presupposing the dominance of the Member States; and later, with the introduction of the value community concept, it outlines the complex nature of the EU-Member State relationship arising from the so-called *sui generis* structure of the European Union (Schütze 2018: 263).

In order to illustrate the complexity of the relationship, the article is going to use the principal-agent problem as an analytical tool. This will be presented in Section B. Building on this law and economics perspective, section C aims to identify three different agency relations within the European Union: between Member States and EU institutions and *vice versa*, and among the Member States themselves. Furthermore, section D aims at analysing the founding treaties currently in force, in order to trace the disciplining strategies attempting to mitigate the agency issues. Section E on the one hand argues – through a case study concerning Hungary – that legal mechanisms prevail over governance strategies, and on the other hand – through a case study focusing mainly on Poland – it presents the value community of the EU in action. Section F concludes the paper emphasising the special role of the CJEU as an arbiter in all three agency relations within the EU.

2. The Principal-Agent Problem

The concept of the principal-agent problem comes from microeconomics, and, as many concepts of similar origin, it might be fruitfully applied in legal affairs (Cooter and Ulen 2004: 15). In order to enlighten the issues arising from the agency relationship, one must take a glance at the idea of perfect competition which presupposes a special information structure of the market, where buyers and sellers have perfect knowledge about prices and quality, implying that prices reflect the quality of the goods. Therefore, poor quality goes with low prices, while high quality induces high prices. In contrast, in reality one of the parties knows more than the other and this leads to so-called *asymmetric information*. In order to overcome this problem, buyers might apply different forms of signalling such as warranty (Pindyck & Rubinfeld 2008: 617).

The situation is similar in the case of a principal-agent relationship where the agent is an individual employed by a principal to achieve the principal's objective (Armour et al. 2009: 35). The problem of asymmetric information appears already when principals hire their agents and they have to rely on different quality signalling characteristics such as their education level. In addition, principals (e.g. owners) cannot always completely monitor their agents (e.g. employees) and the acting employees are also better informed than their principals. In such a situation it might happen that agents have an incentive to pursue their own goals, rather than the goals of the principal.

A similar feature appears in private enterprises having a diversified ownership structure, but the firm itself is actually controlled by the management and the managers' goals may deviate from those of the owners (Armour et al. 2009: 36). Since monitoring the management is costly (the oversight is difficult), there is a need for an incentive structure that rewards the outcome set by the principals and thus mitigates the principal-agent problem.[III]

The basic idea of asymmetric information and conflict of interests illustrated above applies practically to all principal-agent relationships. The theory was already fruitfully used to examine the role of direct democracy in order to reduce the potential risks of representative democracies where citizens are to be considered the principals of the governments (Matsusaka 2005: 185). And now, the underlying idea of this study is to take a look at the EU as a huge, multinational enterprise and to apply the principal-agent theory in order to assess its composition and structure.[IV]

3. Three Agency Problems

3.1. The EU as a Contract

As a starting point, the founding treaties of the European Union can be evaluated as a functional constitution creating a multilevel governance structure by allocating different competencies between the supranational level and the Member States (Isiksel 2016: 19.; Bogdandy 2010: 1). Translating this to a law and economics approach, the founding treaties can be conceptualized as contracts signed by contracting parties (Voigt 2012: 13). As a trace of

this interpretation, the first article of the Treaty on the European Union (TEU) declares that '[b]y this Treaty, the *HIGH CONTRACTING PARTIES* establish among themselves a EUROPEAN UNION, hereinafter called "the Union", on which the Member States confer competences to attain objectives they have in common.'[V] Accordingly, from the point of view of the Member States, the European Union can be described as a contract signed by more partners, and as a constructed representative along the lines of an agency relationship. Consequently, the EU means both a relationship structure among the Member States and also a set of actors (institutions) established by the treaties.

However, if one perceives the institutions of the EU as an agent constructed in order to represent the interests of the Member States, then, similarly to its 'enterprise' counterparts,[VI] the EU also carries an implied moral hazard: the agency problem. The question might arise therefore whether the institutions of the EU counteract the interests of Member States, its principals in the given framework.

3.2. Relationship among the Contracting Parties

Contrary to the basic model where there are only one principal and one agent, the situation becomes more complicated with a multiplicity of principals. The multiple and diverging interests of the many contracting parties go together with high coordination costs that might lead to the simplification of the decision-making rules. In such a situation it can be questionable whether pursuant the action of the agent none of the principals can be worse off (*Pareto criteria*), or it is enough if the gains of an action for some principals outweigh the loss for the rest of the principals (*Kaldor-Hicks criteria*) (Cooter & Ulen 2004: 58).

As it can be seen in the case of the EU, the strictly intergovernmental areas apply the Pareto criteria as all the principals have veto rights.[VII] However, the so-called ordinary legislative procedure which can be considered as being the typical decision-making procedure within the European Union follows the Kaldor-Hicks criteria. The reason why it has become typical might be in close connection with the heterogeneous preferences of the many participants, resulting in huge coordination costs. This might be an explanation why there is a correlation between the widening and the deepening of the European Union: as the number of

the Member States grew, the criteria of unanimity was more and more difficult to maintain since the many veto rights could paralyse the functioning of the institutions (Orbán 2014: 111). The shift toward a decision-making procedure based on Kaldor-Hicks criteria, however, opens up a second type of principal-agent problem: the issue of the relationship among the Member States that can be interpreted as a sort of a majority-minority relationship reflected by the weight of the Member States having different size populations (Bunse and Nicolaidis 2012: 249). [VIII]

3.3. Janus-Faced Actors

Up to now two agency relationships have been identified: the first between the Member States as principals *vis-á-vis* the institutions of the European Union as agents, and the second among the Member States having diverging interests. However, in the case of the European Union there is a third type of principal-agent problem that blurs the whole relationship structure.

The third type of agency relationship questions the clear principal role of the Member States and the pure agent status of the EU institutions as at the end of the day the relationship between the EU and the Member States has seemed to alter along the functioning of the Union. One can name this phenomenon *'the paradox of integration'*, retraceable to two fundamental causes: indirect bureaucracy and the postulation of the EU as a value community.

A. Indirect Bureaucracy

In order to indicate the first fundamental cause, one might think about a couple of examples. For instance, if one examines issues of regional policy, or the area of freedom, security and justice, it can be seen that the administration of the Member States plays a major role at the implementation phase of the policies. At EU level, besides the outstanding role of the European Commission as the 'guardian of the treaties', there are only a few coordinating and controlling mechanisms such as OLAF or FRONTEX. For example, article 17 TEU states that the Commission shall ensure the application of the Treaties and of measures adopted by the institutions pursuant to them; it shall execute the budget and manage programmes; it shall

exercise coordinating, executive and management functions, as laid down in the Treaties. There are a few other exceptions as well[IX] but direct administration is still exceptional within the EU and the general rule is the indirect (or subsidiary[X]) administration carried out by the administrative bodies of the Member States.

This sort of mechanism is supported by article 1 TEU, declaring that EU decisions are taken as openly as possible and as closely as possible to the citizens. Paragraph 3 of Article 4 TEU states that the Member States shall take any appropriate measure, general or particular, to ensure fulfilment of the obligations arising out of the Treaties or resulting from the acts of the institutions of the Union. As a consequence, the Member States shall facilitate the achievement of the Union's tasks and refrain from any measure which could jeopardise the attainment of the Union's objectives. Regarding administrative cooperation, Article 197 TFEU explicitly declares that effective implementation of Union law by the Member States shall be regarded as a matter of common interest. Therefore, Article 291 TFEU emphasizes that Member States shall adopt all measures of national law necessary to implement legally binding Union acts.

In addition, a similar mechanism holds for the judiciary. The European Union itself is a legal system[XI] enforced by a network of courts, culminating in a body based in Luxembourg. From this perspective, the courts of each Member State act as Union courts[XII] when they apply EU law under the guidance of the CJEU.[XIII] And accordingly, Article 19 TEU – which plays a very crucial role concerning the development of European legal order these days[XIV] – states that 'Member States shall provide the remedies necessary to ensure effective legal protection in the areas covered by Union law'.

When it comes to assessment, one might observe that it is logic that the functioning of the EU relies on the administration and the judiciary of the Member States. This mechanism seems to be indispensable as many times policy implementation and jurisdiction could not be carried out effectively through the EU institutions. However, all this means that in these spheres of action when the EU can solely rely on the Member States, the EU becomes a sort of principal who builds up monitoring-coordinating mechanisms to oversee the actions of the Member States.

B. The EU as a Value Community

The second fundamental cause why it seems that the EU has gained the role of a principal goes back to its nature. Namely, postulating the EU as a value community makes it a common reference point as holder of specific values. In this regard, it is fair to say that interpreting Article 2 TEU is the 'Gordian knot' of the European constitutional law and accordingly scholars have already pointed out that this very Article is the core of the European multilevel constitutionalism (Kelemen and Pech 2019).

On the one hand, EU values are oriented towards candidate countries as Article 49 TEU states (Kochenov and Dimitrovs 2021). Thus, for example, the operation of EU law has hitherto been based on the basic hypothesis that the legal systems of the Member States ensure the independent functioning of the courts of the Member States (Lenaerts 2020: 29) and this institutional setting has been examined in the context of the accession conditions, too. On the other hand, Member States have to comply continuously with the common 'rules of the game' (Lenaerts 2020: 29) and based on that EU institutions might formulate normative expectations *vis-á-vis* the Member States. This is why the institutions of the EU started to hold Member States responsible for infringing the principle of the rule of law and other common values. To this viewpoint significant contributions have been added by Central Europe. Important steps toward this development have been the Tavares and the Sargentini Reports adopted with an eye to Hungary[XV] or the rule of law procedure carried out against Poland.[XVI] In these cases EU institutions clearly behaved as principals who attempt to discipline their agents and have been trying to find an answer to the so-called 'Copenhagen dilemma' (Müller 2015: 141).

The issues concerning the EU values (Jakab and Kochenov 2016) and the current debates on the justiciability of Article 2 TEU[XVII] have created a need to rethink some core elements of constitutionalism: the concept of the European Legal Space (Harding 2000: 129-130) requires a minimum 'Europeanization' of the basic constitutional principles as the General Affairs Council Conclusions noted in 2014. Parallelly, the comparative work of the European Commission for Democracy through Law (Venice Commission) thrives to identify common European standards and the Rule of Law Checklist[XVIII] is an important example of that. In addition, there are other tools and academic reflexions as well e.g. the EU Justice Scoreboard,

the new emphasis of CJEU on Article 19 TEU,[XIX] the further development of the notion of EU citizenship which has evolved from the right of workers to free movement to an EU level fundamental political right[XX] or the idea of the so-called 'biting intergovernmentalism' which is based on the second type of agency relationship (Kochenov 2015).

To sum it up, at this stage of the integration the construction of the EU as a whole has reached a particular junction: the roles are 'doubled'; both the Member States and the institutions of the EU are principals and agents of each other, and here lies the paradox of integration. This observation might be in connection with to double sovereignty thesis of Habermas (2012: 1-11) who deduced his theory from the interpretation of EU citizenship, which provides the citizens a dual capacity to act as EU citizens and Member State nationals at the same time.[XXI]

4. Disciplining Strategies of the Two-Way Agency Relationship

Nevertheless, the case of the European Union is unique and very complex. The *sui generis* character of the EU makes it possible to use the 'federal' *adjective* as a structural attribute even if one cannot describe it with the *noun* of federation (Riker 1964: 11; Lenaerts 1997: 747-749; Oeter 2010: 59-62). The most significant challenge upon such a composition is that both participating layers might feel strong incentives to undermine the functioning of the whole system (Kelemen 2007: 53). The supranational level might tend to overstep the competences conferred on the EU,[XXII] while the Member States might abandon their cooperative attitude in order to shirk their obligations. In addition, as one could see above, at the end of the day both the Member States and EU institutions might behave as principals in different situations. These potential phenomena highlight the importance of the different procedures of conflict resolution and the principles guaranteeing the EU's structural integrity. Therefore, the question arises: how is this complex relationship structure manageable with the help of different contractual safeguards?

The principal-agent link generates risks. For neutralising them relevant solutions have to be applied in order to minimise the vulnerability of the principal. Therefore, contracts normally

use different strategies which target either the strengthening of the position of the principal or the limitation of the agent. In the following section I am going to build on the classification of John Armour, Henry Hansmann and Reinier Kraakman, and I am going to analyse and detect the different solutions applied in the founding treaties.

There are two different groups of strategies which aim to address the issues.[XXIII] The *regulatory strategies* are prescriptions of behaviour with an authority (e.g. a court) who is authorised to determine a non-compliance behaviour. The second group is that of the *governance strategies* which aim to facilitatate the principal's control over the agent's behaviour. In the latter case the principal determines the non-compliance behaviour.

	Regulatory	Regulatory	Governance	Governance	Governance
	Agent constraints	Affiliation terms	Appointment rights	Decision rights	Agent incentives
Ex ante	Rules	Entry	Selection	Initiation	Trusteeship
Ex post	Standards	Exit	Removal	Veto	Reward

Table 1: 'Strategies for Protecting Principals' (see Armour et al. 2009: 39)

4.1. Regulatory Strategies

A. Agent Constraints

The most obvious behaviour regulating tools are the rules and standards. Rules require or prohibit a specific behaviour of the agent *ex ante* while standards leave the determination of compliance to an adjudicator (Kaplow 1992: 586).

Among the regulatory strategies the different procedures before the Court of Justice of the European Union (CJEU) have to be outlined. The founding treaties contain effective solutions for both cases when the EU institutions or the Member States are the agents. In the first case the review of legality or annulment procedure,[XXIV] and the action for a wrongful failure to act[XXV] have to be mentioned. In addition, to some extent also the preliminary reference

procedure has a judicial review function (Weatherill 2012: 213) but it primarily reveals the agent role of the Member States as regards the enforcement of EU law.

Furthermore, as for the Member States being the agents of the EU one must highlight the importance of the infringement procedures.[XXVI] These can be initiated by the Member States against each other as well, which is a legal strategy to accommodate the second type of agency relationship within the EU (Kochenov 2015). What is more, Article 260 TFEU gives weight to the judicial procedures: if a Member State fails to comply with a judgement of the CJEU, it is open to the Commission acting as the guardian of the treaties to take another action against that Member State which may result in huge penalty payments. This secondary legal procedure operates as a negative incentivizing mechanism that not only aims to reach the correction of the noncompliant behaviour of a Member State but also serves as a guarantee for the other Member States that their contracting partner will respect the rules of the game at the end of the day.

B. Affiliation Terms

The rights to enter and exit are both legal tools and they regulate the terms on which principals affiliate with agents.

As regards the entry rule, both the EU and the Member States are principals. Article 49 TEU firstly declares that the applicant State shall address its application to the Council, which shall act unanimously after consulting the Commission and after receiving the consent of the European Parliament which shall act by a majority of its members. Then it provides also that the agreement shall be submitted for ratification by all the already contracting States in accordance with their respective constitutional requirements.

The entry rule demonstrates that not only the already existing Member States but also the European Union as an entity has a principal role. Not any country is accepted to become a Member State, only those who are willing and are able to fulfil the accession criteria. In order to meet the conditions, any applicant has an extensive information disclosure duty. In addition, the procedure generates a second type agency problem as well: all the earlier contracting parties have to accept the new contracting partner. Once a country becomes a Member State, it has

the same principal rights as the other members but it also becomes an agent of the EU as it has to carry out its policies and to enforce EU law.

Contrary to this, the right to exit is a clear sign of the principal position of each of the Member States as neither the institutions of the EU nor the Member States, acting collectively, have the right to exclude any country who is already within the club. Article 50 TEU states that any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements. As a result, the right to exit can be evaluated as an *ultima ratio* sovereign right[XXVII] of the Member States aiming to try to constrain the agent behaviour of EU institutions and also the other contracting partners who may neglect its interests (de Búrca 2016: 537).

4.2. Governance Strategies

A. Appointment Rights

Among the governance strategies the appointment rights have outstanding importance. This strategy affects mainly EU institutions as agents and it is reflected by the procedures aiming at electing the leaders of the institutions. It can be evaluated as a typical *ex ante* attempt to determine the future action of the agents. However, the rules concerning the election of the president of the EU and that of the European Commission reveals again the existence of a second type of agency problem: the election does not require unanimity among the principals, therefore some of them might have less influence on future activities.[XXVIII]

The *ex post* pair of selecting the agents is the possibility of their removal. In this regard Member States have much less influence. While in the case of the President of the EU the qualified majority of the European Council can relieve him or her from position,[XXIX] the treaties do not accord such a disciplining right for the Member States in the case of the Commission. According to Article 17 TEU the selection and removal rules regarding the Commission are asymmetrical: while its President is nominated by the European Council to the Parliament, later the Commission is responsible as a body only to the European Parliament.

In the reverse manner, taking the Member States as agents, no appointment rights can be found.

B. Decision Rights

As regards the decision rights *ex ante* one should consider the initiating rights, while *ex post* the option of the veto.

Concerning the *ex ante* mechanism, Member States as principals have almost no influence on the functioning of the EU. Earlier, the Commission had monopoly right to initiate a law-making procedure. Later, the Lisbon Treaty has introduced some nuances and put the Member States into a better position accentuating their principal role. According to Article 76 TFEU the acts referred to in the chapters concerning the judicial cooperation in criminal matters and police cooperation together with the measures referred to in Article 74 that ensure administrative cooperation in the areas covered by area of freedom, security and justice shall be adopted either on a proposal from the Commission or on the initiative of a quarter of the Member States. The new feature can be interpreted as a compensation for the deepening of the European integration as after the entry into force of the Lisbon Treaty almost all elements of the area of freedom, security and justice are decided in ordinary legislative procedure.

In this regard, another element of the Lisbon Treaty can be assessed as a compensation for the further integration: the so-called subsidiarity procedure. As a federal principle, subsidiarity has already been introduced at the birth of the EU as a sort of counterbalance of the integration aiming to protect the sovereignty of the Member States (Estella 2003: 179). In addition, the new procedure described in Protocol No 2 allows the national parliaments to signal if they consider a 'draft legislative act' to be beyond the scope of competencies of the EU institutions (Jancic 2015: 940). This can be evaluated as a sort of *ex post* veto mechanism even if its effectiveness is questionable.[xxx] On the one hand, in the political sphere, the horizontal communication among the national parliaments seems to be slow and they have never reached a so-called 'orange mark' since the introduction of the subsidiarity mechanism in 2009. On the other hand, subsidiarity could function as a legal strategy as well but court litigation has not achieved spectacular successes either. It soon became clear that the CJEU

was following a restrictive interpretation, and without further analysis, came to the conclusion, in the context of a directive, that due account was taken by the EU legislator of the principle of subsidiarity. In addition, in carrying out the tests provided for in Article 5 (3) TEU, the CJEU did not undertake any quantitative or qualitative analysis.[xxxi]

In the reverse manner, taking the Member States as agents, no decision rights can be found.

C. Agent Incentives

The situation is quite different regarding agent incentives. In this case one cannot detect incentivising mechanisms *vis-á-vis* the EU as an agent. Regarding the Member States, however, the picture is more complex.

First of all, the *ex ante* trusteeship status in the case of the EU-Member State relationship cannot be conventionally interpreted. A reason for this might be that normally trusteeship would presume alternativity, the possibility to choose from among the agents but this is not the case here.

As regards the *ex post* incentives, they either motivate the Member States to fulfil effectively the policies of the EU or de-motivate them from acting opportunistically. Concerning the founding treaties, two mechanisms have to be emphasised here. The first is the excessive deficit procedure which might lead to self-disciplining measures by the Member States in order to avoid potential financial sanctions, the coercive means of remedying excessive deficits.[xxxii]

The second mechanism is the Article 7 procedure which aims to protect the fundamental values of the Union listed in Article 2 TEU. In connection with the mechanism the CJEU has jurisdiction to decide on the legality of the acts adopted but only in respect of the procedural requirements. Therefore, despite its legal formulation, the procedure can be evaluated as a rather political tool (Fekete and Czina 2015).

In this procedure the EU is postulated clearly as a value community and as a principal it becomes a reference point detached from the Member States. In addition, the procedure can be initiated not only by EU institutions but also by one third of the Member States, while the main decision under paragraph (1) – stating the 'clear risk of serious breach' of EU values –

should be brought by the Council and under paragraph (2) – finding the 'serious and persistent breach' of EU values – by the European Council. These elements point to the presence of the second type of agency relationship. Nevertheless, the whole procedure has never been fully applied, so its disciplining power can be contested.

Furthermore, it is worth to mention a third incentivising instrument, the so-called pay-for-performance strategy which is not used at treaty level but it could be found in the rules concerning the structural funds during the multiannual financial framework of 2014-2020.[XXXIII] The reason for mentioning it is a recent debate on the newest multiannual financial framework that aimed to create a connection between the respect of EU values and the reception of future EU funds. In this regard, due to the ineffectiveness of the Article 7 procedure, the European Commission has drawn up a proposal for the current financial cycle to make the granting of financial assistance subject to the rule of law. The legal basis for this is Article 322 (1) (a) TFEU, and it can be considered as a new governance strategy as not the CJEU but other EU institution shall constrain the noncompliant Member State: it is the Council that should act by qualified majority upon the proposal of the Commission.[XXXIV]

As it could be seen above, similarly to regular contracts the founding treaties do also contain many safeguards and use many strategies to mitigate the principal-agent problem in both directions. The resulting analysis demonstrates that in many cases both the Member States and the EU have their spheres of action and their tools as principals. In this regard, a key question is the efficient functioning of the mechanism. For example, governance strategies seem to strengthen more or less the Member States, but the efficiency of the tools can be questioned (e.g. subsidiarity control). Parallel with that, there is one important exception, the incentive structure, where EU institutions seem to have stronger tools that may have financial consequences, but the efficiency of those tools is questionable as well (e.g. the so-called Article 7 procedure).

In contrast, legal strategies seem to function way more efficiently which is in connection with the legal character of the European integration (de Witte 2012: 19). Regarding the legal strategies, the central role of the Court of Justice of the European Union has to be emphasised as its mission is to balance the agency problem in both directions.[XXXV] Besides the clear

functioning of the different procedures in front of the CJEU, the possibility to impose pecuniary penalties on the Member States in the context of infringement procedures under Article 260(2) and (3) TFEU provides a further strong incentivising mechanism that strengthens the efficiency of legal strategies.

5. Case Studies

The following section is going to focus on the third agency relationship, and it will present first – through the case of Hungary – the special importance of the legal strategies in comparison with other strategies and then – through the series of judgements relating to judicial independence – the value community nature of the European Union.

5.1. The 5th Amendment of the Fundamental Law of Hungary

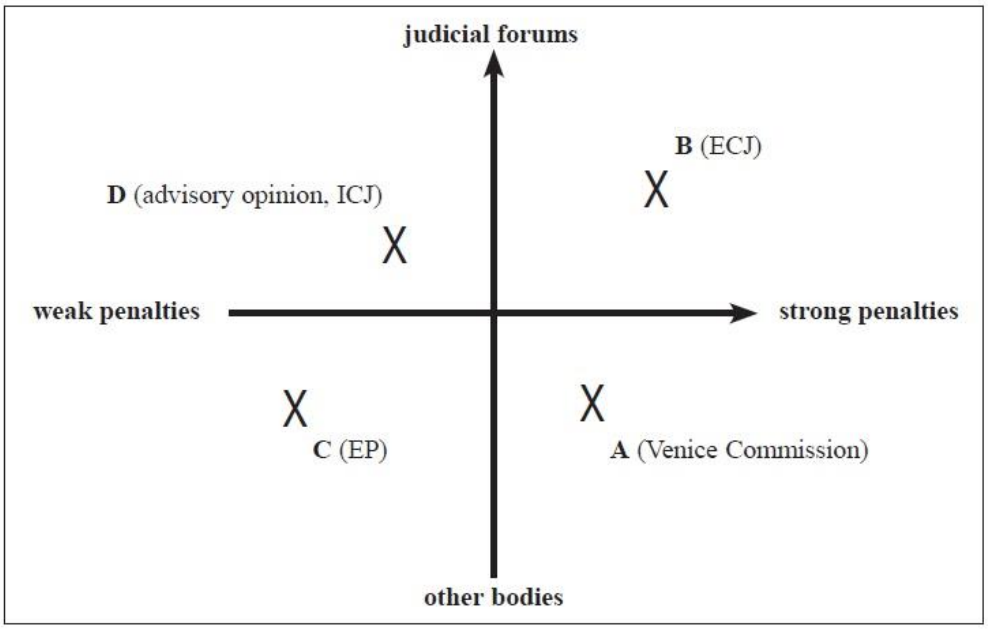
In order to evaluate the efficiency of the disciplining tools, one might turn to the theory of Andrew T. Guzman as a starting point. He calls reciprocity, retaliation and reputation as 'the three Rs of compliance' and underlines the repeated nature of international interactions between the states which makes them interested in a coordinated behaviour even without an enforcement mechanism carried out by a third party (Guzman 2008: 33-45). Whilst he also distinguishes between treaties and other soft law agreements, in his opinion the 'the three Rs of compliance' make both treaties and soft law effective' (Guzman 2008: 180). Therefore, international tribunals can be effective without an enforcement mechanism because their primary role is informational: if a state does not comply with international law, it will be considered as an unreliable partner (Guzman 2008: 34, 51-54).

However, the above presented bilateral situation might change when multilateralism comes into the focus and we take into account the creation of international organisations and their dispute resolution mechanisms. To model the latter, one might turn to the deterrence theory of law and economics literature (Cooter & Ulen 2004: 492-497): a criminal will commit a crime as long as $Uc > p * Up$, where Uc is the expected utility [(u)tility] from the perpetration of the crime [(c)rime], p is the probability of successful investigation [(p)robability] and Up is the

decrease in utility in accordance with the degree of the punishment [(p)unishment]. Consequently, if 10 out of 10 irregular activities are duly punished by the authorities, then even the most risk-loving criminals will reconsider their actions regardless of the degree of punishment. On the contrary, if the probability of the imposition of a fine is close to zero, then however high the amount of the fine may be, nobody will take it seriously, since as *lex imperfecta*, it will never bear an actual legal consequence.

While the above formula is evidently a simplified model to depict the mechanisms of criminal actions, it can shed a new light on the international commitments, compliance or non-compliance of the states. In order to enlighten the deterrence formula presented above, there has to be a body which takes a position in cases of compliance with international and European commitments and standards. Without such a body present, the right side of the deterrence formula would be undefinable, and we would only be able to talk about unilateral commitments of states where the 'three Rs' give incentives for the states by self-interest.

The right side of the formula is composed of two elements: the probability of holding the state accountable for its failure to comply with the commitments, and the prospective legal consequences. It seems to be plausible that if the arbiter is a judicial forum with concrete discretion, the probability of uncovering the infringements and imposing sanctions is higher than in a case when a political body is empowered to adopt a simple political declaration or recommendation. There is a great institutional variety between these two extremes. For instance, the model can be further supplemented by the prestige of the international institution adopting a resolution, which can potentially be detrimental to the reputation of the state in question, and therefore it can have a stronger effect than the opinion of a not-so-reputed advisory body. Consequently, international arbiters can be represented along two imaginary coordinates, one of which represents the nature of the institutions, while the other depicts the strength of the applicable sanctions.



To give an example: the Venice Commission can only issue opinions, however, by virtue of its expertise and prestige, this apparently weak discretionary power can involve relatively important prestige-related consequences and that is the reason why it appears in the lower right corner of the figure. The CJEU has strong influences thanks to the infringement and other procedures, thus it is placed in the upper half of the figure. For that matter, we could also place in that corner the European Court of Human Rights, as even though its decisions are of *inter partes* effect, they serve as minimal standards for national constitutional courts[XXXVI] and also for the European human rights law.[XXXVII] At the same time, a decision about complying with an international commitment can be shaped by many other factors such as the balance between the reachable benefit and the expected sanction of non-compliance or the level of wealth of a country (Shavell 2004: 479-482). In this regard there might be a huge difference between the sanctioning powers of the ECtHR and the CJEU, as the latter can impose huge a lump sum or a penalty payment on the Member State.[XXXVIII]

The functioning of the above depicted applied theory is perfectly manifest in the case of the Fundamental Law of Hungary and its fifth amendment in 2013. Shortly after the fourth modification of the Fundamental Law, three international organizations reacted immediately:

the Venice Commission, which issued an opinion on the new constitutional framework,[XXXIX] and two other EU institutions, the European Commission and the European Parliament. The story that followed is well-known: the European Parliament accepted the so-called Tavares Report while from the part of the European Commission, Commissioner Reding held a speech in which she outlined three areas of the Fundamental Law that were considered problematic from the perspective of European standards.[XL] Unsurprisingly, the fifth modification corrected all three problems raised by the European Commission. However, the content of the Tavares Report and the opinion of the Venice Commission were taken into consideration to a lesser extent (Vörös 2014: 1).

For this result the application of the above described deterrence theory seems to provide a plausible explanation: the possible severe legal consequences had a deterrent and thus constitution modifying effect in contrast with the possible governance strategy following the Tavares Report. Although the Commission alone cannot impose sanctions on the Member States for the Treaty opposing behaviour, being the 'guardian of the Treaties' it is a Commission competence to investigate these issues and launch an infringement proceeding which might lead to severe financial sanctions. In contrast, the European Parliament can only initiate the so-called 'nuclear bomb' procedure where the p component of the above presented equation converges to zero as the essence of the process can be interpreted along the second agency relationship which makes it similar to the prisoners' dilemma game with multiple actors. This means that taking into account the collective action, the so-called free-rider problem gives incentives to each Member State to exit the common retaliatory action: Member States should cooperate in order to regulate their rule-breaker partner; however, only one Member State is enough to jeopardize the procedure.[XLI] What remains after all is the reputational sanction carried out by the report of the European Parliament where the weight or effect depends on the credibility and the authority of the issuer organ.[XLII]

5.2. Defending the value community: the case of judicial independence

As presented, Hungary successfully prevented the infringement procedures in 2013. In contrast, the next case study focuses mainly on the judicial reforms of Poland which landed

before the CJEU in several rounds. The heart of these cases is the principle of judicial independence which is rooted in the common constitutional traditions of the Member States and which constitutes an essential guarantee of the rule of law. Here the focus must be put not only on the vertical dimension, according to which Member States must ensure a judicial system that guarantees the enforcement of EU law, but also on the horizontal one.[XLIII] Namely, the principle of mutual recognition[XLIV] developed in the context of the internal market and then successfully applied in the area of freedom, justice and security, makes mutual trust the driving force behind the functioning of the European Union (Lenaerts 2017: 805). If this mutual trust is lost, the whole EU legal system will become inoperable, as it might happen that the courts of some Member States question the validity of judicial decisions of a partner Member State.

As Member States are committed to EU values, there is a presumption in the European Union that Member States will ensure the independence of the judiciary (Lenaerts 2020: 31). Recently, however, Polish judicial reforms have brought many cases before the CJEU in which these fundamentals have been called into question. In addition, Polish reforms have been monitored by other relevant international actors as well: the Venice Commission has published two opinions,[XLV] and the European Commission initiated the Article 7 procedure.[XLVI]

The Polish cases were preceded by a Portuguese case[XLVII] which gave the CJEU an opportunity to set out important points of principle. Accordingly, in order to assess whether a body has the characteristics of a 'court', it must be taken into account among other conditions that it is independent.[XLVIII] As the CJEU stated, preserving the independence of the judiciary is essential given the second paragraph of Article 47 of the Charter of Fundamental Rights, and preliminary ruling mechanism provided for in Article 267 TFEU can only be initiated by a body that fulfils the condition of independence.

This case can be assessed as the prologue of the so-called Polish cases. Without presenting all the cases in detail,[XLIX] it is worth mentioning the act aiming at lowering of the retirement age for judges of the Supreme Court of Poland which affected nearly a third of the current members of the Supreme Court, including the president, whose constitutionally mandated six-year-long term would have been shortened.[L] Under the new Polish law, the retirement age for

judges of the Supreme Court has been reduced to 65 years. It was possible to extend the active judicial service beyond the age of 65 but this would have required the submission of an application and a health certificate. The extension should have been authorized by the President of the Republic of Poland.

The case was brought before the CJEU as an infringement proceeding. First, in order to prevent the possible and irreversible damages, the CJEU ordered the immediate suspension of the operation of the contested Polish legislation before a final decision was taken.[LI] Later, the provisions proved to be contrary to EU law as they violated the principle of the immovability of judges and the principle of judicial independence. The CJEU recalled in its judgement that EU law is based on the fundamental presumption that all Member States share the values referred to in Article 2 TEU with all other Member States. Although the organization of the judiciary in the Member States falls within the competence of the Member States themselves, in exercising that competence they must comply with their obligations under EU law. In the context of the case the CJEU has stated that the principle of immovability requires, *inter alia*, that judges remain in office until they reach the mandatory retirement age or until the end of their term of office, if this is for a fixed term. Exceptions to this principle can only be made if they are justified by legitimate and compelling reasons, respecting the principle of proportionality. However, in the present case, the CJEU considered that there were serious concerns about the real objectives of the reform and that any extension upon request was at the discretion of the President. On this basis, the CJEU concluded that the power of the President raises reasonable doubts as to the immunity of the judges concerned from external factors and the neutrality of the conflicting interests, thus violating Poland's obligations under the second subparagraph of Article 19 (1) TEU.[LII]

Another case to be highlighted concerns the newly established Disciplinary Board within the Polish Supreme Court.[LIII] The referring court was faced with a procedural problem, as the disputes before it concerning the retirement of Supreme Court judges fell within the exclusive jurisdiction of the newly established Disciplinary Board within the Supreme Court. The question arose as to whether, because of the latter's doubts as to its independence, it was required to disapply the national rules on the division of jurisdiction and, if so, to rule on the

substance of the dispute. The CJEU held that it was contrary to the right to an effective judicial remedy that disputes concerning the application of EU law could fall within the exclusive jurisdiction of a forum which did not constitute an independent and impartial tribunal. Based on this judgement, subsequently, the referring court held that the Disciplinary Board cannot be regarded as a tribunal for the purposes of either EU law or Polish law, but the Disciplinary Board continued to work. As a consequence, the Commission requested the CJEU, in proceedings seeking interim relief, to order Poland to adopt interim measures who decided on 8 April 2020 that Poland must immediately suspend the national provisions on the powers concerning the Disciplinary Board with regard to disciplinary cases concerning judges.[LIV] On 15 July 2021, this was confirmed by the judgement of the CJEU concluding that the disciplinary regime for judges in Poland is not compatible with EU law,[LV] and following a few months of debate, the Polish Government has finally declared that it will comply with the judgement and it will terminate the chamber of the Supreme Court devoted to disciplining judges (Sadurski 2021).

Last but not least, a recent Malta-related judgement[LVI] has to be highlighted. The subject of this case was the scrutiny of the constitutional rules on the appointment of Maltese judges, as amended in 2016. According to the constitutional provisions in force since 1964, the Prime Minister submits the candidates to the President of the Republic for appointment, which, according to the claimant, raises doubts regarding the independence of the judges so appointed. The only element changed in 2016 was the setup of a committee that was entrusted with the task of evaluating and commenting the applications.

The case provided an opportunity to apply Article 49 TEU as the CJEU had to examine the Maltese constitutional rules that had already received green light at the time of accession together with its amendment. The CJEU emphasized in its decision that, under Article 49 TEU, the Union brings together States which have freely and voluntarily acceded to the common values referred to in Article 2 TEU. As a result, the CJEU emphasized that

> 'compliance by a Member State with the values enshrined in Article 2 TEU is a condition for the enjoyment of all of the rights deriving from the application of the Treaties to that Member State. A Member State

> cannot therefore amend its legislation in such a way as to bring about a reduction in the protection of the value of the rule of law (…) the Member States are thus required to ensure that, in the light of that value, any regression of their laws on the organisation of justice is prevented, by refraining from adopting rules which would undermine the independence of the judiciary.'[LVII]

As a consequence, one must see that this is a further argumentative step regarding the protection of the European Union as a value community as the judgement connected Article 2 and 19 TEU and Article 47 of the Charter of the Fundamental Rights to Article 49 TEU dealing with the accession to the European Union. As Dimitry Vladimirovich Kochenov and Aleksejs Dimitrovs formulated, the new judgement has introduced the 'non-regression' principle in EU law as a possible solution of the Copenhagen dilemma (Kochenov and Dimitrovs 2021).

6. Concluding Remarks

The paper addressed the current structure of the European Union along the principal-agent concept. It has revealed three agency relationships. For the first one, the EU has been established as an agent of the Member States but the multiple and diverging interests of the many contracting parties went together with high coordination costs that has led to the simplification of the decision-making rules. This has created a second type of agency problem among the Member States. In addition, the relationship between the EU institutions and the Member States seems to be even more complicated as along its functioning the EU relies on its Member States as being its agents who are meant to carry out its policies and to enforce EU law. For this third type of agency relationship the paper detected two fundamental causes. One of them is a practical reason, the shortcomings of the European bureaucracy and the second one is the postulation of the EU as a value community. Yet, one might even claim that here lies the possible federal moment of the European Union as this postulation perceives the EU as an entity detached from the Member States which can formulate normative expectations *vis-á-vis* the Member States.[LVIII]

As a final evaluation, a few comments have to be added here. First of all, it has to be acknowledged that while the Member States perceive the EU institutions as their agents they argue along the classical sovereignty paradigm (as illustrated by Bodin 1993: 74-87). In contrast, the *sui generis* nature of the European Union means that both the legal and the political reality is built upon the pooled sovereignty paradigm (Keohane 2002: 748. Weiler 1991: 2479). This might explain the existence of an invisible paradigmatic shift between the two visions of Europe labelled as an interest community and a value community.

Secondly, the institutions of the European Union should not be treated as a whole. While the Council and the European Council can be evaluated as the playground of the second type of agency relationship, the Commission and the Parliament play an important role in the first and in the third agency relationship. In addition, the Court of Justice of the European Union has to be taken totally apart as it plays the arbiter role in between the Member States and between the Member States and other EU institutions in both directions, too.

Last but not least, the novelty of the integration process has to be outlined which is the many self-reflective decisions of the CJEU concerning the rule of law, a basic value of the European Union. Based on the Portuguese, Maltese and mainly the Polish cases presented, it can be seen that the CJEU has effectively protected the independency of the Polish judiciary through the interim measure and its judgments until now. As a result, one could provocatively state that today the engine of the European constitutionalism are those Member States who are *unwilling* to comply with the core elements of EU values[LIX] as they direct the Court of Justice of the European Union towards interpreting the axiological foundations of the EU, that is to say the values affirmed in Article 2 TEU.

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* Assistant Professor at the National University of Public Service, Budapest. E-mail: orban.endre@uni-nke.hu.
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I See *Part I: Perspectives*, in Jones et al. 2012: 3-77.
II On the usage of 'paradigm' see Kuhn 1962: 130.
III In addition, there is also a market for managers who maximise profit and bulid up their reputation.
IV For other applications see Kassim 2003: 121; Egeberg 2014: 240.
V Accordingly many constitutional courts name the Member States as the lords of the treaties, see: 'Herren der Verträge' in BVerfGE 89, 155 (190) Maastricht decision and also the Constitutional Court of the Czech Republic in Pl.ÚS 19/08 ze dne 26.11.2008, 106.

[VI] E.g. huge companies or interest unions, see: Armour et al. 2009: 36.
[VII] Such an example is the multiannual financial framework but only with the restriction that the net contributor countries are compensated elsewhere. Orbán 2014: 132.
[VIII] In addition, this approach enables the grouping of the Member States not only as big *versus* small, but also as more and less developed ones or old *versus* new Member States. See Schelkle 2012: 278; Lequesne 2012: 267.
[IX] Articles 244-250 Treaty on the Functioning of the European Union [hereinafter TFEU] (COM), Article 317 TFEU (Implementation of the Budget), Articles 101-106 TFEU (Rules on Competition) and one must note the phenomena of the so-called 'agencification' as well. Szegedi 2014: 298.
[X] The original philosophical meaning of subsidiarity concentrates on the protection and the strengthening of the autonomy of lower levels and communities. Minnerath 2008: 52.
[XI] 'As the Court of Justice has repeatedly held, the founding treaties of the EU, unlike ordinary international treaties, established a new legal order, possessing its own institutions, for the benefit of which the Member States thereof have limited their sovereign rights, in ever wider fields, and the subjects of which comprise not only those States but also their nationals (see, in particular, judgments in van Gend & Loos, 26/62, EU:C:1963:1, p. 12, and Costa, 6/64, EU:C:1964:66, p. 593, and Opinion 1/09, EU:C:2011:123, paragraph 65).' ECJ, Opinion 2/13 of the Court, ECLI:EU:C:2014:2454, para 157.
[XII] Or common law courts of the EU as Koen Lenaerts names. Lenaerts 2020: 30.
[XIII] Article 267 TFEU.
[XIV] See the series of judgements on judicial independece starting with ECJ, Case C-64/16, *Associação Sindical dos Juízes Portugueses*, ECLI:EU:C:2018:117.
[XV] European Parliament, *Report on the situation of fundamental rights: standards and practices in Hungary.* (2012/2130(INI)) (2013), http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A7-2013-0229+0+DOC+XML+V0//en; Lili Bayer & Maïa De La Baume, *European Parliament report calls for sanctions procedure against Hungary,* https://www.politico.eu/article/viktor-orban-european-parliament-report-judith-sargentini-calls-for-sanctions-procedure-against-hungary/.
[XVI] European Commsission, *A new EU Framework to strengthen the Rule of Law*. COM(2014) 158 final.
[XVII] European Commission, *Communication from the Commission to the Council and the European Parliament on Article 7 of the Treaty on European Union. Respect for and promotion of the values on which the Union is based.* COM(2003) 606 final; 6. Scheppele 2016: 105.
[XVIII] Venice Commission, *Rule of Law Checklist*, CDL-AD(2016)007. In effect, the European Commission in its Communication from April 2019 explicitly refers to the Checklist as a possible source of the European understanding of the rule of law. European Commsission, *Communication from the Commission to the European Parliament, the European Council and the Council. Further strengthening the Rule of Law within the Union.* COM/2019/163 final. III.
[XIX] E.g. ECJ, Case C-619/18, *European Commission v. Poland,* ECLI:EU:C:2019:924.
[XX] Opinion of the Advocate General Maduro, ECJ, Case C-380/05, *Centro Europa*, 2007 ECR I-349, para 14. Bogdandy et al. 2012: 489.
[XXI] For a critique of Habermas, see Grimm 2017: 51.
[XXII] In this regards national constitutional courts have developed different constitutional reservations (human rights, *ultra vires* and constitutional identity based reservations) which – as extra-contractual tools – intend to show that in spite of the conferred powers, sovereignty and *Kompetenz-Kompetenz* remain at Member State level. See: Claes & Reestman 2015: 917. Konstadinides 2011: 195.
[XXIII] Armour et al. 2009: 39-45.
[XXIV] Article 263 TFEU.
[XXV] Article 265 TFEU. Craig & de Búrca 1996: 452-455, 483-487.
[XXVI] Article 258 TFEU. Schäfer 2014: 82-94.
[XXVII] ECJ, Case C-621/18, *Wightman*, ECLI:EU:C:2018:999.
[XXVIII] See for example the election of Jean-Claude Juncker.
[XXIX] Article 15 paragraph (5) TEU.
[XXX] There were only three yellow signals. Monti II on a draft regulation, the second on the establishment of a European Public Prosecutor's Office and the third on the Posting of Workers Directive.

[xxxi] ECJ, Case C-84/94, *United Kingdom v. Council,* ECLI:EU:C:1996:431; ECJ, Case C-491/01, *R v. Secretary of State for Health, ex parte Imperial Tobacco*, ECLI:EU:C:2002:741.177–185.
[xxxii] Article 126 paragraph (9) and (11) TFEU.
[xxxiii] European Parliament and the Council, *Regulation No 1303/2013 of 17 December 2013*.
[xxxiv] European Parliament and the Council, *Regulation No 2020/2092 of 16 December 2020, on the General regime of conditionality for the protection of the Union budget*. For the recent legal debate concerning the entry into force of the mechanism see: Alemanno & Chamon 2020.
[xxxv] The CJEU can be assessed as a special constitutional court within the EU, see: Tridimas 1996: 206.
[xxxvi] E.g. Decision no 61/2011 (VII. 13.) of the Constitutional Court of Hungary.
[xxxvii] Article 53 of the EU Charter of Fundamental Rights.
[xxxviii] Article 260 TFEU.
[xxxix] Venice Commission, *Opinion On The Fourth Amendment To The Fundamental Law Of Hungary*, CDL-AD(2013)012.
[xl] Viviane Reding, *Hungary and the Rule of Law - Statement of the European Commission in the Plenary Debate of the European Parliament*, https://ec.europa.eu/commission/presscorner/detail/ro/SPEECH_13_324. The three areas were: the introduction of an ad-hoc tax on Hungarian citizens after CJEU judgements; the power of the President of the National Office for the Judiciary to transfer cases from one court to another; and the restrictions on the publication of political advertisements during election campaigns.
[xli] Similar events can be seen also nowadays as Member States are reluctant to carry on with the Article 7 procedure even after the adoption of the Sargentini Report.
[xlii] Similar efficiency problems arise in connection with the Sargentini report which has triggered the Article 7 procedure without any result. In contrast, the so-called value related CJEU proceedings have reached more spectacular results. See the 'information on values-related infringement proceedings': https://www.asktheeu.org/en/request/6115/response/19716/attach/html/6/st14022.en18.pdf.html.
[xliii] For example when Polish courts had issued three European Arrest Warrants in order to prosecute LM, a Polish national, for illicit drug trafficking, the Irish High Court was awaiting an answer as to what information and guarantees, if any, it should obtain from the issuing judicial authority in order to rule out the post-transfer risks in the context of the Article 7 procedure launched against Poland. ECJ, Case C-216/18, *PPU Minister for Justice and Equality v. LM,* ECLI:EU:C:2018:586. Sonnevend 2018.
[xliv] ECJ, Case C-120/78, *Rewe-Zentral*, ECLI:EU:C:1979:42.
[xlv] Venice Commission, *Opinion on the Draft Act Amending the Act on the National Council of the Judiciary, on the Draft Act Amending the Act on The Supreme Court, Proposed by the President Of Poland, and on the Act on The Organisation of Ordinary Courts*, CDL-AD(2017)031-e; Venice Commission, *Urgent Joint Opinion on the Amendments to the Law on Organisation on the Common Courts, the Law on the Supreme Court and other Laws*, CDL-PI(2020)002-e.
[xlvi]Eureopean Commission, *Reasoned Proposal in Accordance with Article 7(1) of the Treaty on European Union Regarding the Rule of Law in Poland,* COM(2017) 835 final.
[xlvii] ECJ, Case C-64/16, *Associação Sindical dos Juízes Portugueses*, ECLI:EU:C:2018:117.
[xlviii] *Id.* at para 44.
[xlix] For an overview see: Madarasi & György 2021: 92-94.
[l] ECJ, Case C-619/18, *Commission v. Poland,* ECLI:EU:C:2019:924.
[li] ECJ, Case C-619/18R, *Commission v. Poland,* ECLI:EU:C:2018:852 and ECLI:EU:C:2018:1021.
[lii] Another infringement case concerned the Polish law of 12 July 2017 which reduced the retirement age for judges of ordinary courts and prosecutors to 60 for women and 65 for men, and the early retirement age limit for judges of the Supreme Court. See: ECJ, Case C-192/18, *Commission v. Poland,* ECLI:EU:C:2019:924.
[liii] ECJ, Case C-585/18, *A.K.*, ECLI:EU:C:2019:982.
[liv] ECJ, Case C-791/19R, *Commission v. Poland,* ECLI:EU:C:2020:277.
[lv] ECJ, Case C-791/19, *Commission v. Poland*, ECLI:EU:C:2021:596.
[lvi] ECJ, Case C-896/19, *Reppublika*, ECLI:EU:C:2021:311.
[lvii] *Id.* at 63-64.
[lviii] 'A European *Marbury v. Madison* is yet to come.' Jakab 2013.
[lix] For a further Hungarian example see: Vadász 2019.

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