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From 'Homework' to 'Politics'

Some Reflections in favour of a Eurozone Fiscal Capacity

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FEPS YOUNG ACADEMICS NETWORK

The Young Academics Network (YAN) was established in March 2009 by the Foundation of European Progressive Studies (FEPS) with the support of the Renner Institut to gather progressive PhD candidates and young PhD researchers, who are ready to use their academic experience in a debate about the Next Europe. The founding group was composed of awardees of the “Call for Paper” entitled “Next Europe, Next Left” – whose articles also help initiating the FEPS Scientific Magazine “Queries”. Quickly after, with the help of the FEPS member foundations, the group enlarged – presently incorporating around 40 outstanding and promising young academics.

FEPS YAN meets in the Viennese premises of Renner Institut, which offers great facilities for both reflections on the content and also on the process of building the network as such. Both elements constitute mutually enhancing factors, which due to innovative methods applied make this Network also a very unique project. Additionally, the groups work has been supervised by the Chair of the Next Left Research Programme, Dr. Alfred Gusenbauer – who at multiple occasions joined the sessions of the FEPS YAN, offering his feedback and guidance.

This paper is one of the results of the fifth cycle of FEPS YAN. Each of the meetings is an opportunity for the FEPS YAN to discuss the current state of their research, presenting their findings and questions both in the plenary, as also in the respective working groups. The added value of their work is the pan-European, innovative, interdisciplinary character – not to mention, that it is by principle that FEPS wishes to offer a prominent place to this generation of academics, seeing in it a potential to construct alternative that can attract young people to progressivism again. Though the process is very advanced already, the FEPS YAN remains a Network – and hence is ready to welcome new participants.

FEPS YAN plays also an important role within FEPS structure as a whole. The FEPS YAN members are asked to join different events (from large Conferences, such as FEPS “Call to Europe” or “Renaissance for Europe” and PES Convention to smaller High Level Seminars and Focus Group Meetings) and encouraged to provide inputs for publications (i.e. for FEPS Magazine: The Progressive Post). Enhanced participation of the FEPS YAN Members in the overall FEPS life and increase of its visibility remains one of the strategic goals of the network.

THE AUTHORS

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**FROM 'HOMEWORK' TO 'POLITICS'
SOME REFLECTIONS IN FAVOUR OF A FISCAL CAPACITY OF THE EUROZONE**

Abstract

The Maastricht Treaty has represented a major shift in the paradigm of the European integration, with the foundation of the European Union and the establishment of a new framework for a common currency. Within such framework, Member States maintained their competences as regards fiscal policy, but they were subject to the limits contained in Article 109j(1) (now Article 140(1) TFEU) and, subsequently, in the Stability and Growth Pact. Although the provisions concerning the Economic and Monetary Union have not been substantially amended since the Maastricht Treaty, the functioning of the common currency underwent a significant revision during the years of the crisis. However, the commitment to a rules-based fiscal policy was never really put into discussion, with a number of shortcomings that can be observed on the basis of an economic analysis. For this reason, a number of solutions have been suggested in order to favour a shift from the current model of rules-based economic policy towards a form of shared fiscal policy, and, in particular, a special attention has been dedicated to the possible shift towards a fiscal capacity of the Eurozone. In the light of the economic analysis identifying the shortcomings of a rules-based economic governance, the paper will aim at framing the issue of the possible institutional arrangements that should be taken into consideration in order to establish a fiscal capacity for the Eurozone, and to ensure its democratic governance.

Keywords

Economic and Monetary Union

Eurozone

Euro Crisis

Austerity

Fiscal Capacity

1. Introduction

The Maastricht Treaty has represented a major shift in the paradigm of the European integration, with the foundation of the European Union and the establishment of a new framework for a common currency. Within such framework, Member States maintained their competences as regards fiscal policy, but they were subject to the limits contained in Article 109j(1) (now Article 140(1) TFEU) and, subsequently, in the Stability and Growth Pact. Although the provisions concerning the Economic and Monetary Union have not been substantially amended since the Maastricht Treaty, the functioning of the common currency underwent a significant revision during the years of the crisis. However, the commitment to a rules-based fiscal policy was never really put into discussion, with a number of shortcomings that can be observed on the basis of an economic analysis.

For this reason, **a number of solutions have been suggested in order to favour a shift from the current model of rules-based economic policy towards a form of shared fiscal policy. In particular, a special attention has been dedicated, since the dramatic summer of 2012, to a possible fiscal capacity of the Eurozone.** Notwithstanding a certain consensus as regards the desirability of such development, the debate has been, on the one hand, scattered amongst a wide number of proposed solutions and, on the other hand, limited by the clear presence of apparently unsurmountable political obstacles.

Nonetheless, **the establishment of a fiscal capacity of the Eurozone remains a key challenge in the broad context of the reform of the EU in this time of crisis. And it remains a key challenge for the European progressive family, not only for the economic reasons that will be explored through the paper, but also as a way to regain a space for politics that was compressed with the Maastricht Treaty.**

In fact, the Maastricht design formally left to the authority of the Member States the competence to run their own fiscal policies, but it constrained the exercise of such competence within the strict boundaries set out in the Stability and Growth Pact. At the outset, the Member States ended up losing their power to run their fiscal policy, without this power being transferred to the supranational institution, resulting in a net loss of political space, and ultimately of popular sovereignty. To this, it should be added that the rules and constraints contained in the Maastricht Treaty and in the Stability and Growth Pact are founded on an economic theory that clashes with the economic constitutions enshrined in the constitutional texts adopted after the Second World War, therefore surreptitiously substituting their normative content with one that is more lenient to the international balance of power that imposed

itself after the seventies. For these reasons, it seems of capital importance for the progressive forces in Europe to carve a new space for politics at the supranational level in order to re-establish the role of public power, and of democratic control, over fiscal choices, or they risk to be reduced to irrelevance in a new battlefield contended by conservatives and right-wing populists.

In the light of the economic analysis identifying the shortcomings of a rules-based economic governance, and the rationale for a Eurozone fiscal capacity, the paper will aim at framing the issue of the possible arrangements that could be put in place in order to establish a fiscal capacity of the Eurozone, with a special focus on the political accountability and democratic legitimacy of the relative governance structures.

To this end, Section 2 will present the theoretical and political reasons standing behind the adoption of the Maastricht framework. Then, Section 3 will outline the Eurozone's rules-based fiscal policy coordination mechanism and discuss its shortcomings, in order to present the economic reasons that justify the establishment of a fiscal capacity to complement the EMU. Section 4 will review the institutional debate that took place since June 2012 as regards the establishment of a fiscal capacity for the Eurozone, and outline some of the main legal issues that the proposals currently on the table have to face. Section 5 will, then, examine one specific facet of those issues, focusing on the conditions that have to be maintained in order to guarantee the respect of the principle of democracy in the governance of the common fiscal stance. Finally, Section 6 will sum up the analysis conducted throughout the paper, with the aim of defining some general policy proposals.

2. The EMU in the Maastricht design

The path towards a European monetary union is a long and complex history. In this introductory paragraph is delivered a sketchy account of the process which led to the European monetary unification, with a particular focus on the dialectic between France and Germany. In the aftermath of World War II, stability of exchange rates was seen as a priority to achieve a peaceful co-existence of different economies. Responding to this belief, the Bretton-Woods system was designed to achieve global financial stability. But starting from the 60s, along with a profoundly changed political and economic context, the Bretton-Woods system began to show the first difficulties. World trade grew substantially,

while the gold base increased by only a few percentage points. This led to several speculative waves on the US dollar and on its pegged convertibility to gold.

Along with the crisis of the international monetary system, growing attention was given to alternative forms of open-economy macroeconomics. One theme economists focussed on was supranational monetary unions. In this context the **Optimum Currency Area (OCA) theory** – first introduced in the ‘30s – was substantially developed. The OCA theory aims at outlining the main requirements for a monetary union to be successful. Roughly speaking, according to the OCA theory, different countries can successfully employ a single currency if they satisfy the following optimality criteria: i) they are not subject to divergent economic trends, ii) they have sufficient amount of wage and price flexibility, including labour mobility, iii) they share a budgetary union. In its early developments, the OCA theory was grounded on a Keynesian paradigm. According to such a paradigm, the stated conditions are exogenous to the formation of a currency union, i.e. countries should meet them *before* entering a currency union (Masini 2014). This is also the reason why a budgetary union was seen as an essential element to a monetary union. A budgetary union could work as an insurance mechanism reallocating resources from countries experiencing a positive economic cycle to the country facing difficulties in order to foster its catching up.

In the late 60s the balance of economic power between Europe and the US had profoundly changed and the stability of the Bretton-Woods system was undermined by persistent American deficits. In Europe, tensions on the value of the D-Mark and of the frank were undermining European trade integration fostered by the European Economic Community. European leaders started to conceive a European monetary coordination system to sustain European monetary stability. National interests played a relevant role as well, with Willy Brandt’s strategy to find a ‘Western flank’ for his early *Ostpolitik*. At the same time, French Finance Minister Valery Giscard d’Estaing was interested in promoting European monetary union as a way to tackle both the US dollar monetary preeminence and the growing strength of the D-Mark among European currencies (Dyson and Featherstone 1999, 272; Needham 2017).

As a result, **in October 1970 the Werner Report ‘to identify the basic issues for a realization by stages of economic and monetary union’ was delivered** (Werner Report 1970, 35). Delivered by the European Commission and by European heads of state, the Report was the first attempt to designing a European

monetary union. Shortly afterwards, **in 1971 US president Nixon unilaterally suspended the direct international convertibility of the US dollar to gold.** It was the end of the Bretton-Woods system and the beginning of an era of floating currencies. Such a new context made European currency coordination at the same time more difficult and more necessary. The outcome was the implementation in 1972 of a system close to the one outlined in stage 1 of the Werner report: the so-called **European currency ‘snake’ which limited fluctuations between member currencies. However, since the burden for the readjustment was left to the weaker currency, the system proved to be rather unstable: Italy left in 1973; France left in 1974, rejoined in 1975 and left again in 1976.**

The 70s were an era of profound monetary instability. The oil crisis of 1973 led to the unprecedented phenomenon of stagflation, which showed that there was no trade-off between inflation and unemployment (Verdun 1997, 4). The Keynesian fundamental belief of the central role of monetary policies in determining economic output was put at a strain. **In this context the monetarist approach to economics, developed starting from the 60s, gained momentum.** Supported by a growing evidence that the Keynesian policies of the 50s and 60s had only produced inflationary bias, the monetarist paradigm stated that «monetary authorities cannot systematically lower the unemployment rate below its natural level. They can only lower unemployment temporarily» (De Grauwe 2003, 151). According to this view, the only way to reduce the ‘natural’ unemployment rate is to act on the structure of the economy itself, that is by promoting ‘structural reforms’. In the monetarist perspective monetary policy constitutes a solely nominal phenomenon, which cannot influence the ‘real’ economic system. **As a consequence, the central bank has to deal only with the phenomenon it can influence, that is price level. From the monetarist perspective, monetary unions are desirable because they account for greater zones of fixed exchange rates and therefore price stability. The OCA theory was influenced by these views as well. Contrary to Keynesian oriented – mainly academic – economists, monetarists sustained the endogeneity of optimality criteria: once the political decision of creating a monetary union was taken, member countries would have experienced an economic convergence. However, as a matter of facts, European economies did not converge during the 70s.**

Once again, it was politics to take the lead towards EU monetary unification. In 1977, the President of the European Commission Jenkins delivered a speech arguing that a single currency would act as a structural reform strengthening the European economy. Chancellor of Germany Helmut Schmidt had

strategic interests in re-launching the program of currency union as a means to insulate Germany against US monetary and defense unpredictability. Giscard-d'Estaing, then President of France, was interested as well in joining a monetary union in which France would have been protected by the credibility of the D-Mark. A new European Monetary System was launched in 1979. The introduction of the European Currency Unit (ECU) and of the Exchange Rate Mechanism (ERM) were designed in order to shift more burden of adjustment to the Bundesbank.

However, the Bundesbank did not depart from its strict monetary policies and constantly considered German money supply targets as a priority over the emission of D-Marks to buy foreign currency and devalue the ECU (thus making the whole area more competitive) (Needham 2017). The EMS underwent several challenges, such as the global economic downturn resulting from the second oil shock and the French expansive policies. Elected in 1981, the socialist leader Francois Mitterand implemented a package of expansive reforms. This led to profound public deficits and to severe devaluating pressures on the franc, which put at risk French membership within the EMS. In 1983 Mitterand announced the transition to a policy of economic rigour. Such a U-turn was taken with the advice of Jacques Delors, French Finance Minister and with the Bundesbank, which agreed to share the cost of a devaluation of the D-Mark by 5.5 per cent vis-a-vis a franc devaluation of 2.5 per cent.

In 1986 the Single European Act was signed under the Delors Commission leading to the establishment, starting from 1990, of a Single European market with free movement of capital between EEC countries. This pushed under further pressure monetary policies of weaker economies. **At this point it was definitely clear that it was not possible for EEC countries to have at the same time i) free trade, ii) freedom of capital movements, iii) fixed exchange rates and iv) independent macroeconomic policies, both fiscal and monetary. EEC countries had to choose between moving towards a monetary union or to give up one of the other conditions. Despite being officially free, monetary policy was in fact bounded to the Bundesbank one. The German economy was in the position of setting interest rates according to its needs without having to worry about exchange rates fluctuations with its trading partners.**

The prospect of a monetary union became therefore more appealing both as a way to strengthen the European position against the dollar and as a way to limit the Bundesbank excessive influence. Weaker

countries preferred to pass on monetary control to a supranational institution on which they could have an influence rather than to the Bundesbank. For German Chancellor Helmut Kohl, a monetary union resulted appealing as a renewed *Ostpolitik*, especially after the election of Mikhail Gorbachev as General Secretary of the Communist Party of the Soviet Union. German Finance Minister Hans-Dietrich Genscher and Chancellor Kohl, despite the opposition of the Bundesbank, supported the project of a European monetary unification with an independent central bank. Mitterand, re-elected in 1988, agreed with Genscher that a committee of EEC central bankers and other experts should be appointed to enquire the possibility of a monetary union, the so-called Delors Committee. In Italy, Ciampi and Prodi supported the program as well.

The Delors committee delivered its Report in 1989. It outlined the design of a European monetary union with a central bank modeled on the Bundesbank (i.e. with a mandate limited to guaranteeing price stability) and a three stage convergence strategy. During stage one member states were supposed to strengthen their economic policy coordination within the current institutional framework. Stage two would provide ‘the basic organs and structure of the economic and monetary union’, that is a European Monetary Institute and a European Central Bank. Stage three would imply the irrevocable fixing of currencies and should have taken place by 1999 (European Commission, 1989). The Delors Committee members showed a remarkable unanimity in sketching the Report (the Committee was labeled an ‘epistemic community’) and were strongly influenced by the monetarist economic paradigm (Verdun, 1997). Despite the criticisms of several Keynesian economists, monetarism was prevalent among think-tanks and policy advisors, and it clearly backed a political consensus.

The Delors Report was adopted by EEC members in June 1989. In November 1989 the Berlin wall fell down: Germany needed a Western flank more than ever. In December 1991 EEC members delivered the Maastricht Treaty leading to a monetary union. **As in the Delors Report, the mandate of the European Central Bank was directly taken from the Bundesbank model. Moreover, in order to comply with German fear of possible financial instability and to make the monetary union more acceptable to German public opinion, severe entry conditions were designed.** In order to access the monetary union, candidate countries would have to show a concrete commitment to keep inflation low and to implement stable budgetary policies. Such policies remained at the country level, but were strongly influenced by communitarian rules. Here is the beginning of the rules-based national coordination system. In order to

access the monetary union, a candidate country had to meet the following conditions:

- Its inflation rate of no more than 1.5% above the average of the three EU member states with the lowest inflation over the previous year;
- Its long-term interest rate is not more than 2% higher than the average observed in the three low-inflation countries
- It has joined the exchange rate mechanism of the EMS and has not experienced a devaluation during the two last years preceding the entrance into the union
- a national budget deficit at or below 3 per cent of GDP¹
- Its government debt should not exceed 60% of GDP² (De Grauwe, 2012)

As it is easy to see, no reference is made to price and labour flexibility. The Treaty outlines a monetary area deeply influenced by the monetarist paradigm and does not mention any plan towards any form of budgetary union.

The monetary storm of 1992-93 put the Maastricht program at serious risk, with the British pound and the Italian lira withdrawing from the ERM in 1992, the expenditure of much of French reserves and the widening of the ERM intervention bands (Needham 2017). However, the Maastricht treaty was adopted by EEC states, under the threat that without a monetary union the common market would not have survived another similar crisis. The Delors compromise about the independence of the European Central Bank and the lack of a budgetary union, which made the Treaty acceptable to Germany, was an essential element to the successful implementation of a European monetary union. **The design of the currency union was the outcome of a multi-layered compromise, in which national interests, supranational ambitions, economic theory, empirical evidence and power imbalances played a complex role. It was the response to a specific economic and geopolitical context, and designed a monetary structure according to a precise balance of power** (Bonizzi et al. 2016).

¹ if it is, it should be declining continuously and substantially and come close to the 3% norm, or alternatively, the deviation from

² if it does it should 'diminish sufficiently and approach the reference value (60%) at a satisfactory stage', Art. 104c(b)

3. A critical appraisal of Fiscal Policy in the Eurozone

The crucial frame for European fiscal policy was set in stone with the Treaty of Maastricht and the Stability and Growth Pact in the 1990s. European policymakers decided on rules-based national coordination paired with multilateral surveillance. While monetary policy was centralized with the creation of the European Central Bank (ECB), fiscal policy was left to the Member States. Numerical constraints on public deficits and debts were implemented to avoid moral hazard. Consequently, **fiscal discipline is seen as the primary target**. The rules require national public budgets to be balanced over the economic cycle, thereby allowing automatic stabilizers to work without undermining the annual deficit criterion. Accordingly, debt stabilization is guaranteed and member states are given some leeway to conduct countercyclical fiscal policy – the second objective of the framework. From the start, budgetary surveillance was an important part of the framework and member states have to constantly deliver stability programmes to EU institutions. **The main principles of numerical rules and multilateral surveillance remained regardless the various changes to the framework in 2005 and after the financial crisis**. A set of fiscal reforms tightening EMU rules and procedures emerged in response to the crisis (Six-Pack, Fiscal compact³, Two-Pack). The underlying strategy after the crisis was to tighten fiscal discipline further while simultaneously integrating more flexibility for extraordinary economic times (European Commission 2015). Table 1 summarizes the current numerical constraints EMU member states currently face. Even though the general numerical constraints are simple, the several changes of the total budgetary framework have, however, made the system increasingly opaque (Claeys et al. 2016).

Nonetheless, the idea of the fiscal framework is straightforward. The focus lays on taming fiscal policy, in order to avoid deficit bias of public finances. Sound public finances are viewed as necessity for price stability and support economic growth. The assumption is that if a country's fiscal performance is unsustainable it may impact euro-wide inflation and requires contractionary monetary policies. **Real discretionary stabilization is handed over to centralized monetary policy, while fiscal policy is essentially downgraded to the provision of the institutional frame and automatic stabilizers are meant to smooth national economic fluctuations. In traditional public finance, however, fiscal policy also has a stabilization function.**

³ See the FEPS Conference paper of Sawyer (2013b) for a critical appraisal of the Fiscal Compact

Table 1: Current numerical constraints of Fiscal Governance in the EMU

Aggregate	General threshold	Further information
Budget deficit	Current budget deficit not higher than 3% of GDP	In case of excess deficits an excessive deficit procedure will be opened.
Public debt level	Debt-to-GDP ratio under 60%	According to the debt criterion, excess public debt (deviation from actual debt-to-GDP level to the 60% threshold) must be reduced by 1/20 th a year on average over a three year horizon.
Structural budget balance	Higher than the medium-term objective (MTO) of the respective country	The structural balance is the cyclically adjusted budget balance net of one-off and temporary effects. The medium-term objective is defined as -0.5% of GDP for countries above the debt limit and -1.0% of GDP for countries under the debt limit. There is an automatic correction adjustment of 0.5% required in case of deviation from MTO.

Adjusted measure of real government expenditures	Expenditure growth cannot exceed medium-term potential output growth	The adjusted measure excludes interest expenditure, expenditure on Union programmes fully matched by Union revenues and non-discretionary changes in unemployment benefits (EU Regulation 1175/2011 of EU Parliament). Expenditure growth has to be below potential growth if structural balance is below MTO.
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The macroeconomic task of fiscal policy is to stabilize aggregate demand at its potential. The concentration on fiscal discipline ignores this function. It further neglects the effectiveness and role of fiscal policy in stimulating short and long-term growth (Furman 2016). From a Keynesian perspective, fiscal policy has an impact on aggregate demand. Famously, Keynes (1936) proposed countercyclical fiscal spending in order to dampen business cycle fluctuations and thereby use deficits and debt as shock absorbers in order to let automatic stabilizers work properly. Automatic stabilizers are an important mechanism to help counteracting shocks to aggregate demand without implementing discretionary changes to spending or taxes. Thus, decreasing the deficit in the recession or increasing the surplus in the boom would intensify the business cycle and result in procyclical, non-optimal, policy action. Countercyclical discretionary fiscal policy should therefore be used to decrease business cycle fluctuations via its impact on aggregate demand and counteract the recession or the boom respectively⁴.

A surge of empirical studies on the fiscal multiplier confirms significant output effects of discretionary fiscal policy (Gechert 2015a, Bousard et al. 2012, Bouthevillian et al. 2009). Moreover, the impact changes according to the state of the economy. The effectiveness of fiscal policy seems to increase in

⁴ It is important to note that even according to Barro's (1979) Ricardian equivalence theorem and concept of tax smoothing, debt should be an absorber of shocks. Governments are advised to let debt increase during a macroeconomic shock and its aftermath. Merely when times have normalized they should gradually adjust debt via tax or expenditure policies. Therefore, strictly constraining deficits is not supported by the neoclassical perspective either.

times of recession (Auerbach and Gorodnichenko 2012, Batini et al. 2012, Baum et al. 2012). **The strict application of fiscal rules is to a high degree responsible for Eurozone austerity during the European crisis, leading to a restrictive pro-cyclical fiscal stance in the recession with detrimental growth and employment effects.** The negative output effects of required consolidation measures have been widely acknowledged (Blanchard and Leigh 2013, House et al. 2017, Gechert et al. 2015, Fatás and Summers 2016) show that in a recessionary situation the adjustments may remain “efforts” of consolidation with eventually higher deficit- and debt-to-GDP ratios due to the deteriorating effects on GDP – hence, consolidation may be self-defeating. This effect is due to the negative long-term effects of austerity measures on potential growth.

Even though the fiscal framework went through significant reform, the main structure kept unchanged – centralized monetary policy and decentralized wage and fiscal policy coordination, the latter with focus on discipline. Member states central banks cannot react to its country’s individual situation. Countries are unable to devalue or appreciate their currency via the exchange rate. Furthermore, if monetary policy is constrained by the zero lower bound, the tool for aggregate demand stabilization is missing in the policy mix. The Eurozone has a blind eye on the problem of economic stabilization and thus no sufficient instrument for asymmetric shocks. **In a recessionary environment the problems of the design are most apparent. If expansionary fiscal policy is constraint by deficit and debt targets and monetary policy by the zero lower bound, internal devaluation becomes necessary for crisis countries.** This is what we have seen in the Eurozone over the past years with well-known results.

The economic crisis of the Eurozone is still, eight years after the outbreak of the financial crisis, not solved. Real GDP merely stagnated compared to pre-crisis values. On a per capita basis, real GDP even decreased over the same period. While Germany and other countries of the core were growing on a low but positive rate, countries like Spain, Portugal and especially Greece had negative cumulative economic growth. Productivity is stagnating or declining in most countries and unemployment is still very high. As one consequence, income inequality in most countries has further increased (Stiglitz 2016). The post-crisis macroeconomic performance in the US, Canada or Japan has been much better compared to the Eurozone. Immense macroeconomic imbalances have piled up since the beginning of the currency union and are fundamental to the current economic. The currency union observed the raise of intra-EMU inflation differentials, the divergence of price competitiveness and consequently the emergence of huge

current account imbalances (Hein et al. 2012). Since the beginning of EMU, the expected real convergence of macroeconomic variables did not occur, instead, asymmetric shocks have prevailed (Thirion 2016). Policymakers have reacted with austerity and structural reform. In 2010, many Eurozone countries started with the consolidation of their public finances by increasing taxes or cutting public expenditures. The Eurozone's austerity measures summed up to over 6 % of GDP from 2010 to 2013⁵. The goal was to regain confidence by markets and thereby increase private activity through fiscal stability and structural reform⁶.

There seems to be a rather broad consensus in mainstream economics that the EMU is not an optimal currency area (Baldwin and Giavazzi, 2016). The conventional solution to the problem and the strategy over the past years in Europe was to implement structural reforms targeting more flexible labour and product markets (De Grauwe and Ji, 2016). The rigid structures were doomed to be responsible for the weak performance. However, with macroeconomic imbalances still very high after half a decade of European crisis, the strategy to achieve convergence via more flexibility needs to be questioned. De Grauwe and Ji (2016) point out that the focus on structural reform is even flawed from the OCA perspective itself, because one assumes that asymmetric shocks are permanent. However, their work shows that if shocks are temporary, stabilization policies become key.

In the EMU, member states do not issue debt in their own currency and therefore miss control over the currency. Financial markets have consequently the power to penalize countries in form of higher bond rates (De Grauwe 2011). Therefore, capital can move from countries most hit to countries least hit by the recession, making it easier for the latter and almost impossible for the former to stabilize the situation,

⁵ Data according to the discretionary fiscal effort database included in Ameco (2016). The calculations exclude Germany, because the country hardly implemented consolidation measures and would thereby bias the picture. The comparably small contractionary German impulses in the years 2011 and 2012 were only due to phasing out of temporary measures of their 2009 and 2010 stimulus packages.

⁶ "My understanding is that an overwhelming majority of industrial countries are now in those uncharted waters, where confidence is potentially at stake. Consolidation is a must in such circumstances." (Trichet 2010);

"All the eurozone governments need to demonstrate convincingly their own commitment to fiscal consolidation so as to restore the confidence of markets, not to speak of their own citizens." (Schäuble 2010)

especially in the current fiscal straightjacket. The result is procyclical fiscal policy which works against automatic stabilizers (De Grauwe and Ji 2016). Clearly, the implemented European Stability Mechanism (ESM) absorbs some of these risks, but it seems obvious that this is not enough for real stabilization purposes. De Grauwe and Ji (2016) convincingly show that even though business cycles are more synchronized now between Member States than before EMU, their different amplitudes have, however, increased. Thirion (2016) further identifies that the Eurozone system itself caused some of its asymmetric shocks. For example, the boom of private debt in Spain or Ireland was partly due to low interest rates. **It is difficult to find a one-size-fits-all fiscal policy rule. Deficits might have to be much higher in one country than in another to stabilize growth and employment.** Critical observers discussed problems regarding the (reformed) SGP and (numerical) budget targets in light of a sectorial balance perspective even before the debt crisis (e.g. Hein and Truger 2007). The current setting cannot withstand an analysis from a sectorial balance view. Simple national accounting identities show that the public balance reflects the saving and investment decisions, as well as the current account position of a country. In other words, the public balance is a counter-part of the private and the external balance. From a sectorial balance perspective we can derive that if current accounts are to be balanced in the long-term, the public sector has to be the adjusting variable to any given private sector balance in order to ensure a targeted level of employment. Therefore, Hein and Detzer (2014; 17) develop the following simple requirement for fiscal policy

$$D = D_L + D_s(Y^T - Y) \text{ and } D_s > 0,$$

with D_L permanent public deficit (surplus), Y output, Y^T output at targeted non-inflationary full employment and D_s the discretionary fiscal policy reaction to short-term deviations of output from its potential (output gap). The equation basically summarizes the stabilization function of fiscal policy, “aligning aggregate demand with the level of potential output” (Bibow 2013; 24). Fiscal policy’s long-term objective is to balance private sector savings with the current account in balance, as well as to react to deviations from targeted output respectively (Hein and Detzer 2014).

This might require deficits higher than the current fiscal straightjacket in Europe tolerates. Especially considering the immense current account imbalances which have piled up, there must be much more room to maneuver to allow for a catching up process to happen (Hein and Detzer 2014). With the

implementation of the Macroeconomic Imbalance Procedure (MIP) there have been efforts made to tackle that problem, but the asymmetric design (focus of adjustment on deficit countries and hardly any attention on surplus countries) provides little hope for progress in the future. The present fiscal framework is incompatible with the policy requirements laid out above. Up to this point, national coordination of fiscal policy is lacking to generate a Euro-wide fiscal stance suitable regarding the macroeconomic environment and cyclical conditions.

The decentralized rules-based framework produced problems with compliance and moral hazard in the upturn and procyclical discretionary policy in the downturn. A functional fiscal policy in the lines presented above needs to be much better coordinated. Bibow (2013; 25) correctly points out that “discipline at lower levels of government is indeed an important aspect of governance, but typically not the only one”. **If policymakers do not want to abandon the national fiscal straightjackets, a centralized solution which provides “coordination, flexibility, and redistribution” becomes crucial for the survival of the currency union.** The proposal to coordinate national fiscal policies between member states efficiently to overcome macroeconomic imbalances in the Euro area is incompatible with the current framework of fiscal rules. Therefore, a system where fiscal capacities are transferred from the national to a supranational level in order to deal with idiosyncratic and uncertain situations seems essential. A relevant budget for the Eurozone may provide the required stabilization anchor and instrument for rebalancing the Eurozone on a high non-inflationary employment level, both in the short and long run (Hein and Detzer 2014). Nonetheless, it has to be emphasized that any form of fiscal capacity should not be used to further suppress crisis countries via the restrictive deflationary fiscal policies the Eurozone has experienced since 2010 or to further implement structural reforms in the lines of increasing flexibility in the labour and product markets. In that light, Bibow (2013) and Hein and Detzer (2014) critically review the most prominent proposals for a fiscal capacity. The authors regard for instance the plans of the European Commission (2012) or the Tommaso Padoa-Schioppa Group (Enderlein et al. 2012) to implement some form of insurance fund as a new instrument to promote further structural reform and are therefore highly skeptical.

A more promising idea is to install a European unemployment insurance scheme (e.g. Dullien, 2013; Andor 2016). De Grauwe and Ji (2016) point out that that the unemployment insurance must, however, be given the opportunity to go into deficit, otherwise it does not capture the asymmetric aggregate

demand problems of the EMU and might cause severe political problems. If it fulfills this requirement, the unemployment insurance can be an efficient tool to deal with cyclical stabilization. However, Hein and Detzer (2014; 23) clarify that an European unemployment insurance might be a good instrument for short run demand problems but cannot “provide stabilization of aggregate demand in the euro area beyond the trade cycle” or “contribute to overcoming the structural imbalances in the euro area which have contributed to the crisis”. **A relevant Eurozone budget would enable policymakers to deliver a stable expenditure path in all countries, provide public investment more directly and thereby tackle the Eurozone investment deficiency.** Cutting investment spending instead of making changes to current spending, tax rates or transfers is easier and faster to implement for governments under fiscal pressure. Especially in the current framework, there is no efficient public investment protection. However, many empirical studies confirm the high impact of public investment on growth and employment in the short run (Meta regression analysis by Gechert 2015). Furthermore, the long run impact on productivity growth is ignored (Hein and Stockhammer 2010). Obviously, an insurance solution is a step forward, but a Eurozone budget is the superior solution for stabilizing the inherently fragile Eurozone both in the short- and the long-term.

In sum, it has been shown that **the so-called design failures of the Eurozone can better be understood as an “unfinished building”** (Bofinger 2016; 228). Thirion (2016) points out that the idea behind the Delors Report (European Commission, 1989) was that fiscal integration would be followed by monetary and economic integration. The doubts regarding the framework have recently become stronger again and reached political leaders and major policy institutions like the IMF. **A better functioning of the EMU can only be achieved by “doing much more together”, as has been recently laid out in Scenario 5 of the Commission’s White Paper (European Commission 2017).** Importantly, Scenario 5 includes the need for a Eurozone fiscal stabilization function. The EMU design failures lead to a vast amount of policy proposals in academia and by European policymakers. The ideas range from a higher European fiscal capacity (Five President Report, Enderlein et al 2012), to a Euro Treasury (Bibow, 2013), an unemployment insurance (Beblavý et al 2015, Dullien 2013, Andor 2016) or a stabilization fund (De Grauwe and Ji, 2016). Most of them unite the need for further political integration to achieve some

mechanism for Eurozone-wide stabilization⁷. **A proper Eurozone budget is a necessary step forward to overcome the missing instrument for euro-wide demand management, to correct the huge macroeconomic imbalances and to enter a sustainable growth path.** Nonetheless, “the emergence of de facto political union must also be addressed through the development of democratic structures in parallel” (Sawyer 2013; 26). Without democratic underpinning the project is doomed to fail. The following sections elaborate on this issue.

4. The institutional debate on a fiscal capacity for the Eurozone

As it appears from the analysis conducted in the previous sections, when the EMU was established at the time of the adoption of the Treaty of Maastricht, it was believed that convergence of economic conditions through the four criteria set out in Article 109j(1) (now Article 140(1) TFEU) would have been sufficient to ensure the necessary stability and coordination amongst the Member States participating to the single currency. However, **the severe distress that affected the economies of certain Eurozone Member States as a consequence of the financial crisis erupted in 2007, revealed that such architecture was ill-conceived, and needed to be deeply, and urgently corrected** (De Grauwe, 2013).

Lacking the political conditions to redesign the structure of the EMU from its very legal foundations, the Eurozone Member States and the EU institutions undertook a laborious, fragmented and not always coherent effort in order to progressively shore up, repair and renovate such structure, without formally amending its underpinning principles (De Streel, 2013; Louis and Lastra, 2013). In the years that followed the outbreak of the Greek debt crisis, the procedures aimed at ensuring the respect of the fiscal discipline by the Eurozone Member States (and, to a lesser extent, the macro-economic convergence amongst their economies) have been significantly strengthened, while some limited instruments of financial solidarity have been progressively adopted, alongside the continuous and sustained effort of the ECB to supplement the loopholes in the mechanisms of fiscal and macro-economic coordination within the limits of its monetary policy mandate. Moreover, the creation of a

⁷ The different line of proposals is replacing some design features in the current set of rules (expenditure rules Hein and Detzer (2014), Golden Rule of investment Truger (2015))

Banking Union centralising the functions of supervision and resolution as regards the most significant credit institutions in the Eurozone represents nothing less than the edification of a new founding pillar of the EMU.

The effort has undoubtedly produced some significant results, and has contributed to a partial stabilisation of the financial framework within the Eurozone, although at the price of creating a complex legal patchwork whose inconsistencies and loopholes are yet to be fully explored and assessed (Chiti and Teixeira, 2013; Keppenne, 2014). **Such effort, however, appears far from being concluded**, as it is testified by a number of institutional documents issued over the last year, and especially by the so-called Five Presidents report, published in July 2015 (Juncker et al., 2015). As it appears from the Five Presidents report, the work is still in progress in a number of different fields, including, in particular, economic convergence, financial integration and fiscal stabilisation.

In this context, the issue of a fiscal capacity of the Eurozone is not new. **Reference to a fiscal capacity of the Eurozone is made in several institutional documents dating back to the summer of 2012**, and the debate concerning it is very extensive, as it covers a large variety of instruments, with different purposes and configurations, that have sometimes little in common with each other. **In general, the notion of fiscal capacity is intended in the sense of the possibility, for certain designated institutions, to count on a defined amount of financial means, directly raised or transferred by the Member States, in order to carry out certain specific tasks linked to economic convergence or financial stabilisation within the Eurozone** (Repasi, 2013; Fabbrini, 2016).

As it appears from this very general definition, a very large number of possible solutions could fall under such broad umbrella. Moreover, it is easy to spot that some embryos or prototypes of instruments intended to fulfil such function already exist amongst the instruments put in place by the European Union and by its Member States during the crisis. The discussion on how to supplement those instruments, and eventually stabilise them within the architecture of the EMU, is currently ongoing both within the institutions and outside, in the political and in the academic sphere. It isn't hard to understand that giving account of the entirety of the debate would be overly ambitious in the context of this paper: therefore, our focus will be limited to the institutional side.

The Report "Towards a Genuine Economic and Monetary Union", presented in its first version by the

President of the European Council on 26 June 2012, included a rather general proposal for “an integrated budgetary framework”, which included “the development of a stronger capacity at the European level, capable to manage economic interdependencies, and ultimately the development at the Euro-area of a fiscal body, such as a treasury office” (Van Rompuy, 2012a: 6). The subsequent Interim Report of 12 October 2012 specified that “the fiscal capacity would support new fiscal functions which are not covered by the Multiannual Financial Framework” (Van Rompuy, 2012b: 5). Such functions would amount, in particular, to “facilitate adjustments to country-specific shocks by providing some degree of absorption at the central level” and “structural reforms that improve competitiveness and potential growth” (Van Rompuy, 2012b: 5). Next to such fiscal capacity, and separated from it, the Interim Report also referred to “individual arrangements of a contractual nature” concluded by Eurozone Member States with the EU institutions “on the reforms promoting growth and jobs these countries commit to undertake and their implementation”, which “could include supporting reform efforts through limited, temporary, flexible and targeted financial incentives” (Van Rompuy, 2012b: 7).

On 20 November 2012, the European Parliament adopted a resolution on the Report “Towards a Genuine Economic and Monetary Union”, in which it explicitly backed the proposal for the establishment of a “central budget for the Euro-area”, and expressed the view “that a ‘genuine EMU’ cannot be limited to a system of rules but requires an increased budgetary capacity based on specific own-resources [...] which should in the framework of the Union budget, support growth and social cohesion addressing imbalances, structural divergences and financial emergencies which are directly connected to the monetary union” (European Parliament, 2012a: para. CM).

On 28 November 2012, the European Commission presented its “Blueprint for a Deep and Genuine Economic and Monetary Union”, based on a three-step approach (European Commission, 2012b). In the first step, “the Commission merged the idea of ‘contractual arrangements’ with the idea of ‘fiscal capacity’ in the ‘Convergence and Competitiveness Instrument’” (Repasi, 2013: 8). In the second step, such instrument would evolve into a proper fiscal capacity for the Eurozone, relying on own resources and enabled to resort to borrowing on the financial markets. The third step would finally lead to the establishment of a “Central Budget providing for a fiscal capacity with a stabilisation function”, working as “an EMU-level stabilisation tool to support adjustment to asymmetric shocks, facilitating stronger economic integration and convergence and avoiding the setting up of long-term transfer flows”

(European Commission, 2012b: 31).

On 5 December 2012, the President of the European Council submitted the final Report “Towards a Genuine Economic and Monetary Union”, which included the proposal for “an insurance-type mechanism between euro area countries to buffer large country-specific economic shocks” (Van Rompuy, 2012c: 9). Such mechanism could consist either of “contributions and disbursements [...] based on fluctuations in cyclical revenue and expenditure items”, or of “a complement or partial substitute to national unemployment insurance systems” (Van Rompuy, 2012c: 11). Moreover, the report envisaged the possibility to put in place specific “financial incentives” for Member States that “enter into arrangements of a contractual nature with EU institutions”. However, in its conclusions, the European Council of 13/14 December 2012 only referred to such form of “financial incentives” for Member States concluding contracts with EU institutions on structural and fiscal reforms, while the other possible components of a “fiscal capacity” were not mentioned anymore (European Council, 2012).

It appears, in sum, from this brief overview of the institutional dialogue that took place in 2012, stimulated by the peak of the crisis that threatened the financial stability (and the same existence) of the Eurozone, that (notwithstanding the relatively more forward-looking approach of the Parliament and of the Commission) the proposals for a shared fiscal capacity were essentially oriented towards a dual objective: on the one hand, it was meant to serve as a “carrot” to compensate the “stick” of structural reforms; on the other hand, it was intended as an instrument to absorb asymmetric shocks (and therefore to partially complement the dangerously incomplete structure of the EMU), but still while avoiding to lead to permanent transfers between countries (European Parliament, 2017c: p. 10; Repasi, 2013; Thirion, 2017). Anyways, the mentioned proposals put forward by the various supranational institutional actors have been ultimately toned down by the representatives of the Member States, once the financial storm seemed to be on its way to settle down. In the meantime, however, next to the strengthening of the macroeconomic surveillance framework, certain instruments of financial solidarity were put in place outside the framework of the EU, therefore indirectly constituting a partial response to the EMU deficiencies and an embryo of a shared financial “capacity”, even though with a limited purpose.

The idea of a fiscal capacity of the Eurozone, however, kept lingering in the public debate on EMU

reform, both within and outside the institutional sphere.⁸ In the institutional context, the European Parliament proved (quite unsurprisingly) to be the most consistent and advanced advocate of the idea. Reference to further steps towards a genuine fiscal capacity “governed under the Community method as an integral part of the EU budget” is contained in a resolution of May 2013 (European Parliament, 2013: para. 22), and again, in June 2015, it is once again reaffirmed the support for “a euro area fiscal capacity based on specific own-resources which should, in the framework of the Union budget [...] assist Member States in the implementation of agreed structural reforms” (European Parliament, 2015: para. 57) (see Fabbrini, 2016). Besides the European Parliament, since 2013, political support to the idea of a fiscal capacity of the euro area came also, in different forms, from some Member States’ Governments (see Fabbrini, 2016: p. 156; Macron and Gabriel, 2015; Padoan, 2016). However, it is precisely at the European Council level that a commitment for a concrete plan in this sense never gained momentum, which also explains the low profile maintained by the Commission after the Blueprint of 2012. It is worth to add that during those years, the issue of a shared fiscal capacity amongst Eurozone Member States also invests the debate on the Banking Union (European Commission, 2012a), with the limited result of the creation of a Single Resolution Fund.⁹

⁸ Outside the institutional sphere, in particular, the debate has not been limited to academic literature, but it has heavily involved think tanks and research groups, and has produced a significant policy-oriented literature. In particular, it is worth to mention the involvement of FEPS (Rodrigues, 2014), and, amongst others, of the Delors Institute (Enderlein et al., 2012; Rubio, 2016), Bruegel (Wolff, 2012; Pisani-Ferry et al., 2013; Demertzis and Wolff, 2016) and, with special attention to the specific issue of a European unemployment insurance, of CEPS (Beblavý and Maselli, 2014; Beblavý et al., 2015). Moreover, it is worth to recall that the issue of a fiscal capacity has been included of several reflexions and proposals offered by various groups of academics in the run up to the 2014 European Parliament Election (see, in particular, von Bogdandy et al., 2013; Bénassy-Quéré et al., 2014; Piketty et al., 2014). In the political sphere, however, the debate has remained rather limited to specialised circles, and it hasn’t found a vast echo in the civil society.

⁹ Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, OJ L 225, 30.7.2014, p. 1–90; Council of the European Union, Agreement on the transfer and mutualisation of contributions to the Single Resolution fund, Brussels, 14 May 2014, 8457/14.

The objective of a “targeted fiscal capacity at the Eurozone level” was again contained in the political guidelines laid down by Jean-Claude Juncker in July 2014, while he was taking office as new President of the Commission, amongst his proposals for “A deeper and fairer Economic and Monetary Union” (Juncker, 2014: 8). Moreover, although in a separated context, Juncker announced “an ambitious Jobs, Growth and Investment Package”, making use “of the common EU budget and of Union financial instruments such as the European Investment Bank” (Juncker, 2014: 5), preluding to the launch, in November 2014, of the European Fund for Strategic Investments (EFSI),¹⁰ which can also be considered as a sort of prototype of a building block of a shared fiscal capacity, although strictly curtailed and, in this case not limited to the Eurozone.

In June 2015 the President of the European Commission, in close cooperation with the Presidents of the European Council, the Eurogroup, the ECB, and the European Parliament, published the Report “Completing Europe’s EMU” (the so-called Five Presidents Report; Juncker, 2015). However, such report confirms the political difficulties to agree on the establishment of a fiscal capacity for the euro area, and once again the President of the Commission has to limit himself to a generic reference. In fact, building on the previous report “Towards a Genuine EMU,” the new report indicates the importance of creating “a euro area-wide fiscal stabilization function”, although little details are given at this regard, and the achievement of this objective is postponed to “the longer term” (Juncker, 2015: 14). In this sense, **the Five Presidents Report seems “timid and in retreat from the Reports of 2012”**, which dared (at least) to outline a more ambitious roadmap (Louis, 2016). Following up on the report, the Commission published a Communication indicating the steps towards its implementation: no mention is made of a fiscal capacity,¹¹ and the attention is rather focused on improving the instruments of coordination of national fiscal policies (European Commission, 2015).

As regards the most recent developments, it is once again the European Parliament that seems to relaunch the debate. In particular, the Resolution on a budgetary capacity for the Eurozone approved on

¹⁰ European Commission, Press release, EU launches Investment Offensive to boost jobs and growth,

Strasbourg, 26 November 2014, IP/14/2128, available at: http://europa.eu/rapid/press-release_IP-14-2128_en.htm.

¹¹ The Commission prefers to use the milder expression of “fiscal stance”, which alludes to a coordinated rather than to a centralised approach.

16 February 2017 on the basis of the Béres Report calls for the establishment of a fiscal capacity aimed at fulfilling three different functions, and namely: promoting convergence through the implementation of structural reforms, and contribute in absorbing both asymmetric and symmetric shocks (European Parliament, 2017c).¹² However, the political obstacles seem to be still relevant at the level of the European Council, and the recent declarations of the Heads of State and Government of the Member States in Bratislava¹³ and in Rome¹⁴ do not make any reference to the issue.

Besides the political obstacles, the creation of a fiscal capacity entails a number of complex legal issues, which vary significantly according to the function and the design of the instrument proposed. In fact, as it is pointed out in the European Parliament Working Document that preceded the adoption of the recent Resolution on a budgetary capacity for the Eurozone, “the European policy debate so far has focused on several functions for a budgetary capacity for the euro area: (a) fiscal stabilisation linked to macroeconomic aggregates, (b) a micro approach of unemployment insurance, (c) joint resources for a fiscal backstop in systemic financial crises, (d) the lender of last resort function for illiquid sovereigns more broadly, (e) pooled resources to finance added-value projects/common public goods and (f) support for convergence” (European Parliament, 2017c: p. 13). Different types of instruments can be, in turn, designed to fulfil each of the functions sketched above (European Parliament, 2017c; D’Alfonso and Stuchlik, 2016; Thirion, 2017). A fiscal capacity can, therefore, take, amongst others, the form of an insurance mechanism that works as a “rainy day fund”, of a fully-fledged Eurozone budget, of an EMU-wide basic unemployment benefit scheme, of a re-insurance system for national unemployment schemes, of the pooling of sovereign issuance (Eurobonds), of the creation of a European Monetary

¹² On the same day, the European Parliament has also approved two other resolutions, more generally dedicated to the reform of the functioning of the EU as a whole (European Parliament, 2017a; European Parliament, 2017b). Both resolutions make explicit reference to the establishment of a fiscal capacity of the euro area.

¹³ European Council, Bratislava Declaration and Roadmap, available at: <http://www.consilium.europa.eu/en/press/press-releases/2016/09/16-bratislava-declaration-and-roadmap/>

¹⁴ European Council, The Rome Declaration, Declaration of the leaders of 27 member states and of the European Council, the European Parliament and the European Commission, available at: <http://www.consilium.europa.eu/en/press/press-releases/2017/03/25-rome-declaration/>

Fund, of a fund similar to that of the recently created European Fund for Strategic Investments, or of a fund ensuring the provision of common essential public goods (European Parliament, 2017c: p. 13).

Each of these instruments presents specific legal issues, whose assessment depends on its specific design as regards, in particular the funding, the triggering mechanisms, the institutional ‘location’ of the budget and its governance. **The legal issues arising can be, however, roughly grouped around a few axes. First of all, the issue of competence: not all the options outlined above can be, in fact, lawfully achieved without a previous reform of the Treaty.** However, it does not have to be underestimated the fact that the Treaty has already proven to be relatively elastic, and to offer some room for manoeuvre where in presence of a strong political will. In particular, it seems reasonable to argue that, with a careful design, several of the possible solutions would indeed be allowed under the Treaty currently in force (Fabbrini, 2017). Second, a similar issue of competence has to be taken into consideration as regards the funding of the instrument, especially where such funding is based on taxes levied directly at the EU level (Fabbrini, 2017; Monti et al.; 2016). Thirdly, and linked to the issue of competence, there is the question concerning the possibility to establish the fiscal capacity outside the legal and institutional framework of the EU. This solution would have the advantage of reducing the relevance of the competence issue, although the use of external agreement is not without limits.¹⁵ On the other hand, however, choosing to place the fiscal capacity outside the framework of the EU would put at risk the coherence of EU law, and it would contribute to curtail the use of the Community method. Fourth, the EU competence has to be used in the respect of the Treaty provisions, including Article 125 TFEU, establishing the so-called “no-bailout clause”. The clause, however, has been interpreted in a lenient way so far by the Court,¹⁶ and it does not seem to pose insurmountable problems in this context. **Fifth, it remains to consider the issue of the scope of the instrument, which would be shared only by some of the Member States. In this sense, the creation of a fiscal capacity for the Eurozone (as a form of differentiated integration) would create a number of complications as regards the legal and the institutional relationship between the participating Member States and those who keep sharing the EU budget.**

¹⁵ See CJEU, Case C-370/12, Pringle [2012], ECLI:EU:C:2012:756.

¹⁶ See CJEU, Case C-370/12, Pringle [2012], ECLI:EU:C:2012:756; CJEU, Case C-62/14, Gauweiler [2015], ECLI:EU:C:2015:400.

The issue of differentiation is linked to the final one, which concerns the governance of the instruments, and of the relative institutional arrangements. The management of the fiscal capacity depends, once again, by the type of instrument chosen: in particular, **the creation of a form of Eurozone budget entailing a margin of discretion in its management would require an adequate form of political control, to ensure the respect of the principle of democracy.** Such issue will be the object of the next section.

5. The constitutional aspects of a fiscal capacity for the Eurozone and the issue of political accountability

So far, the fiscal capacity of the Eurozone is connected to the issue of political legitimacy in a negative sense, namely that we need to have political control on it. Nevertheless, it is also related to it in a positive sense, as a major paragon for increasing the political legitimacy of the EU. The first part of our analysis needs to deal with the question why a common EMU budget is needed from a constitutional point of view in terms of the present conjuncture. It is beyond any doubt that the last years in Europe have been marked by the results of the economic crisis and the efforts to deal with it. The leitmotiv of the management of the present crises was the predominance of the intergovernmental dimension in all the arrangements. The community method was abandoned as too slow and negotiations as well as agreements between governments were preferred, as suitable for giving the rapid solutions needed.

This fact, acknowledged not only by major political actors and scholars (Venizelos, 2016b) but also by the European institutions themselves (European Parliament, 2017c, 2015, p. 4) brings us to the core of the problem to which the fiscal capacity of the Eurozone constitutes the answer: the lack of democratic accountability at the Eurozone level. The European Council, as the par excellence intergovernmental institution played the dominant part during the crisis while the European Parliament did not have any role that could be described as decisive. The idea of an **intergovernmental negotiation** taking place whenever a crisis emerges, combined with a perception of sovereignty as the ability to form the final crisis manager showcases the close relation between the lack of fiscal capacity of the Eurozone with its democratic deficit as well as with its sovereignty deficit.

Therefore, an issue of fiscal policy is closely connected to a series of constitutional and democratic legitimacy issues. It is thus submitted that the establishment of a fiscal capacity for the Eurozone

dynamically addresses not only the financial but also the constitutional pathologies of the crisis period.

First of all, as the **crisis** has proved for the weaker Member States, sovereignty is comprised, among others, by the so called “**fiscal sovereignty**”; in other words, a right of each sovereign entity to its own fiscal policy and consequently to its ability to absorb financial shocks and implement its own economic and social policy (Venizelos, 2016a, p.18). The latter element is especially important from a social democratic point of view, since it entails the ability to move from a neoliberal towards a **social Europe model**. Moreover, its significance for the position of the Eurozone in the international equilibrium of economic powers is showcased by the comparison of the existent slight EU budget with that of federal entities, where it frequently exceeds 20% of the gross domestic product, (IMF, 2016, p. 45) being almost 20 times that of the EU, which is about 1% of the Member States’ GDP. In this direction, it is indicative that the foundation of the most famous federal budget, the US budget can be traced back to times of crisis, when Treasury Minister, Alexander Hamilton assumed on behalf of the federal government the liabilities of the states that have gone bankrupt and have resorted to bailout after the American Revolution (IMF, 2013 p. 13). Therefore, economic crisis, enhanced fiscal capacity and fiscal sovereignty are notions closely connected. After bailout episodes, history has proved that a stronger center is needed.

Nevertheless, at the state level, fiscal sovereignty is connected to political sovereignty as well. The latter can be divided in internal which is related to the conduct of foreign relations and internal. Internal sovereignty either directly through the notion of parliamentary sovereignty in the United Kingdom (Dicey, 1902 p. 37). or indirectly through the principle of popular sovereignty (Venizelos, 2016b) is connected to the Parliament, as an assembly representing the electorate. In the classical political theory, Parliament is associated not only with the legislative power; “the time of the House is by no means wholly occupied by legislation” (Jennings, 1957 p. 5). Holding the government into account and checking and approving government’s spending are equally important functions of the Parliament, shaping its overall character as a deliberative democratic assembly (Ekins, 2012 p. 155).

A Parliament where any of the aforementioned functions is lacking is inevitably facing important, existential deficiencies. The same goes for a function nominally existent but not actually living up to the expectations for an assembly of such an importance. In this context, budgetary issues are really

important and a budget equivalent to the 1/20th of other federal budgets means that what is at stake in the European Parliament is not equally important from this point of view with the assemblies of other federal or confederal entities; representation through Parliaments is connected since the time of Magna Carta with the raising and allocation of revenues. The simple principle “**no taxation without representation**”, used during the American Revolution but having roots that date back as early as 1215 should always be the guiding principle; “no taxation with representation though”, can be equally problematic, since the inexistence of an adequate European Union and especially Eurozone fiscal capacity entails both a representation and an accountability deficit at the European level which combined with the existence of a monetary union at the Eurozone level create not only a major fiscal but also a democratic issue that needs to be addressed.

The creation of a fiscal capacity for the Eurozone can contribute to the amelioration of the present situation regarding accountability and democracy in the Union. It is submitted that the establishment of a **Eurozone budget** subject to the scrutiny and approval of the **European Parliament** will decisively contribute to the functioning of the accountability mechanisms within the EU. In this way, the enhancement of the monetary and political union will be accompanied by the development and deepening of democratic structures. A Parliament where the budget discussed and voted is larger and connected to a monetary union is much more empowered, compared to the current state of affairs. Thus, its representativeness gains an advanced meaning, connected to the paramount expression of a real economic union which through economic unity achieves a fiscal quasi-sovereignty, a crucial step towards integration.

Moreover, it is equally important from a constitutional point of view that the crisis management will shift from an intergovernmental negotiation model towards a **fiscal union and accountability-based model**. Thus, the Parliament will provide the major forum for the discussion and decision-making on a series of steps taken at the Eurozone level. At the same time, a Eurozone fiscal capacity will inevitably lead to a common authority for supervision and management for the common budget (European Parliament, 2017c, p. 4) which can be formed as a euro-area Treasury (Juncker, Tusk, Dijsselbloem, Draghi and Schulz, 2015, p. 18) Voting on the budget and issues relating to it in the European Parliament will consequently be accompanied by the responsibility and accountability of the relevant political heads of such an authority to the European Parliament. This both requires and entails a richer conception of

responsible government within the EU, an enhanced democratic accountability greater than that included in the collective responsibility of the whole Commission towards the Parliament provided by the motion of censure of art. 234 TFEU (European Parliament, 2013, p. 27). Therefore, gradually this measure will lead to individual responsibility to the Parliament, since a mistake of the Treasury in many cases will not justify a motion of censure against the whole Commission. Individual responsibility which could be established either legally or conventionally will be an important step in the direction of achieving parliamentary government within the EU framework, an effort significantly boosted by the **Spitzenkandidaten convention** for the election of the Commission President during the last European Elections (European Parliament, 2012b)

Nevertheless, the establishment of an **EMU fiscal capacity** as well as an advanced framework of democratic accountability and political constitutionalism within the bounds of the European Parliament creates also a representation question. If the European Parliament is the forum for the discussion and voting on the budget, that means that MEPs from non-EMU countries that are EU Member States and are represented in the Parliament will have a right to deliberate and vote on issues relating to the EMU's fiscal capacity. The solution to this important issue lies on the creation of a specific Eurozone subcommittee (Ayrault and Steinmeier, 2016, p. 9). within the European Parliament, which will, among others, discuss and vote the budget and to which the Members of the Treasury will be accountable.

To sum up, we consider the establishment of a fiscal capacity for the Eurozone as a means towards not only effective Eurogovernance and crisis management but also as a reform with important constitutional aspects. It will enhance the parliamentary character of the European Union, boost democratic accountability, turning the European Parliament into a deliberative assembly deciding on fiscal issues. Simultaneously, the creation of an EMU budget and consequently of a Treasury can be proven catalytic for the move from the currently dominant intergovernmental arrangements towards the deeper political unification of the European Union.

6. Conclusion and policy proposals

As a conclusion, we join the dominant literature in endorsing the creation of a fiscal capacity for the Eurozone. Such conclusion derives, first of all, from the considerations of economic theory exposed in

Section 3, which explain how the survival of the Eurozone is dependent on the correction of the flaws of the Maastricht design (see also Bonizzi et al., 2016). Second, the creation of a fiscal capacity constitutes a fundamental step in the direction of convergence and solidarity, very much needed in the current political context. Third, the establishment of a common budget for the Eurozone countries can constitute a vector of legitimacy for the European Parliament, which will be entrusted with the political task to supervise its management, therefore contributing to enhancing the democratic profile of the EU institutions. Fourth, and most of all, **the shift from fiscal constraints to a fiscal capacity represents a change of paradigm: turning back from rules to politics in the approach to fiscal policy has to be intended as a space regained to public power**, and therefore to popular sovereignty, against the unmediated forces of the markets.

Our proposal for a fiscal capacity of the Eurozone consists of three points.

1. A fiscal capacity to break the austerity

The establishment of a fiscal capacity must not be a disguised way of imposing further fiscal discipline.

This has to be reflected in the design of the instrument, and in the way the instrument is managed. As regards the type of instruments to be put in place, we consider the recent European Parliament Resolution based on the Béres Report as a good basis (European Parliament, 2017c). However, the “convergence” pillar should not become the lever to drive structural reforms oriented to the devaluation of labour in peripheral Member States. Moreover, the instruments envisaged by the mentioned European Parliament Resolution should be accompanied by a stronger centralised action in the field of public investments, with the strengthening of the EFSI.

2. An instrument situated within the framework of the EU

The fiscal capacity must be situated within the legal and institutional framework of the EU. The establishment and the governance of the fiscal capacity must be based on the Community method.

The governance structure should take into consideration the appropriate measures of coordination between participating and non-participating Member States, without producing a duplication of the EU institutions (see also European Parliament, 2017b).

3. Political direction entrusted to the European Parliament

The executive powers relative to the management of the capacity should be granted to the Commission, with the aim of creating a proper Eurozone Treasury (European Parliament, 2017a), whose **political accountability and democratic control should be ensured by the provision of appropriate procedures of parliamentary oversight**. Such procedures shall not be limited to ex-post consultations, **and shall instead favour the participation of the European Parliament to the formulation of the relevant political choices**. Moreover, such procedures can take into account the view of the national Parliaments only as long as the mechanism does not undermine the position of the European Parliament (see also European Parliament, 2017b; Rodrigues, 2014).

GLOSSARY

Asymmetric shock. The circumstance when an economic event affects one economy or part of an economy more than another. An asymmetric shock is particularly relevant when the economic event has a differentiated impact in two different regions of a currency union.

Austerity. Contractionary fiscal actions (e.g. increasing taxes or decreasing government spending) in the downturn (Wren-Lewis 2016).

Banking Union. The legal and institutional framework for banking supervision at the EU level. The banking Union consists of the Single Supervisory Mechanism (SSM) and of the Single Resolution Mechanism (SRM). As of today, only the Eurozone Member States participate to the Banking Union.

Current account. The current account is defined as the sum of the balance of trade (export of goods and services minus imports), net income from abroad and net current transfers. Economies with a positive (negative) current account are net lenders to (net borrowers from) the rest of the world.

EFSI (European Fund for Strategic Investments). EFSI is an initiative launched jointly by the European Commission to help overcome the current investment gap in the EU by mobilising private financing for strategic investments. EFSI is one of the three pillars of the Investment Plan for Europe that aims to revive investment in strategic projects around Europe to ensure that money reaches the real economy.

EMU-wide basic unemployment benefit scheme. Under such a system, a certain share of contributions to the unemployment insurance would be paid to a European fund which would provide basic unemployment insurance directly to the short-term unemployed.

Eurozone fiscal capacity. The possibility, for certain designated institutions, to count on a defined amount of financial means, directly raised or transferred by the Member States, in order to carry out certain specific tasks linked to economic convergence or financial stabilisation within the Eurozone. The notion partially overlaps with the one of Eurozone budget: sometimes it is used in a broader sense, sometimes in an interchangeable way.

Fiscal Compact. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) is more commonly referred to as Fiscal Compact. The TSCG is an intergovernmental treaty signed by the Member States of the Eurozone and Bulgaria, Denmark as well as Romania. The Fiscal

Compact is, however, only one part of the treaty. Generally, the Fiscal Compact further tightened fiscal rules in its signature countries.

Fiscal Multiplier. The fiscal multiplier describes the effect of discretionary fiscal measures on GDP. A positive (negative) multiplier of one means that the measure (e.g. an increase in spending or a tax cut) amounting to 1 % of GDP increases (reduces) GDP by 1 %.

Fiscal policy / Monetary policy. Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply.

Fiscal rules. The most commonly used definition for fiscal rules in the academic literature is from Kopits and Symansky (1998; 2): “A fiscal policy rule is defined, in a macroeconomic context, as a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance”.

Fiscal sovereignty. The capacity of each sovereign entity to its own fiscal policy and consequently to its ability to absorb financial shocks and implement its own economic and social policy

Macroeconomic Imbalance Procedure (MIP). The MIP is included in the Six-Pack. It is meant to monitor and guide as well as correct economic imbalances in the EU. Member States have to prepare Alert Mechanism Reports for EU’s surveillance. According to scoreboard indicators, the MIP can initiate measures to correct macroeconomic imbalances. The MIP is criticized for being asymmetric, putting emphasis on the adjustment of current account deficit countries with little attention on surplus countries.

Optimum Currency Area (OCA) theory. Monetary theory aimed at identifying the economic characteristics a geographic area should have in order to maximise economic efficiency by embracing a fixed exchange rate system.

Own resources. Own resources are the EU's revenue. The different types of own resources and the method for calculating them are set out in a Council Decision on own resources. There are three types of EU own resources: traditional own resources (mainly customs duties on imports from outside the EU); own resources based on value added tax (VAT); own resources based on GNI (each Member State transfers a standard percentage of its GNI to the EU, the largest source of revenue of the EU budget).

Potential output. Potential output describes the maximum of goods and services an economy can produce when all its resources are used most efficiently. At potential output all productive capacities are utilized, hence there is full employment. It is an unobservable variable and needs to be estimated.

Rainy day fund. An insurance mechanism where Member States' contributions and disbursements would be calculated on the basis of some cyclically-sensitive economic indicator.

Six Pack. A package of legislative measures implemented on 13th December 2011 reforming the Stability and Growth Pact, proposed by the European Commission and approved by all Member States. It consists of five regulations and one directive generally tightening fiscal and macroeconomic surveillance in Europe. On the fiscal side it strengthened the SGP and budgetary surveillance. Furthermore the Six Pack includes the implementation of the Macroeconomic Imbalance Procedure (MIP) which monitors and controls economic imbalances.

Spitzenkandidaten convention. The nomination of candidates for the position of the President of the European Commission by the major European political groups and the agreement that President will become the candidate of the group that wins the most votes in the European Elections

Stagflation. Composition of 'stagnation' and 'inflation'. It is a macroeconomic state in which the inflation rate is high, the economic growth rate slows, and unemployment remains steadily high.

Two Pack. The Two Pack comprehends two regulations emending the European Semester and European budget surveillance. It was a follow up package of the Six Pack in 2011. The Two Pack also integrates agreements of the Fiscal Compact into European law.

Zero lower bound. A state in which the central bank wants to stabilize the economy and fight deflationary tendencies by lowering the short-term nominal interest rates but is unable to achieve its objective. Mainly because interest rates are (close to) zero and cannot go much lower, but there also might be various other reasons, such as high uncertainty and low sales expectations of investors. There is a broad economic literature on the issue.

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