



**INTERNATIONAL REFLECTION SEMINAR: “FROM THE EUROZONE TO A ‘EURO UNION’”**

**26-27 JUNE 2015 – NEUMÜNSTER ABBEY, LUXEMBOURG**

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## **INTRODUCTION**





**SEMINAIRE DE REFLEXION «DE LA ZONE EURO A L'UNION DE L'EURO »**

**26-27 JUIN 2015**

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**TOWARDS A EURO UNION**

THE ORIGINAL VERSION WAS PUBLISHED  
IN GERMAN BY DIE ZEIT ON OCTOBER 17, 2013.

**Crisis, what crisis?**

If public sentiment in Germany is anything to go by, there is little reason to worry about Europe. The period when it was feared that the euro might collapse seems a long time ago. Financial markets have calmed down. The design flaws of the monetary union seem to have been papered over, and European Council President Herman van Rompuy was able to claim, unchallenged, before the UN General Assembly in New York that the "existential threat to the euro" is over.

We think this is fundamentally wrong. There is no reason to relax the guard. On the contrary, the complacency of large sections of the German public with regard to the euro crisis is not only unfounded: it is dangerous. None of the fundamental problems underlying the euro crisis have been solved – not the banking crisis, nor the sovereign debt crisis, nor the competitiveness crisis. National debt problems continue to escalate. Banks are overloaded with bad loans, crippling the private sector. In the crisis countries, a generation is being deprived of its livelihoods and opportunities. The margins of the political spectrum in these countries are becoming increasingly radicalized. And willingness to find common solutions for the euro area appears to be rapidly on the wane.

We – eleven German economists, lawyers and political scientists – cannot accept the prospect of further playing for time and betting – with ever-larger wagers – that the crisis will eventually pass. Europe has structural problems that require structural solutions. Even though this is not a popular view at the moment, we are convinced that the monetary union needs deeper integration. More particularly, it needs a sufficiently powerful European economic government.

We speak as German but also as EU citizens who are connected with other EU citizens in a community. This is no contradiction: it is in Germany's self-interest to overcome fears about a transfer union and to stop dismissing any constructive proposal as an attempt to pull the money out of German pockets.

The no-bailout principle, which states that no state is allowed to save another from bankruptcy, was right. But if its enforcement causes incalculable damage, neither debtors nor creditors will believe the assertion that states must take direct responsibility for themselves. The architecture of the euro area can only be sound and stable if it prevents such collateral damage. That requires deeper integration, in four areas.

### **Responsible debtors need responsible creditors**

The Maastricht Treaty assumed that common debt rules would solve the problem of the irresponsible building up of debt. Greece showed this to be a delusion. Therefore, it was right to toughen sovereign debt rules with the fiscal pact. But it is also true that the crisis would not have been prevented by the fiscal pact itself in countries like Spain and Ireland. The fiscal risks that piled up in those countries were ultimately caused by excessive private sector debt.

Whether the indebtedness is public or private, it becomes a problem for the monetary union only if private creditors do not write off their losses on their own account, but socialise them. But that is exactly what happened: the debts of financial institutions, and of banks in particular, were socialised. The banks were able to do so because they knew that their systemic importance would give the European taxpayer no choice but to save them.

To put a stop to this game once and for all, the euro area needs a robust banking union. The single banking supervisor must ensure that the banking sector has a solid capital base. The common bank restructuring mechanism must make creditors accountable: if banks suffer large losses, first shareholders must fill the gap, then subordinated bondholders, thereafter senior creditors and lastly the bank funds financed by the banks themselves. Only when these options have been exhausted, should there be resort to the European taxpayer.

In principle, the European Council recognised all of this in the summer of 2012. But we predict that implementation will fail by the spring of 2014. As of May 2014, the European Single Supervisory Mechanism will perform stress tests and should show the red card to ailing banks. But how will this work, if no one knows how banks are to be recapitalised or liquidated in an emergency? Without a resolution mechanism, the supervisors will continue to sweep bank balance sheet problems under the carpet and Europe will face a Japanese-style decade of economic stagnation. Time is pressing. The 2014 European elections must not be an excuse for delaying solutions to the structural problems in the euro area.

## **Responsibility and solidarity go hand in hand**

The responsibility of member states entails the responsibility of their taxpayers. It is therefore inevitable that taxpayers will have to shoulder a large share of the burdens of the crisis, and suffer painful reforms. But the limit of responsibility when livelihoods are threatened. If in Greece, Portugal or Spain, a whole generation is deprived of their chance to live a productive life, it is not just a Greek, Portuguese or Spanish problem, but one that affects us all as citizens of the EU.

The monetary union cannot be permanently stable without a controlled transfer mechanism. Situations in which a euro-area country suffers an acute liquidity emergency and is forced to enact draconian austerity measures on its population must remain exceptional. To prevent such extremes, we need a euro-area insurance mechanism to cushion the fiscal consequences of a dramatic economic downturn. The euro area could therefore establish a common unemployment insurance system, to complement national systems; all countries that organise their labour market in line with the needs of the monetary union could be eligible for participation. This would create a mechanism to counteract deep recessions with automatic European stabilisers. Thus, the macro-economic cohesion of the euro area could be strengthened and the integration of the European labour market accelerated.

In fact, more labour mobility in the monetary union is urgently needed. Germany should not have to complain about a lack of skilled workers when many skilled workers are unemployed in Spain. The unemployed in crisis countries should be enabled to find work in other euro-area countries by attending language courses and being offered other training.

Moreover, in the current low interest rate environment, countries such as Germany would be well advised to invest in their own infrastructure and, thereby, to create demand across the euro area.

## **Democracy and rule of law must be strengthened**

In a Union, member states must mutually be able to rely on the fact that their governments are legitimately elected, their laws legitimately written and their citizens free and equal before the law. Potential members must therefore accept that they will be reviewed in depth on their democratic, constitutional, and fundamental rights standards. By joining, a state takes on the obligation to continue to comply with these standards. But the EU lacks effective and credible instruments to enforce this obligation – as in the case of Hungary.

This can become especially problematic if a member states goes through a severe economic crisis. Experience shows that such crises radicalise societies and threaten democratic institutions.

It is unacceptable that the EU can more effectively enforce state aid breaches than breaches of democratic or constitutional rules. The EU must be equipped with a sanctions mechanism to ensure that member states can rely on each other and that their citizens are not defenceless against the undermining of their constitutional orders.

The European Union is a community of law. The authority of European law depends on the functioning of the legislative, the executive and the judiciary in member states. Where they do not, the Union's foundations are threatened. Promoting effective rule of law should therefore be a much higher priority than, for instance, agricultural policy.

### **Cohesion: Public goods must be provided**

Political unions can provide public goods that each country would not be able to provide on its own. The original driver for European integration was securing the peace. Effective protection of external borders, humanitarian treatment of refugees and asylum seekers in the Schengen area, internal markets and the protection of our environment are also public goods that the EU is committed to provide. Providing a stable common currency is a public good for the euro area.

The limit of member states' responsibilities in a crisis are reached when the provision of such public goods is in danger. If a member state can, for example, no longer ensure airport security, it will harm European air transport as a whole. If a member state subjects asylum seekers to inhumane conditions, the European asylum system breaks down. If crisis countries begin to close their markets to protect domestic manufacturers, the internal market and common commercial policy are threatened. If the economic crisis in a member state reaches the point where financial markets speculate on its exit from the monetary union, then this can destroy the common currency.

The provision of these public goods must always function independently of the possible bankruptcy of a member country. That does not mean that their provision must be completely centralised. It may be sufficient to enable the EU to step in to provide support in a crisis. The EU does not need to begin to build decent accommodation for asylum seekers, but it must at least financially support those states that cannot achieve this on their own.

These four points – the responsibility of creditors, protection of opportunities, protection of democracy and rule of law, and preservation of public goods – are the minimum required to keep the euro alive. But more needs to be done to develop the full potential of the EU. The EU must exploit promote common public goods for the benefit of all.

We see particular potential in the common foreign and security policy. In a multipolar world in which China, Russia and others expand their spheres of influence and the global supremacy of the USA decreases, Europe ought to be able to defend her common interests effectively. It should be possible for Europe to pursue a joint strategy on global trade and finance legislation as well as on the use of global commons such as the deep sea or outer space. It is self-evident that countries in the euro area with a common currency should also claim a common seat at the IMF and World Bank. Were there an effective common foreign policy and centralised decision-making structures for security policy, a joint seat at the UN Security Council would be achievable.

The challenges of the 21st century go beyond those of classical security and foreign policy. The NSA affair has shown, for instance, that EU citizens cannot expect states to protect their privacy. What is needed is a European market for data security, one that defines strict internet privacy and encryption standards and enforces these within the scope of agreements with third countries, instead of overturning them through intelligence cooperation arrangements. Ideally, these public goods should be developed for the European Union as a whole, including the United Kingdom. Inasmuch as this turns out to be impossible, however, the euro area should retain the strategic option of a Europe of different speeds in these areas.

### **A Euro-Treaty for the Euro-Union**

To achieve this political agenda, the euro area needs a new contractual basis of its own. What is called for now is a Euro-treaty to replace previous piecemeal reforms. With such a contract, collective insights and experiences from the crisis would be stored permanently. A Euro-treaty would re-focus public debate on Europe's political needs and wishes, away from the current preoccupation with what is legally feasible. The issue of amendments to Germany's Basic Law, which may be required in the context of further EU integration, would finally be discussed specifically with reference to the Euro-treaty.

The idea of a Europe of different speeds is not new. The euro crisis has shown, however, that such a deepening should include the entire euro area. In order to avoid a division of Europe, the interests of all member states ought to be considered, especially the smaller ones.

In dealing with the euro crisis, heads of state and government have so far set the tone. But this intergovernmentalism is not up to the tasks that need to be done in a monetary union. This is a key reason why the European Central Bank has, willy-nilly, seen itself compelled to take on such a central role in preserving the common currency.

We finally need a European executive that can negotiate reform packages with crisis countries, decide on bank closures and ensure the provision of public goods. The Euro Union needs an economic government capable of acting.

This economic government should have graduated rights of intervention in national budgetary autonomy. As long as member states comply with their obligations, this may involve only non-binding recommendations. If a member state, however, violates the stability criteria, the economic government must be able to make binding stipulations of how much the state has to save – the state will keep the decision where to save.

The economic government also needs a budget for the promotion of public goods, as well a growth fund to support reform processes in euro-area countries. In principle, it would be possible to finance this budget through taxation. But there are good reasons not to give the economic government extensive access to the European tax base. It makes sense to finance the euro-budget through a membership fee, in the amount of about 0.5 per cent of the gross domestic product.

The Euro-government must be chosen and scrutinised by a Euro-Parliament. It stands to reason to staff this body with deputies from the European Parliament representing euro-area countries, since its purpose is the provision of public goods in the euro area. There are also voices in our group, however, that prefer the Euro-Parliament to be made up from members of national parliaments, to ensure that control over governmental spending remains in their hands.

Either way, countries that are planning to introduce the euro in the near future (“pre-ins”) should be involved in the negotiation of the Euro-treaty from the outset. This also applies to the institutions of the Euro-Union – through a representation with the right to speak but no voting power.

No one should succumb to the fallacy that the crisis will fade away and that the stabilizing mechanisms that have been hastily cobbled together will suffice to make the euro a long-term success. One of the founding fathers of the European Union, Jean Monnet, once said: "L'Europe se fera dans les crises". The current crisis is probably the greatest that the Union has had to endure in its history. It now depends on us to use this historic opportunity.

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## OFFICIAL DOCUMENTS





# Europe: pour une Union solidaire différenciée

**De Sigmar Gabriel et Emmanuel Macron**

03.06.2015

Commentaires 5

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## Signaler une erreur

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D'une frontière à l'autre de l'Union européenne, de la Grèce au Royaume-Uni, l'idéal européen est touché en son cœur. Ce n'est pas surprenant, puisque la terrible crise des dernières années a révélé deux faiblesses majeures de l'architecture européenne. La première est l'interruption du processus de convergence économique entre les pays de l'Union européenne, et ceux de la zone euro en particulier. Il ne s'agit pas là d'une difficulté théorique: le chômage est une réalité quotidienne pour des millions d'Européens, notamment notre jeunesse, qui risque de devenir une génération sacrifiée. La seconde faiblesse, ce sont les tensions politiques: au sein des Etats membres, dans lesquels les forces antieuropéennes se développent, et entre Etats membres. Les situations grecque et britannique, aussi différentes soient-elles, témoignent que l'intérêt général européen et les intérêts nationaux apparaissent de plus en plus divergents.

Dans ce contexte, dix ans après le «non» au référendum européen en France, il est temps de rouvrir le débat économique et politique. Il est temps de renforcer la zone euro dans le cadre d'une réforme plus vaste de l'UE - une Union au sein de laquelle chaque Etat membre doit trouver sa place. Nous souhaitons vivement que, dans les prochains jours, une solution soit apportée aux difficultés les plus urgentes de la Grèce. Mais nous devons aussi penser dès maintenant l'avenir de l'Europe.

## Une nouvelle étape d'intégration pour la zone euro

L'euro s'est fondé sur un accord politique franco-allemand, mais aussi sur une ambiguïté constructive typiquement européenne. Cela donne à la France et à l'Allemagne une responsabilité particulière pour pallier les carences de l'euro. A la fin des années 1980, nous partagions un projet politique commun, assis sur des objectifs économiques différents. L'Allemagne souhaitait assurer sa réunification et remplacer le système monétaire européen moribond par un dispositif stable, sur le modèle de la Bundesbank. La France voulait ancrer l'Allemagne en Europe et améliorer la capacité de notre

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continent à dompter la mondialisation. Ces objectifs ont convergé vers un approfondissement de l'intégration européenne, mais ils ont conduit à masquer les défauts de construction de l'union monétaire. Nous devons maintenant les réparer afin que l'euro tienne sa promesse de prospérité économique et, plus largement, évite une dérive de l'Europe vers davantage de mécontentement et de divisions.

Pour y parvenir, il nous faut accélérer la construction d'une union économique et sociale, en nous accordant sur un processus de convergence par étapes. Ce processus nécessiterait de poursuivre les réformes structurelles (marché du travail, attractivité...), les réformes institutionnelles (notamment dans le domaine de la gouvernance économique), mais également de rapprocher nos systèmes fiscaux et sociaux (via, par exemple, des salaires minimums mieux coordonnés ou une harmonisation de l'impôt sur les sociétés). Ce projet renforcerait nos économies, permettrait de placer les pays de la zone euro sur un pied d'égalité et d'enrayer la course au moins disant qui sévit aujourd'hui à travers la concurrence fiscale, le dumping social et les dévaluations internes non coopératives. Il rapprocherait nos économies, améliorerait notre potentiel de croissance et permettrait de définir quelles politiques nous devons centraliser, harmoniser ou simplement coordonner, au sein de la zone euro.

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Par ailleurs, cet agenda de convergence entre les Etats membres poserait les bases d'un budget commun à l'échelle de la zone euro, qui est la condition de l'efficacité de notre union monétaire. Aujourd'hui, la zone euro repose avant tout sur des règles, qui visent à assurer la discipline budgétaire. Ces règles sont importantes, mais rien ne garantit que la somme des politiques budgétaires nationales conduit à une situation optimale pour la zone euro tout entière, dans les moments de crise comme dans les périodes de croissance. Il importe donc de donner à la zone euro une compétence budgétaire en plus des budgets nationaux, afin d'améliorer notre capacité à faire jouer les stabilisateurs économiques et à adapter notre politique budgétaire au cycle économique. Dans un premier temps, la compétence budgétaire de la zone euro pourrait être développée dans le cadre du plan Juncker afin de financer des projets d'investissement (infrastructures, réseaux européens, capital-risque...). Dans un second temps, nous pourrions créer pour la zone euro une véritable capacité budgétaire, qui posséderait deux volets: un volet «production», pour soutenir des investissements; un volet «stabilisation», avec des stabilisateurs automatiques européens (par exemple un fonds complémentaire des systèmes nationaux d'assurance-chômage). Ce budget disposerait de ressources propres (par exemple, la taxe sur les transactions financières ou une fraction d'un impôt sur les sociétés harmonisé) et d'une capacité d'emprunt.

Ce budget de la zone euro ne pourrait et ne devrait pas dispenser les Etats membres d'une discipline budgétaire nationale. Cet équilibre serait renforcé par la mise en place d'un cadre légal de restructuration ordonnée des dettes nationales, si celle-ci devait, en dernier ressort, s'avérer nécessaire. Cela responsabiliserait les pays bénéficiaires de l'aide des autres Etats membres tout en évitant une austérité inappropriée lorsque le poids de la dette n'est plus soutenable. Dans le même temps, le Mécanisme Européen de Stabilité (MES) serait intégré au droit communautaire pour constituer un véritable Fonds Monétaire Européen.

La zone reposerait ainsi sur des institutions communes plus fortes, s'adaptant aux situations nationales et aux circonstances économiques. Pour garantir le bon fonctionnement de ces institutions, l'Europe doit apporter des solutions à son déficit démocratique et à la difficulté de mise en œuvre des décisions. Concrètement, les nouvelles

responsabilités confiées à la zone euro devraient s'accompagner d'un contrôle démocratique plus fort, par exemple devant une formation «zone euro» au sein du Parlement européen. Un «commissaire à l'euro» pourrait incarner cette zone euro renforcée traitant non seulement des questions budgétaires mais aussi de croissance, d'investissement et d'emploi.

### Plus d'ambition pour l'Union tout entière

Renforcer l'euro ne concerne pas seulement la zone euro. Cela ne peut se faire sans une remise à plat plus large de l'Union européenne, notamment parce que nous devons être capables de répondre à une question centrale: «quelle est la place des Etats membres qui ne font pas partie de la zone euro?». Une zone euro renforcée devrait être le cœur d'une Union approfondie. Nous avons besoin d'une Union plus claire et plus efficace, avec plus de subsidiarité et une gouvernance simplifiée. L'instrument fondamental de l'intégration européenne est le marché unique: nous devrions donc franchir de nouvelles étapes vers un marché intérieur mieux intégré, avec une approche ciblée sur quelques secteurs clé, comme l'énergie ou le numérique.

Un meilleur fonctionnement de l'Europe nécessite également d'accroître le sentiment d'appartenance commune. Ce sont en effet les liens plus étroits entre les citoyens qui donnent leur légitimité aux institutions. C'est pourquoi nous avons besoin de renforcer notre *affectio societatis*. Nous proposons ainsi la généralisation du programme Erasmus, pour permettre à chaque Européen, à l'âge de 18 ans, de passer au moins un semestre dans un autre pays européen, pour étudier ou pour suivre un apprentissage.

La construction de cette nouvelle architecture européenne est capitale, non seulement pour mettre en place dès à présent des politiques efficaces, mais également pour assurer la stabilité politique et économique de l'euro et de l'Union dans la durée. Nous devons réconcilier l'intérêt général européen et les intérêts nationaux. Notre objectif commun doit être de rendre impensable pour tout Etat membre défendant légitimement ses intérêts d'envisager son avenir en dehors de l'Union – ou au sein d'une Union amoindrie. Pour atteindre cet objectif, nous avons besoin d'une Union solidaire et différenciée. La

France et l'Allemagne ont la responsabilité d'ouvrir la voie, car l'Europe ne peut plus attendre. (TDG)

(Créé: 03.06.2015, 22h36)

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La rédaction

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## 5 Commentaires

### franck Monnet

04.06.2015, 09:33 Heures

L'Europe a choisi le modèle néo-libérale (école de chicago), devenir un marché ouvert.Géré par des technocrates....Une monnaie unique (forte) avec des économies disparates, cela ne marche pas.Il fallait intégrer les économies des pays fondateurs, et ensuite élargir au fur et à mesure.Que la suisse n'intègre pas cette Europe, restons à l'écart.



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## Sur ce thème



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## Abandon des quotas obligatoires pour aider l'Italie et la Grèce

**Asile** Le président du Conseil européen a annoncé l'abandon de l'idée des quotas pour répartir les demandeurs d'asile.

[Plus...](#)

Mis à jour à 17h49

## Les assurances ont une passe difficile

**Taux d'intérêt** Deux tiers des principaux assureurs pourraient opérer des restructurations dans leurs activités. [Plus...](#)

Mis à jour à 09h54

## L'UE prolonge les sanctions contre la Russie

**Crise en Ukraine** L'Union européenne va prolonger de six mois ses sanctions contre Moscou pour son rôle dans le conflit ukrainien. [Plus...](#)

22.06.2015

## Entre Genève et Lausanne, chacun ses goûts

**#Genève200** [Plus...](#)

Par Joelle Kuntz journaliste et écrivaine

Mis à jour à 16h17

## Entre Genève et Yverdon: L'Emile, de Rousseau

**#Genève200** [Plus...](#)

Par Joelle Kuntz journaliste et écrivaine 24.06.2015

## Bientôt les dernières Fêtes de Genève ancienne formule: après, on fait quoi?

**Perspective** [Plus...](#)

Par Benjamin Chaix 24.06.2015



## Memorial lecture in honour of Tommaso Padoa-Schioppa

Speech by Mario Draghi, President of the ECB,  
London, 9 July 2014

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### Summary

*The governance of structural reforms deserves as much attention as enforcing fiscal rules and should be done at the euro area level, ECB President Mario Draghi said in a speech in London on Wednesday.*

*Structural reforms need strong domestic ownership since they reach deeply into societal arrangements. But at the same time, the example of the International Monetary Fund shows that there is a convincing case to be made for a supranational body that makes it easier to frame national debates on reform. This can shift the debate from whether to how to implement reforms, Mr Draghi argues.*

*The outcome of structural reforms – a higher level of productivity and competitiveness – is not merely in a country's own interest, but in the interest of the monetary union as a whole.*

*In the euro area, there is therefore a case for establishing rules on structural reform at the EU-level. While a lack of reform can threaten cohesion of the union, the recovery shows us how decisive reform can strengthen it.*

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Ladies and gentlemen,

The belief that there are interests of the people that cannot be safeguarded by purely national authorities, and that require the establishment of supra-national institutions, was a constant motivation through the life and work of Tommaso Padoa-Schioppa.

It is also this belief that motivated the involvement of Tommaso in your work to develop global accounting standards. More than 100 countries speak the same accounting language today, whereas a decade ago, no major economy used the International Financial Reporting Standards (IFRS). I trust that the momentum will be kept, and in particular that European policy-makers will progress swiftly in the adoption of IFRS 9.

But where Tommaso Padoa-Schioppa's deep-rooted convictions found their most pronounced expression was in his constant support for European integration and his seminal contribution to the creation of the euro.

At the end of a recent press conference, I said that the crisis would not have been as severe if we had had more, not less, integration in Europe; and that our future lies with more integration, not the renationalisation of our economies. I suspect Tommaso would have agreed.

## Sovereignty as a positive concept

Sovereignty in the European Union is not only a normative concept linked to the rights of states. It is also a *positive* concept. A sovereign that cannot effectively deliver the expectations of its citizens is only sovereign in name. Genuine sovereignty exists only if policy-making is effective.

This notion of the efficacy of public powers is reflected in the principle of subsidiarity embedded in the EU Treaties – or what is known as the federalist principle in the United States – the logic of which was elegantly captured by John Locke in the 1680s:

*“For all power given with trust for attaining an end, (...) whenever that end is manifestly neglected (...) that power must devolve in the hands of those that gave it, who may place it anew where they shall think best for their safety and security”.*

European integration has, in effect, been a process of progressively applying this principle: governments have pooled sovereignty every time it has proved necessary so that they could continue to deliver on their duties towards their people.

At the start of the process, the objective was to prevent continental war. Two world wars had demonstrated the inability of European governments, acting alone, to provide physical security for their citizens. Thus, they established common institutions, such as the Coal and Steel Authority, that could guarantee peace more effectively.

In parallel, and quite independent of policy actions, economic integration has also progressed, in a more gradual but also more continuous process. Such integration results indeed at least as much from technological developments and improvements in transportation and communication as it does from policy choices. It is, in large parts, inescapable. But because it creates far-reaching interdependencies, it has required governments to respond. They have had to proactively choose to pool sovereignty to regain control of their economies.

With the establishment of the Single Market, in particular, the pace and reach of integration accelerated markedly. This was of course its purpose – and it remains the most significant and successful achievement of the European Union. But a free market does not only assume the freedom to take part. It also assumes the means to protect that freedom, by which I refer to the protection of property rights, the enforcement of contracts, the conditions of fair competition and the avoidance of moral hazard. Economic integration therefore required integration of some economic policies.

The euro itself emerged in fact as a corollary of the Single Market. It was conceived, as early as the late 1950s, as a response to the costs associated with exchange rate frictions within a single market, which at the beginning was only for agricultural products.

Already in 1944, in an influential study commissioned by the League of Nations, the great economist Ragnar Nurkse had warned convincingly of the economic losses resulting from currency volatility. Tommaso himself later argued in his “inconsistent quartet” that free trade, free capital movement, fixed exchange rates and independent monetary policies were ultimately incompatible.

And the euro itself has had consequences. Some of these were identified early, in particular with respect to fiscal governance. Some were fully acknowledged only later, such as the pervasive effects of macroeconomic imbalances.

But in both cases, the crisis showed that the cohesion of the Union in fact relied on the behaviour of *each* of its members. This is why I believe that the case for community-level governance does not apply only to fiscal policy, or to the banking union, but also to structural reforms, as I will endeavour to explain.



## **Fiscal policies within a monetary union**

The case for fiscal governance at the community level is well understood, and stems from the negative externalities that unsound public finances in a Member State can generate for its neighbours. The crisis not only validated this concern; it reinforced it, by showing that externalities could be even more pervasive than initially thought.

The fiscal soundness of a government is obviously first and foremost in the interest of its own country. Countries with excessively stretched public finances can lose the ability to use fiscal policy as a counter-cyclical stabilisation tool. Indeed, this ability relies on the government being able to access markets under favourable conditions at the time when it needs to, at the trough of the cycle. As we have seen during the crisis, this cannot be taken for granted when doubts arise about the sustainability of the debt.

This would be problematic anywhere but it is more so in a monetary union, as the common monetary policy can only aim at price stability for the euro area as a whole. It cannot cater specifically for asymmetric shocks. In the absence of a federal budget, like we see in the United States, the soundness of government credit everywhere is of paramount importance to counteract regional slumps.

If some governments retain the ability to stabilise their economies but others do not, then it becomes more plausible that economic divergence will occur. This is one channel through which the cohesion of the Union can be affected. This ability depends on keeping debt low and budget deficits close to zero when output grows at potential, not on having more flexibility in the existing rules.

Keeping one's own house in order also has a further benefit: it helps mitigate the effects of contagion. As we have seen during the crisis, those governments that had more robust fiscal positions were much less affected by contagion – at the extreme they even benefited from safe-haven status.

This protection, however, is not absolute, because it relies on the ability of markets to discriminate between sound and unsound debtors. Yet bubbles and panic happen. A bubble is a situation where markets ignore fundamentals, even if debtors are unsound. For too long, markets failed to raise funding costs for countries with unsustainable policies. And a panic is a situation where markets also ignore fundamentals, but this time to the detriment of sound debtors.

In fact, the main channel of contagion within a monetary union is not direct exposures between one country and another. It is the fact that if a precedent set in one country is seen to be replicable elsewhere, it can affect the conditions of market access for all. Put differently, the main channel of financial contagion is not the asset side of balance sheets, but the liability side.

We perhaps saw this effect most clearly with the fragmentation of the banking sector three years ago. Fears that one country could leave the euro resulted not just in that country being cut off financially, but in fragmentation everywhere.

This fragmentation created considerable damage. The renationalisation of finance hindered the homogenous transmission of monetary policy across borders. And it resulted in a divergence of financial conditions across the euro area. This initiated an economic divergence process, which, in turn, could have challenged the sustainability of the euro area.

The ECB therefore had to act and we did – through the creation of the Outright Monetary Transactions (OMT) programme – to nip in the bud unwarranted fears of a euro area break-up, and prevent an adverse equilibrium from becoming entrenched through prophecies that were as much false as they were self-fulfilling. It was necessary to

protect the monetary transmission process. And it was necessary to protect price stability, which is essential for the cohesion of the Union.

The threats to price stability today do not come from unfounded fears of a break-up of the euro, but from the consequences of changes in other factors, such as energy and food prices, relative price adjustment in stressed countries, exchange rate behaviour, weak demand and high unemployment. Nonetheless, those threats are real and to cope with them the Governing Council is determined to keep the monetary policy stance accommodative for an extended period of time.

Moreover, the Governing Council is unanimous in its commitment to also using unconventional instruments within its mandate, should it become necessary to further address risks of too prolonged a period of low inflation. We are strongly determined to safeguard the firm anchoring of inflation expectations over the medium to long term.

The lesson I draw from the fragmentation we have experienced is that the cohesion of the Union is in the fundamental interest of all of its members. If it is called into question, as we have experienced first-hand, the consequences cannot be anticipated with total certainty, but they are detrimental to all.

It is therefore of considerable relevance and importance that Europe has already made extensive progress in strengthening its rules, for example through the fiscal compact. What is essential now is that these rules are enforced. To unwind the consolidation that has been achieved, and in doing so to divest the rules of credibility, would be self-defeating for all countries, for three reasons.

First, the high level of indebtedness in almost all euro area countries implies a higher vulnerability to market pressure and contagion, if the euro area faces further economic or financial shocks. The higher the level of debt, the greater the probability of falling into a bad equilibrium, where high rates lead to defaults.

Second, if fiscal rules are applied by national governments to achieve not only stability but also sustainable growth, they do not in my view clash with national ownership of the budget. Fiscal rules should be viewed in the national debate as promoting growth-friendly fiscal consolidation and not simply as a painful accounting exercise.

Third, respecting the rules matters because it is a prerequisite for any other form of integration. It is only by demonstrating a willingness to fulfil their commitments that Member States can achieve the degree of mutual trust that is a pre-requisite of integration in other areas. Indeed, any pooling of sovereignty requires a great amount of mutual confidence, in particular in the fiscal area, which is traditionally seen as a prerogative of national parliaments.

### **Structural policies within a monetary union**

This same reasoning that I am applying to the fiscal framework can, to a large extent, be extended to other areas of economic policy. In particular, I think there is a case for some form of common governance over structural reforms. This is because the outcome of structural reforms – a continuously high level of productivity and competitiveness – is not merely in a country's own interest. It is in the interest of the Union as a whole.

The Single Market and the single currency were conceived as a sort of 'Ricardian' union, meaning a union in which each country, each sector and each firm can exploit its comparative advantages. I do not think there is any disagreement that the Single Market was a success.

But it is not enough for the cohesion of the Union that the Single Market and the single currency constitute a positive-sum game, in the sense that their existence raises aggregate welfare. The cohesion of the euro area relies on the fact that it is Pareto-

improving: it must be the case that all the countries are better off inside the Union than they would be outside.

And it is obviously not enough that this is true only at the moment when they join. It has to be true continuously.

There are many instances around the world of political unions whose cohesion is maintained because the weaker regions or states benefit from recurrent fiscal transfers from their peers, typically through the operations of a central budget. It is then possible for those weaker regions to maintain recurrent external deficits, while the stronger regions post permanent surpluses. This is the case in the United States, for instance, but it is also true within most individual countries in Europe.

In the euro area, however, while there are cohesion funds for catching-up countries, and private credit flows can finance temporary imbalances, permanent fiscal transfers between Member States are not envisaged. So, in the medium term, each economy has to stand on its own feet. It has to be productive and competitive enough to benefit from the opportunities afforded by the Single Market.

We can do and have done much to reduce imbalances that are generated by factors other than lack of competitiveness and structural weaknesses. External imbalances have been decreasing since the announcement of OMTs. Persisting imbalances, however, could eventually undermine the economic and political cohesion of our Union. And, as I have already discussed, any threat to the cohesion and sustainability of the Union has pervasive effects for all, in the form of contagion, and uncertainty which weighs on investment.

This is where structural reforms play a crucial role – and perhaps an even more important role in the euro area than in other unions. Markets can be opened through EU legislation. But it is only through structural reforms that firms and individuals can be enabled to take full advantage of that openness.

Indeed, the intention of the Single Market was to free individuals and firms, within a market where no distinction would be made on account of nationality or place of establishment. This is why competition policy is enforced at the EU level, so that no firm is *protected* by its nationality.

By the same token, no firm or individual should be *penalised* by its country of residence. Yet, firms face very different operating environments across the euro area, which can prevent them from exploiting the advantages of the market. For example, the World Economic Forum ranks Finland third in the world in terms of global competitiveness, whereas Greece is ranked 91st. The World Bank ranks Ireland 15th in the world in terms of ease of doing business, whereas Malta is ranked 103rd.

The persistence of such differences creates the risk of permanent imbalances. With this in mind, I believe that structural reforms in each country are enough of a common interest to justify that they are made subject to discipline at the community level.

I see two reasons why this approach could be favourable to national governments today.

The first is that, over the past few years, we have seen both the risks associated with insufficient competitiveness in some Member States and the benefit of structural reforms. We have witnessed the accumulation of external imbalances in peripheral economies prior to the crisis, and how that left them vulnerable to “sudden stop” dynamics.

And more recently, we have seen the improvement that has taken place when governments implemented reform. The change in current account positions in stressed countries ranges from an almost 11 percentage point correction of GDP in Spain to a 16

percentage point improvement in GDP in Greece, only part of which is explained by lower imports in the context of a recession.

In fact, the return of market confidence in the euro area results mainly from the acknowledgement that individual governments, in particular in some of the most stressed countries, have taken significant corrective action and will continue to do so where needed. So while lack of reform can threaten the cohesion of the Union, we can already see how decisive reform can strengthen it.

But we are only at the beginning. The final judgment now rests on our being able to show that cohesion also produces growth and jobs.

The second reason why a stronger role for the Union could be beneficial is that, similar to fiscal policies, establishing rules at the level of the Union may in fact help national authorities implement reform.

Structural reforms reach deep enough into societal arrangements and practices that they can only succeed if they are made the object of strong domestic ownership. At the same time, those reforms require substantial political capital. Historical experience, for example of the IMF, makes a convincing case that the discipline imposed by supranational bodies can make it easier to frame the debate on reforms at the national level. In particular, the debate can be framed not in terms of *whether*, but in terms of *how* reform needs to take place.

In other words, I am not convinced by the argument that, in terms of structural reforms, there is an opposition between rules and ownership. On the contrary, they can be mutually reinforcing.

## Conclusion

In conclusion, there is a strong case for us to apply the same principles to the governance of structural reforms as we do to fiscal governance. The essential cohesion of the Union depends on it.

With the benefit of hindsight, it would have been useful to establish, alongside the existing convergence criteria, a set of structural criteria that had to be met to enter the euro area, and then respected once inside. But we have to start from where we are. Thus, I would see merits in initiating, as a one-off, a new convergence process within the euro area – one which ensures that all countries are truly in a position to benefit from membership, and that none cause harm to another.

Today, national governments are not able to fully exercise their sovereignty alone, whether sovereignty is defined normatively, à la Jean Bodin, in terms of inalienable rights, such as to declare war and treat the conditions of the peace, to judge in last resort, to raise taxes and to mint money; or whether it is defined positively, à la John Locke, in terms of a fiduciary power to act for certain ends.

Individually, national governments are simply not powerful enough. To serve their purpose, they have to learn to govern together; they have to learn to be sovereign together so as to respond to their citizens' needs. Those needs today are growth and job creation.

## Videos

- **Memorial Lecture**  
([http://www.ecb.europa.eu/https://www.youtube.com/watch?v=i\\_Jmemnn1vs](http://www.ecb.europa.eu/https://www.youtube.com/watch?v=i_Jmemnn1vs))

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European  
Commission

# Completing Europe's Economic and Monetary Union

Report by:

**Jean-Claude Juncker**

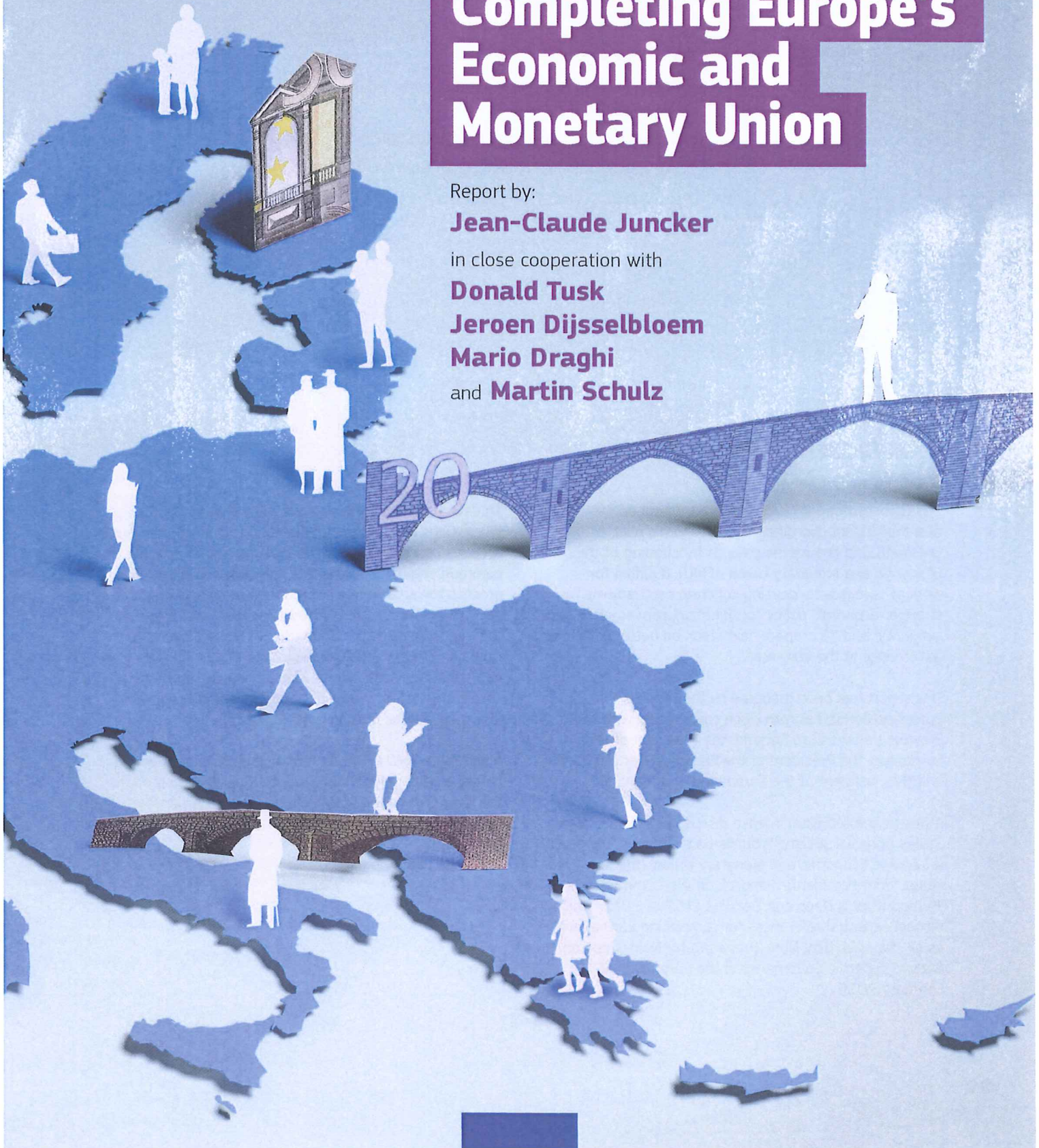
in close cooperation with

**Donald Tusk**

**Jeroen Dijsselbloem**

**Mario Draghi**

and **Martin Schulz**



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## Introduction

The Euro Summit of October 2014 underlined the fact that 'closer coordination of economic policies is essential to ensure the smooth functioning of the Economic and Monetary Union' (EMU). It called for work to continue to 'develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity' and 'to prepare next steps on better economic governance in the euro area'.

This report has been prepared by the President of the European Commission, in close cooperation with the President of the Euro Summit, the President of the Eurogroup, the President of the European Central Bank, and the President of the European Parliament.

It has benefitted from intense discussion with Member States and civil society. It builds on the report 'Towards a Genuine Economic and Monetary Union' (the so-called 'Four Presidents' Report'), on the Commission's 'Blueprint for a Deep and Genuine EMU' of 2012, which remain essential references for completing EMU as well as on the Analytical Note 'Preparing for Next Steps on Better Economic Governance in the Euro Area' of 12 February 2015.

This report reflects the personal deliberations and discussions of the five Presidents. It focuses on the euro area, as countries that share a currency face specific common challenges, interests and responsibilities. The process towards a deeper EMU is nonetheless open to all EU Members. It should be transparent and preserve the integrity of the Single Market in all its aspects. In fact, completing and fully exploiting the Single Market in goods and services, digital, energy and capital markets should be part of a stronger boost towards economic union, as well as more jobs and higher growth.

A complete EMU is not an end in itself. It is a means to create a better and fairer life for all citizens, to prepare the Union for future global challenges and to enable each of its members to prosper.



# 1

## The Nature of a Deep, Genuine and Fair Economic and Monetary Union



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The euro is a successful and stable currency. It is shared by 19 EU Member States and more than 330 million citizens. It has provided its members with price stability and shielded them against external instability. Despite the recent crisis, it remains the second most important currency in the world, with a share of almost a quarter of global foreign exchange reserves, and with almost sixty countries and territories around the world either directly or indirectly pegging their currency to it.

Europe is emerging from the worst financial and economic crisis in seven decades. The challenges of recent years forced national governments and EU institutions to take quick and extraordinary steps. They needed to stabilise their economies and to protect all that has been achieved through the gradual and at times painstaking process of European integration. As a result, the integrity of the euro area as a whole has been preserved and the internal market remains strong.

However, as economic growth and confidence return to much of Europe, it is clear that the quick fixes of recent years need to be turned into a lasting, fair and democratically legitimate basis for the future. It is also clear that with 18 million unemployed in the euro area, a lot more needs to be done to improve economic policies.

Europe's Economic and Monetary Union (EMU) today is like a house that was built over decades but only partially finished. When the storm hit, its walls and roof had to be stabilised quickly. It is now high time to reinforce its foundations and turn it into what EMU was meant to be: a place of prosperity based on balanced economic growth and price stability, a competitive social market economy, aiming at full employment and social progress. To achieve this, we will need to take further steps to complete EMU.

The euro is more than just a currency. It is a political and economic project. All members of our Monetary Union have given up their previous national currencies once and for all, and permanently share monetary sovereignty with the other euro area countries. In return, countries gain the benefits of using a credible and stable currency within a large, competitive and powerful single market. This common destiny requires solidarity in times of crisis and respect for commonly agreed rules from all members.

However, this bargain only works as long as all members gain from it. For this condition to hold, countries have to take steps, both individually and collectively, to compensate for the national adjustment tools they give up on entry. They must be able, first, to better prevent crises through a high quality of governance at European and national level, sustainable fiscal and economic policies, and fair and efficient public administrations. Second, when economic shocks occur,

as they inevitably will, each country has to be able to respond effectively.

They must be able to absorb shocks internally through having suitably resilient economies and sufficient fiscal buffers over the economic cycle. This is because, with monetary policy set uniformly for the whole euro area, national fiscal policies are vital to stabilise the economy whenever a local shock occurs. And with all countries sharing a single exchange rate, they need flexible economies that can react quickly to downturns. Otherwise they risk that recessions leave deep and permanent scars.

Yet relative price adjustment will never occur as quickly as exchange rate adjustment. And we have seen that market pressures can deprive countries of their fiscal stabilisers in a slump. For all economies to be permanently better off inside the euro area, they also need to be able to share the impact of shocks through risk-sharing within the EMU. In the short term, this risk-sharing can be achieved through integrated financial and capital markets (private risk-sharing) combined with the necessary common backstops, i.e. a last-resort financial safety net, to the Banking Union. In the medium term, as economic structures converge towards the best standards in Europe, public risk-sharing should be enhanced through a mechanism of fiscal stabilisation for the euro area as a whole.

Preventing unsustainable policies and absorbing shocks individually and collectively did not work well before or during the crisis. Though several important institutional improvements have since been made, the legacy of the initial shortcomings persists. There is now significant divergence across the euro area. In some countries, unemployment is at record lows, while in others it is at record highs; in some, fiscal policy can be used counter-cyclically, in others fiscal space will take years of consolidation to recover.

Today's divergence creates fragility for the whole Union. We must correct this divergence and embark on a new convergence process. The success of Monetary Union anywhere depends on its success everywhere. Moreover, in an increasingly globalised world, Member States have a responsibility and self-interest to maintain sound policies and to embark on reforms that make their economies more flexible and competitive.

Progress must happen on four fronts: first, towards a **genuine Economic Union** that ensures each economy has the structural features to prosper within the Monetary Union. Second, towards a **Financial Union** that guarantees the integrity of our currency across the Monetary Union and increases risk-sharing with the private sector. This means completing the Banking Union and accelerating the Capital Markets

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Union. Third, towards a **Fiscal Union** that delivers both fiscal sustainability and fiscal stabilisation. And finally, towards a **Political Union** that provides the foundation for all of the above through genuine democratic accountability, legitimacy and institutional strengthening.

All four Unions depend on each other. Therefore, they must develop in parallel and all euro area Member States must participate in all Unions. In each case, progress will have to follow a sequence of short- and longer-term steps, but it is vital to establish and agree the full sequence today. The measures in the short-term will only increase confidence now if they are the start of a larger process, a bridge towards a complete and genuine EMU. After many years of crisis, governments and institutions must demonstrate to citizens and markets that the euro area will do more than just *survive*. They need to see that it will *thrive*.

This longer-term vision needs the measures in the short term to be ambitious. They need to stabilise the European house now and prepare the ground for a complete architecture in the medium term. This will inevitably involve sharing more sovereignty over time. In spite of the undeniable importance of economic and fiscal rules and respect for them, the world's second largest economy cannot be managed through rule-based cooperation alone. For the euro area to gradually evolve towards a genuine Economic and Monetary Union, it will need to shift from a system of rules and guidelines for national economic policy-making to a system of further sovereignty sharing within common institutions, most of which already exist and can progressively fulfil this task. In practice, this would require Member States to accept increasingly joint decision-making on elements of their respective national budgets and economic policies. Upon completion of a successful process of economic convergence and financial integration, this would pave the way for some degree of public risk sharing, which would at the same time have to be accompanied by stronger democratic participation and accountability both at national and European levels. Such a stage-based approach is necessary as some of the more ambitious measures require changes to our current EU legal framework – some more profound than others – as well as significant progress in terms of economic convergence and regulatory harmonisation across euro area Member States.

The aim of this report is two-fold: to lay out the first steps that will launch this process today, and to provide a clear orientation for the longer-term measures. The process would be organised in two consecutive stages (see Roadmap in Annex 1):

**Stage 1 (1 July 2015 - 30 June 2017):** In this first stage (**'deepening by doing'**), the EU institutions and euro area Member States would build on existing instruments and make the best possible use of the existing Treaties. In a nutshell, this entails boosting competitiveness and structural convergence, completing the Financial Union, achieving and maintaining responsible fiscal policies at national and euro area level, and enhancing democratic accountability.

**Stage 2:** In this second stage (**'completing EMU'**), concrete measures of a more far-reaching nature would be agreed to complete EMU's economic and institutional architecture. Specifically, during this second stage, the convergence process would be made more binding through a set of commonly agreed benchmarks for convergence that could be given a legal nature. Significant progress towards these standards – and continued adherence to them once they are reached – would be among the conditions for each euro area Member State to participate in a shock absorption mechanism for the euro area during this second stage.

**Final Stage (at the latest by 2025):** At the end of Stage 2, and once all the steps are fully in place, a deep and genuine EMU would provide a stable and prosperous place for all citizens of the EU Member States that share the single currency, attractive for other EU Member States to join if they are ready to do so.

The Presidents of the EU institutions will follow up on the implementation of the recommendations in this report. To prepare the transition from Stage 1 to Stage 2, the Commission will present a White Paper in spring 2017 assessing progress made in Stage 1 and outlining the next steps needed, including measures of a legal nature to complete EMU in Stage 2. The White Paper will draw on analytical input from an expert consultation group, which will further explore the legal, economic and political preconditions of the more long-term proposals contained in this report. It will be prepared in consultation with the Presidents of the other EU institutions.

This report puts forward ideas which, following further discussion, can be translated into laws and institutions. This requires a broad, transparent and inclusive process – a process which should begin without delay.

# 2

## Towards Economic Union – Convergence, Prosperity and Social Cohesion

The notion of convergence is at the heart of our Economic Union: convergence *between* Member States towards the highest levels of prosperity; and convergence *within* European societies, to nurture our unique European model.

In EMU, monetary policy is centralised, but important parts of economic policy remain national. However, as the crisis made particularly visible, euro area members depend on each other for their growth. It is in each member's common and self-interest to be able to cushion economic shocks well, to modernise economic structures and welfare systems, and make sure that citizens and businesses can adapt to, and benefit from, new demands, trends and challenges. It is equally in each member's interest that all others do so at a similar speed. This is crucial in a Monetary Union like EMU where large scale fiscal transfers between members are not foreseen and where labour mobility is relatively limited.

This does not mean that all Member States that share the single currency are or should be alike, or that they should follow the same policies. What ultimately matters is the outcome: that all euro area Member States pursue sound policies so that they can rebound quickly from short-term shocks, are able to exploit their comparative advantages within the Single Market and attract investment, thereby sustaining high levels of growth and employment.

Much can be achieved already through a deepening of the Single Market, which is important for all 28 EU Member States but in particular for the Member States which share the euro as their currency. In significant policy areas, such as goods and services, as well as in areas with untapped potential such as energy, digital and capital markets, the Single Market is still incomplete. This shows that there are significant political obstacles despite the enormous economic potential associated with a truly Single Market. In order to make progress, relevant decisions in each of the areas should be seen as part of a political package which benefits all Member States, instead of being conceived as independent from each other. But that alone is not enough. Sustainable convergence also requires a broader set of policies that come under the heading of 'structural reforms', i.e. reforms geared at modernising economies to achieve more growth and jobs. That means both more efficient labour and product markets and stronger public institutions.

For convergence to happen between euro area members, further progress is required. First, in the short term (Stage 1), we need to set in motion a renewed effort for all to converge towards the best performance and practices in Europe, building upon and further

strengthening the current governance framework. The ultimate aim is to achieve similarly resilient economic structures throughout the euro area. This should lead to a new boost for jobs and growth with competitiveness and social cohesion at its core.

In Stage 2, this convergence process would be formalised and would be based on a set of commonly agreed standards with a legal character. Significant progress towards the latter would be regularly monitored and would be a condition for members to benefit from further instruments, such as a shock absorption mechanism to be set up for the euro area as a whole.

## 2.1. A new boost to convergence, jobs and growth

A renewed impetus for reform is in the spirit of the 2011 Euro Plus Pact on Stronger Economic Policy Coordination for Competitiveness and Convergence, which, however, largely failed to deliver the expected results in view of its intergovernmental, non-binding nature<sup>1</sup>. Instead of further 'pacts', concrete progress on the basis of EU law is needed to move towards an Economic Union of convergence, growth and jobs. It should rest on the following four pillars: the creation of a euro area system of Competitiveness Authorities; a strengthened implementation of the Macroeconomic Imbalance Procedure; a greater focus on employment and social performance; and on stronger coordination of economic policies within a revamped European Semester. This should be implemented in the short run (Stage 1), on the basis of practical steps and in line with the Community method.

### A euro area system of Competitiveness Authorities

Euro area governance is well established for the coordination and surveillance of fiscal policies. It needs to be improved in the broader and increasingly central field of 'competitiveness'. The European Semester – and the creation of the Macroeconomic Imbalance Procedure – are a first step to correct this shortcoming, but much more needs to be done to make sure all Member States improve their competitiveness as part of the same momentum.

The creation by each euro area Member State of a national body in charge of tracking performance and policies in the field of competitiveness is recommended. This would help to prevent economic divergence and it would increase ownership of the necessary reforms at the national level. These Competitiveness

<sup>1</sup> The 'Euro Plus Pact on Stronger Economic Policy Coordination for Competitiveness and Convergence' was agreed in 2011 by the Heads of State and Government of the euro area and Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. It is open to other EU Member States on a voluntary basis. It was conceived as an intergovernmental solution to foster reforms and coordination. However, its implementation has suffered from a number of shortcomings, including the absence of a monitoring institution, but its underlying rationale is still relevant and should be revived. Hence, its relevant parts should be integrated into the framework of EU law.

Authorities should be independent entities with a mandate to 'assess whether wages are evolving in line with productivity and compare with developments in other euro area countries and in the main comparable trading partners', as already agreed by a large majority of Member States under the Euro Plus Pact. In addition, these bodies could be mandated to assess progress made with economic reforms to enhance competitiveness more generally. In the end, a competitive economy is one in which institutions and policies allow productive firms to thrive. In turn, the development of these firms supports the expansion of employment, investment and trade.

A euro area system of Competitiveness Authorities should bring together these national bodies and the Commission, which would coordinate the actions of national Competitiveness Authorities on an annual basis. The Commission should then take into account the outcome of this coordination when it decides on steps under the European Semester, in particular for its Annual Growth Survey and for decisions to be taken under the Macroeconomic Imbalance Procedure (MIP), including whether to recommend the activation of the Excessive Imbalance Procedure.

### Competitiveness Authorities

The aim of the Competitiveness Authorities should not be to harmonise practices and institutions in charge of wage formation across borders. Those processes vary widely within the EU and rightly reflect national preferences and legal traditions.

Based on a common template, each Member State should decide the exact set-up of its national Competitiveness Authority, but they should be democratically accountable and operationally independent. National actors, such as social partners, should continue to play their role according to the established practices in each Member State, but they should use the opinions of the Authorities as guidance during wage setting negotiations. Some Member States, like the Netherlands and Belgium, already have such authorities.

### A stronger Macroeconomic Imbalance Procedure

The Macroeconomic Imbalance Procedure (MIP) was created at the height of the crisis. It is part of the European Semester, the annual cycle of reporting and surveillance of EU and national economic policies. It serves as a tool to prevent and correct imbalances before they get out of hand. It has become a vital device for European surveillance, for instance to prevent real estate bubbles, or to detect a loss of competitiveness, rising levels of private and public debt, and a lack of investment. It needs to be used to its full potential. This requires action on two fronts in particular:

- It should be used not just to detect imbalances but also to encourage structural reforms through the European Semester. Its corrective arm should be used forcefully. It should be triggered as soon as excessive imbalances are identified and be used to monitor reform implementation.
- The procedure should also better capture imbalances for the euro area as a whole, not just for each individual country. For this, it needs to continue to focus on correcting harmful external deficits, given the risk they pose to the smooth functioning of the euro area (for example, in the form of 'sudden stops' of capital flows). At the same time, the Macroeconomic Imbalance Procedure should also foster adequate reforms in countries accumulating large and sustained current account surpluses if these are driven by, for example, insufficient domestic demand and/or low growth potential, as this is also relevant for ensuring effective rebalancing within the Monetary Union.

### A stronger focus on employment and social performance

The employment and social situations vary widely across the euro area, partly as a result of the crisis but also because of underlying trends and poor performance pre-dating the crisis. Europe's ambition should be to earn a 'social triple A'.

This is also an economic necessity. For EMU to succeed, labour markets and welfare systems need to function well and in a fair manner in all euro area Member States. Hence, employment and social concerns must feature highly in the European Semester. Unemployment, especially long term unemployment, is one of the main reasons for inequality and social exclusion. Therefore, efficient labour markets that promote a high level of employment and are able to absorb shocks without generating excessive unemployment are essential: they contribute to the smooth functioning of EMU as well as to more inclusive societies.

There is no 'one-size-fits-all' template to follow, but the challenges are often similar across Member States: getting more people of all ages into work; striking the right balance between flexible and secure labour contracts; avoiding the divide between 'insiders' with high protection and wages and 'outsiders'; shifting taxes away from labour; delivering tailored support for the unemployed to re-enter the labour market, improving education and lifelong learning - to name but a few. Beyond labour markets, it is important to ensure that every citizen has access to an adequate education and that an effective social protection system is in place to protect the most vulnerable in society, including a 'social protection floor'. Our populations are ageing rapidly and we still need major reforms to ensure that pension and health systems can cope. This will include aligning the retirement age with life expectancy.

To secure EMU's long-term success, we should go a step further and push for a deeper integration of national labour markets, by facilitating geographic and professional mobility, including through better recognition of qualifications, easier access to public sector jobs for non-nationals and better coordination of social security systems.

### A stronger coordination of economic policies

The European Semester has significantly strengthened the coordination of economic policies. However, the addition of numerous 'packs', 'pacts', 'procedures' and manifold reporting requirements has blurred its rationale and effectiveness. The European Semester must be about setting our priorities together and about acting on them, in a European perspective, with a clear sense of our common interest. Steps have been taken to simplify and strengthen the European Semester: a greater focus on priorities, fewer documents and more time to discuss them, greater outreach at political level and engagement with national authorities. These steps must be pursued further in order to:

- Give Member States clear recommendations that continue to focus on priority reforms that are essential to raise potential growth, support job creation and exploit the opportunities offered by the Single Market. Country-Specific Recommendations need to be concrete and ambitious, especially as regards their expected outcome and the time-frame for delivery. At the same time, they should remain 'political', i.e. Member States should have a degree of freedom concerning the exact measures to be implemented. The national reform programmes that Member States prepare every year should serve as a basis for them to discuss their reform intentions.
- Hold Member States accountable for the delivery of their commitments. Periodic reporting on implementation, regular peer reviews or a 'comply-or-explain' approach should be used more systematically. The Eurogroup could already in Stage 1 play a coordinating role in cross-examining performance, with increased focus on benchmarking and pursuing best practices. This must go hand in hand with the use of the Macroeconomic Imbalance Procedure (MIP) to its full potential.
- Better integrate the euro area and the national dimensions. To this end, the European Semester should be structured into two successive stages - a European and a national stage. This means that discussions and recommendations concerning the euro area as a whole should take place first, ahead of country-specific discussions, so that common challenges are fully reflected in country-specific action. Annex 2 illustrates this proposal.
- Establish a clear long-term vision: not everything can

or should happen in one year. The annual cycle of the European Semester should go together with a stronger multi-annual approach in line with the renewed convergence process.

## 2.2. Formalising the convergence process

In the medium term (Stage 2), the convergence process towards more resilient economic structures, as described above, should become more binding. This would be achieved by agreeing on a set of common high-level standards that would be defined in EU legislation, as sovereignty over policies of common concern would be shared and strong decision-making at euro area level would be established. In some areas, this will need to involve further harmonisation. In other areas, where different policies can lead to similarly good performance, it will mean finding country-specific solutions. The common standards should focus primarily on labour markets, competitiveness, business environment and public administrations, as well as certain aspects of tax policy (e.g. corporate tax base). Progress towards these standards would be monitored regularly. Country-Specific Recommendations would continue to be used in this context. Furthermore, the Macroeconomic Imbalance Procedure (MIP) could be utilised as a tool not only to prevent and correct imbalances but also to foster reforms and monitor progress in each euro area Member State towards these common standards. Significant and sustained convergence towards similarly resilient economies should be a condition for access to a shock absorption mechanism to be set up for the euro area, as briefly outlined in sub-section 4.2.

Defining the specific standards and indicators requires deeper analysis. However, as an example, the standards for labour markets should combine security and flexibility and could be developed along the various pillars of the 'flexicurity' concept (e.g. flexible and reliable labour contracts that avoid a two-tier labour market, comprehensive lifelong learning strategies, effective policies to help the unemployed re-enter the labour market, modern social security systems and enabling labour taxation).

# 3

## Towards Financial Union - Integrated Finance for an Integrated Economy





Progress towards a stronger Economic Union will go a long way to improving the functioning of EMU. At the same time, this must be accompanied by the completion of a Financial Union. Indeed, Economic and Financial Unions are complementary and mutually reinforcing. Progress on these two fronts must be a top priority in Stage 1 of the Roadmap towards a genuine EMU.

In a Monetary Union, the financial system must be truly single or else the impulses from monetary policy decisions (e.g. changes in policy interest rates) will not be transmitted uniformly across its Member States. This is what happened during the crisis, which in turn aggravated economic divergence. Also, a single banking system is the mirror image of a single money. As the vast majority of money is bank deposits, money can only be truly single if confidence in the safety of bank deposits is the same irrespective of the Member State in which a bank operates. This requires single bank supervision, single bank resolution and single deposit insurance. This is also crucial to address the bank-sovereign negative feedback loops which were at the heart of the crisis.

At the same time, the financial system must be able to diversify risk across countries, so it can moderate the impact of country-specific shocks and lower the amount of risk that needs to be shared through fiscal means.

All these reasons justify the urgent need for a Financial Union. We have largely achieved the goal on bank supervision with the setting up of the Single Supervisory Mechanism. The Single Resolution Mechanism has also been agreed, but not yet fully implemented. To complete the Financial Union, we need to launch a common deposit insurance scheme and the Capital Markets Union. Given their urgency, these measures should all be implemented in Stage 1.

### 3.1. Completing the Banking Union

Completing the Banking Union requires first and foremost the full transposition into national law of the Bank Resolution and Recovery Directive by all Member States. This is crucial for sharing risk with the private sector. Indeed, the Banking Union is a way to better protect taxpayers from the cost of bank rescues.

Second, we also need a swift agreement on an adequate bridge financing mechanism – a way of ensuring there is enough money if a bank needs to be unwound even if the financing in the Single Resolution Fund is not enough at that time – for the Fund by the time it becomes operational on 1 January 2016.<sup>2</sup>

Third, setting up a credible common backstop to the Single Resolution Fund and making progress towards a full level playing field for banks in all Member States should be a priority during the transition period to the creation of the Single Resolution Fund. A backstop should therefore be implemented swiftly. This could be done through a credit line from the European Stability Mechanism (ESM) to the Single Resolution Fund. This backstop should be fiscally neutral over the medium term by ensuring that public assistance is recouped by means of *ex post* levies on the financial industry.

Next, we propose the launching of a European Deposit Insurance Scheme (EDIS) – the third pillar of a fully-fledged Banking Union alongside bank supervision and resolution. As the current set-up with national deposit guarantee schemes remains vulnerable to large local shocks (in particular when the sovereign and the national banking sector are perceived to be in a fragile situation), common deposit insurance would increase the resilience against future crises. A common scheme is also more likely to be fiscally neutral over time than national deposit guarantee schemes because risks are spread more widely and because private contributions are raised over a much larger pool of financial institutions. Setting up a fully-fledged EDIS will take time, but taking concrete steps in that direction should be a priority already in Stage 1 using the possibilities under the current legal framework. A possible option would be to devise the EDIS as a re-insurance system at the European level for the national deposit guarantee schemes. Just like the Single Resolution Fund, the common EDIS would be privately funded through *ex ante* risk-based fees paid by all the participating banks in the Member States and devised in a way that would prevent moral hazard. Its scope should coincide with that of the Single Supervisory Mechanism.

In due course, the effectiveness of the ESM's direct bank recapitalisation instrument should be reviewed, especially given the restrictive eligibility criteria currently attached to it, while respecting the agreed bail-in rules. A more easily accessible mechanism for direct bank recapitalisation would boost depositor confidence by keeping distressed sovereigns at arm's length in the governance of restructured banks, and it would break the sovereign-bank nexus at national level.

All banks participating in the Banking Union need to enjoy a level playing field. This will require further measures, in addition to and beyond the single rule book, to address the still significant margin for discretion at national level which still has important implications, notably for the quality and composition of banks' capital. A large part of the discrepancies could be addressed within the context of the Single Supervisory Mechanism. But for other issues, legislative changes are necessary, in particular for those related to differing

<sup>2</sup> This follows up on the [ECOFIN Council statement](#) of 18 December 2013.

legal and institutional frameworks. Similarly, the recent revision of the Deposit Guarantee Schemes Directive has led to more harmonisation, especially on pre-funding of national schemes, but it still contains some national discretion, which should be reviewed.

At the same time, the EU needs to continue to pay attention to potential new risks developing in the banking sector, including risks related to the shadow banking sector. Existing structures need to be able to detect risks to the financial sector as a whole. To this end, we should consider strengthening our macroprudential institutions, building on the role and powers of the European Systemic Risk Board (ESRB), while maximising its synergies with the ECB. Finally, in the medium term, it may make sense to review the treatment of bank exposures to sovereign debt, for example by setting large exposure limits. This could further de-link financial stability from national public finances. However, such far-reaching changes to the current framework should only be considered as part of a coordinated effort at the global level.

### 3.2. Launching the Capital Markets Union

Alongside Banking Union, launching the Capital Markets Union must be seen as a priority<sup>3</sup>. This applies to all 28 EU Member States, but it is particularly relevant to the euro area. It will ensure more diversified sources of finance so that companies, including SMEs, can tap capital markets and access other sources of non-bank finance in addition to bank credit. At the same time, a well-functioning Capital Markets Union will strengthen cross-border risk-sharing through deepening integration of bond and equity markets, the latter of which is a key shock absorber. Truly integrated capital markets would also provide a buffer against systemic shocks in the financial sector and strengthen private sector risk-sharing across countries<sup>4</sup>. This in turn reduces the amount of risk-sharing that needs to be achieved through financial means (public risk-sharing). However, as the closer integration of capital markets and gradual removal of remaining national barriers could create new risks to financial stability, there will be a need to expand and strengthen the available tools to manage financial players' systemic risks prudently (macro-prudential toolkit) and strengthen the supervisory framework to ensure the solidity of all financial actors. This should lead ultimately to a single European capital markets supervisor.

In this context, it is important that regulation creates incentives to risk-pooling and risk-sharing and ensures that all financial institutions have sufficient risk management structures in place and remain prudentially sound. Taxation can also play an important role in terms of providing a neutral treatment for different but comparable activities and investments across jurisdictions. A true Capital Markets Union also requires other improvements, some of which can only be achieved through legislation, such as: simplification of prospectus requirements; a revived EU market for high quality securitisation; greater harmonisation of accounting and auditing practices; as well as addressing the most important bottlenecks preventing the integration of capital markets in areas like insolvency law, company law, property rights and as regards the legal enforceability of cross-border claims.

<sup>3</sup> See the Green Paper *'Building a Capital Markets Union'*; European Commission, 18 February 2015.

<sup>4</sup> Increased cross-border investment flows should in principle lead to greater private-sector risk sharing. This is for two reasons: 1) holding a more geographically diversified portfolio of financial assets, including corporate bonds and equities, provides for returns that are less volatile and less correlated with domestic income (capital market channel for risk sharing); 2) when a country is hit by an economic shock, cross-border flows should enable its residents to lend or borrow to offset the shock (credit market channel of risk sharing).

# 4

## Towards Fiscal Union - an Integrated Framework for Sound and Integrated Fiscal Policies

One of the main lessons of the crisis has been that fiscal policies are a matter of vital common interest in a Monetary Union. Even a strong Economic and Financial Union and a price stability-oriented common monetary policy are no guarantee for EMU to always function properly. Unsustainable fiscal policies not only endanger price stability in the Union, they also harm financial stability insofar as they create contagion between Member States and financial fragmentation.

Responsible national fiscal policies are therefore essential. They must perform a double function: guaranteeing that public debt is sustainable and ensuring that fiscal automatic stabilisers can operate to cushion country-specific economic shocks. If this is not the case, downturns are likely to last longer in individual countries, which in turn affects the whole euro area. But this is not enough. It is important to ensure also that the sum of national budget balances leads to an appropriate fiscal stance<sup>5</sup> at the level of the euro area as a whole. This is key to avoid pro-cyclical fiscal policies at all times.

Finally, in case of a very severe crisis, national budgets can become overwhelmed, as was the case in some countries in recent years. In such situations, national fiscal stabilisers might not be enough to absorb the shock and provide the optimal level of economic stabilisation, which in turn can harm the whole euro area. For this reason, it would be important to create in the longer term a euro area-wide fiscal stabilisation function. Such a step should be the culmination of a process that requires, as a pre-condition, a significant degree of economic convergence, financial integration and further coordination and pooling of decision making on national budgets, with commensurate strengthening of democratic accountability. This is important to avoid moral hazard and ensure joint fiscal discipline.

In the meantime, we need to reinforce trust in the common EU fiscal governance framework. A continued thorough, consistent and transparent implementation of our current fiscal framework is therefore essential to prepare the ground for further steps ahead.

## 4.1. Responsible budgetary policies as EMU's cornerstone

In recent years, the so-called 'Six-Pack', the 'Two-Pack' and the Treaty on Stability, Coordination and Governance have brought significant improvements to the framework for fiscal policies in the EMU. Together, they drive our efforts to prevent budgetary imbalances, to focus on debt developments and on better enforcement mechanisms, as well as on national ownership of EU rules. This new governance framework

already provides for ample *ex ante* coordination of annual budgets of euro area Member States and enhances the surveillance of those experiencing financial difficulties. Every Member State must stick to the rules, or the credibility of this framework is at risk. The rules are admittedly complex, but the forthcoming review of the 'Six-Pack' and 'Two-Pack' should be an opportunity to improve clarity, transparency, compliance and legitimacy, while preserving their stability-oriented nature.

In the short run (Stage 1), the current governance framework should be strengthened through the creation of an advisory European Fiscal Board. This new advisory entity would coordinate and complement the national fiscal councils that have been set up in the context of the EU Directive on budgetary frameworks. It would provide a public and independent assessment, at European level, of how budgets – and their execution – perform against the economic objectives and recommendations set out in the EU fiscal governance framework. The composition of the Board should be pluralistic and draw from a wide range of expertise. The mandate of this new European Fiscal Board should rest on a number of guiding principles as set out in Annex 3.

Such a European Fiscal Board should lead to better compliance with the common fiscal rules, a more informed public debate, and stronger coordination of national fiscal policies.

## 4.2. A fiscal stabilisation function for the euro area

There are many ways for a currency union to progress towards a Fiscal Union. Yet, while the degree to which currency unions have common budgetary instruments differs, all mature Monetary Unions have put in place a common macroeconomic stabilisation function to better deal with shocks that cannot be managed at the national level alone.

This would be a natural development for the euro area in the longer term (Stage 2) and under the conditions explained above, i.e. as the culmination of a process of convergence and further pooling of decision-making on national budgets. The objective of automatic stabilisation at the euro area level would not be to actively fine-tune the economic cycle at euro area level. Instead, it should improve the cushioning of large macroeconomic shocks and thereby make EMU overall more resilient. The exact design of such euro area stabilisers requires more in-depth work. This should be one of the tasks of the proposed expert group.

<sup>5</sup> The concept of fiscal stance reflects changes to the fiscal balance in order to influence aggregate economic demand and output. Under the Stability and Growth Pact, the fiscal stance is measured on the basis of the structural fiscal balance, i.e. the fiscal balance corrected for the effects of the economic cycle and net of one-off and other temporary measures. Generally speaking, a fiscal deficit (surplus) would suggest an expansionary (contractionary) fiscal stance.

## Options and guiding principles for a euro area stabilisation function

A prospective stabilisation function could, for example, build on the European Fund for Strategic Investments as a first step, by identifying a pool of financing sources and investment projects specific to the euro area, to be tapped into according to the business cycle. Various additional sources of financing should be considered. It will be important to ensure that the design of such a stabilisation function rests on the following guiding principles:

- It should not lead to permanent transfers between countries or to transfers in one direction only, which is why converging towards Economic Union is a precondition for participation. It should also not be conceived as a way to equalise incomes between Member States.
- It should neither undermine the incentives for sound fiscal policy-making at the national level, nor the incentives to address national structural weaknesses. Accordingly, and to prevent moral hazard, it should be tightly linked to compliance with the broad EU governance framework and to progress in converging towards the common standards described in Section 2.
- It should be developed within the framework of the European Union. This would guarantee that it is consistent with the existing EU fiscal framework and with procedures for the coordination of economic policies. It should be open and transparent vis-à-vis all EU Member States.
- It should not be an instrument for crisis management. The European Stability Mechanism (ESM) already performs that function. Instead, its role should be to improve the overall economic resilience of EMU and individual euro area countries. It would thus help to prevent crises and actually make future interventions by the ESM less likely.

# 5

## Democratic Accountability, Legitimacy and Institutional Strengthening



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Greater responsibility and integration at EU and euro area level should go hand in hand with greater democratic accountability, legitimacy and institutional strengthening. This is both a condition for success and a natural consequence of the increasing interdependence within EMU. It also means better sharing of new powers and greater transparency about who decides what and when. Ultimately, this means and requires more dialogue, greater mutual trust and a stronger capacity to act collectively.

At the height of the crisis, far-reaching decisions had often to be taken in a rush, sometimes overnight. In several cases, intergovernmental solutions were chosen to speed up decisions or overcome opposition. Now is the time to review and consolidate our political construct – and to build the next stage of our Economic and Monetary Union.

A number of concrete steps towards more accountability and participation should be taken already in the short run (Stage 1):

### **A key role for the European Parliament and national Parliaments**

First practical steps have been initiated by the European Parliament to strengthen parliamentary oversight as part of the European Semester. ‘Economic dialogues’ between the European Parliament and the Council, the Commission and the Eurogroup, have taken place in line with the provisions of the ‘Six-Pack’ and ‘Two-Pack’ legislation. This has already been part of the last European Semester rounds. These dialogues may be enhanced by agreeing on dedicated time-slots during the main steps of the Semester cycle. A new form of inter-parliamentary cooperation was established to bring together European and national actors. This takes place within the European Parliamentary Week organised by the European Parliament in co-operation with national Parliaments, which includes representatives from national Parliaments for in-depth discussions on policy priorities. The ‘Two-Pack’ also enshrined the right for a national Parliament to convene a Commissioner for a presentation of the Commission’s opinion on a draft budgetary plan or of its recommendation to a Member State in Excessive Deficit Procedure – a right that should be exercised more systematically than at present.

We could further strengthen the timing and added value of these parliamentary moments in line with the renewed European Semester outlined in Annex 2. In particular, the European Commission could engage with the European Parliament at a plenary debate before the Annual Growth Survey is presented, and continue the debate following its adoption. Moreover,

a second dedicated plenary debate could be held upon presentation by the Commission of the Country-Specific Recommendations, in accordance with the relevant provisions of the ‘Six-Pack’ on economic dialogue. At the same time, Commission and Council representatives could participate in inter-parliamentary meetings in particular in the context of the European Parliamentary Week. This new practice could be progressively agreed upon in more detail between the EU institutions (Commission, Ecofin Council, Eurogroup and the European Parliament) in full respect of their respective institutional role, in the form of a non-binding interinstitutional agreement.

The European Commission should also work out model arrangements to make the interaction with national Parliaments more efficient. Such interaction should apply to national parliamentary debates both on the Country-Specific Recommendations addressed to the Member State and within the annual budgetary procedure. That would give more life to the right recognised in the ‘Two-Pack’ to convene a Commissioner. As a rule, national Parliaments should be closely involved in the adoption of National Reform and Stability Programmes.

The European Parliament should organise itself to assume its role in matters pertaining especially to the euro area.

### **Consolidating the external representation of the euro**

As EMU evolves towards Economic, Financial and Fiscal Union, its external representation should be increasingly unified. This process may take place gradually, but it should be put in motion starting in Stage 1.

The EU is the world’s largest trading block and the world’s largest trader of manufactured goods and services. It has achieved this by acting with one voice on the global stage, rather than with 28 separate trade strategies. The large economic and financial size and the existence of a single monetary and exchange rate policy for most of its members, make the EU policy decisions and economic developments increasingly relevant for the world economy.

However, in the international financial institutions the EU, and the euro area, are still not represented as one. This fragmented voice means the EU is punching below its political and economic weight as each euro area Member State speaks individually. This is particularly true in the case of the IMF despite the efforts made to coordinate European positions.

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## **Integrating intergovernmental solutions within the EU legal framework**

Several intergovernmental arrangements were created during the crisis. This was explained by the shortcomings of the EMU's architecture but ultimately they need to be integrated into the legal framework of the European Union. This is already foreseen for the Treaty on Stability, Coordination and Governance, and should be done also for other cases, such as the Euro Plus Pact and the intergovernmental agreement on the Single Resolution Fund.

Finally, the European Stability Mechanism has established itself as a central instrument to manage potential crises. However, largely as a result of its intergovernmental structure, its governance and decision-making processes are complex and lengthy. In the medium term (Stage 2), its governance should therefore be fully integrated within the EU Treaties.

## **A central steer by the Eurogroup**

The Eurogroup has a central role to play in discussing, promoting and representing the interest of the euro area. It will step up its involvement in the revamped European Semester. In the short run, this may require a reinforcement of its presidency and the means at its disposal. In the longer run (Stage 2), a full-time presidency of the Eurogroup could be considered with a clear mandate within the framework of this report. With the support of all EU institutions, it could play an even greater role in representing the interest of the single currency, within the euro area and beyond.

## **A euro area treasury**

The Stability and Growth Pact remains the anchor for fiscal stability and confidence in the respect of our fiscal rules. In addition, a genuine Fiscal Union will require more joint decision-making on fiscal policy. This would not mean centralisation of all aspects of revenue and expenditure policy. Euro area Member States would continue to decide on taxation and the allocation of budgetary expenditures according to national preferences and political choices. However, as the euro area evolves towards a genuine EMU, some decisions will increasingly need to be made collectively while ensuring democratic accountability and legitimacy. A future euro area treasury could be the place for such collective decision-making.

## **CONCLUSION**

This report has put forward the principal steps necessary to complete EMU at the latest by 2025. It offers a roadmap that is ambitious yet pragmatic. Some of these steps can and should be implemented without delay. First initiatives to this end should be launched by the EU institutions as of 1 July 2015. Others will require more time. But above all, the report offers a clear sense of direction for Europe's EMU. This is essential for citizens and economic actors alike, and for their confidence in the single currency. Translating these proposals into action will require a shared sense of purpose among all Member States and EU institutions. The European Council is invited to endorse these proposals at the earliest occasion.







## Annex 1

### Roadmap Towards a Complete Economic and Monetary Union

**STAGE 1** 1 JULY 2015 - 30 JUNE 2017

#### IMMEDIATE STEPS

##### Economic Union

- A new boost to convergence, jobs and growth
- Creation of a euro area system of Competitiveness Authorities;
- Strengthened implementation of the Macroeconomic Imbalance Procedure;
- Greater focus on employment and social performance;
- Stronger coordination of economic policies within a revamped European Semester.

##### Financial Union

- Complete the Banking Union
- Setting up a bridge financing mechanism for the Single Resolution Fund (SRF);
- Implementing concrete steps towards the common backstop to the SRF;
- Agreeing on a common Deposit Insurance Scheme;
- Improving the effectiveness of the instrument for direct bank recapitalisation in the European Stability Mechanism (ESM).
- Launch the Capital Markets Union
- Reinforce the European Systemic Risk Board

##### Fiscal Union

- A new advisory European Fiscal Board
- The board would provide a public and independent assessment, at European level, of how budgets – and their execution – perform against the economic objectives and recommendations set out in the EU fiscal framework. Its advice should feed into the decisions taken by the Commission in the context of the European Semester.

##### Democratic accountability, legitimacy and institutional strengthening

- Revamp the European Semester
- Reorganise the Semester in two consecutive stages, with the first stage devoted to the euro area as a whole, before the discussion of country specific issues in the second stage.
- Strengthen parliamentary control as part of the European Semester
- Plenary debate at the European Parliament on the Annual Growth Survey both before and after it is issued by the Commission; followed by a plenary debate on the Country-Specific Recommendations;
- More systematic interactions between Commissioners and national Parliaments both on the Country-Specific Recommendations and on national budgets;
- More systematic consultation and involvement by governments of national Parliaments and social partners before the annual submission of National Reform and Stability Programmes.
- Increase the level of cooperation between the European Parliament and national Parliaments
- Reinforce the steer of the Eurogroup
- Take steps towards a consolidated external representation of the euro area
- Integrate into the framework of EU law the Treaty on Stability, Coordination and Governance; the relevant parts of the Euro Plus Pact; and the Inter-governmental Agreement on the Single Resolution Fund

**STAGE 2**

**COMPLETING THE EMU ARCHITECTURE**

**Economic Union**

- Formalise and make more binding the convergence process

**Fiscal Union**

- Set up a macroeconomic stabilisation function for the euro area
- Convergence towards similarly resilient national economic structures would be a condition to access this mechanism.

**Democratic accountability, legitimacy and institutional strengthening**

- Integrate the European Stability Mechanism (ESM) into the EU law framework
- Set up a euro area treasury accountable at the European level

**FINAL STAGE AT THE LATEST BY 2025**

## Annex 2

### A More Integrated European Semester

To better integrate the euro area and the national levels, the European Semester should be structured into two successive stages distinguishing more clearly between a European moment and a national moment (the figure below illustrates the new structure).

The first stage (November of year 'n-1' to February of year 'n') would be devoted to assessing the situation in the euro area as a whole. The Commission's Annual Growth Survey (AGS) would be the basis for this discussion and would draw on a number of thematic reports, such as the Alert Mechanism Report, the annual report of the European Systemic Risk Board, the Joint Employment and Social Report, as well as the views of a new European Fiscal Board and the new euro area system of Competitiveness Authorities. Together, these reports would give a complete picture of euro area challenges. The AGS would be presented to and discussed by the European Parliament. At the same time as the AGS, the Commission would present a dedicated recommendation for action within the euro area, as well as a list of Member States it considers for 'in-depth reviews', according to the Macroeconomic Imbalance Procedure. These documents would be discussed with

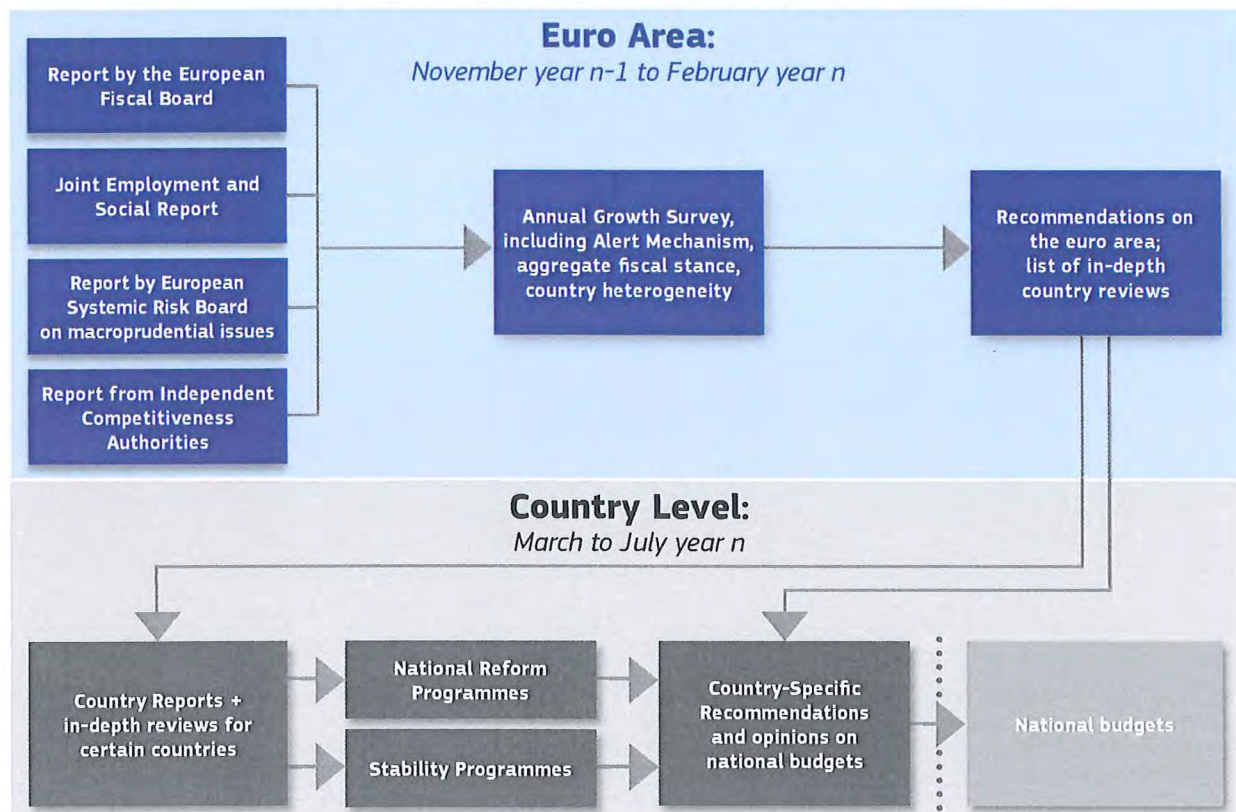
the European Parliament within the framework of the economic dialogue, as foreseen in the 'Six-Pack' legislation, and with the different formations of the Council and the Eurogroup. This means that by end-February every year, a genuine discussion will have taken place on the priorities set for the EU, and the euro area in particular, for the coming year.

The following stage (March to July of year 'n') would be devoted to reviewing and assessing the performance and policies of the Member States in the light of these priorities. This is the phase where Member States should systematically involve national Parliaments, together with social partners and civil society, in the discussion of national priorities. This stage will start with the publication of the Commission's Country Reports, which summarise Member States' challenges and performance. This stage would end with the adoption of Country-Specific Recommendations, which should clearly take into account the euro area dimension agreed in the first stage.

EU-level social partners could be involved in discussions earlier, for instance through a renewed Tripartite Social Summit and Macroeconomic Dialogue, to maximise their contributions to this new process.

Annex 2

### A MORE INTEGRATED EUROPEAN SEMESTER



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## Annex 3

### Advisory European Fiscal Board - Guiding Principles

The mandate of the advisory European Fiscal Board should rest on the following principles:

- It should coordinate the network of national fiscal councils and conform to the same standard of independence.
- It should advise, not implement policy. Enforcing the rules should remain the task of the European Commission, which should be able to deviate from the views of the European Fiscal Board provided that it has justifiable reasons and explains them.
- It should form an economic, rather than a legal, judgement on the appropriate fiscal stance, both at national and euro area level, against the background of EU fiscal rules. This should be done on the basis of the rules set in the Stability and Growth Pact (SGP).
- It should be able to issue opinions when it considers it necessary, including in particular in connection with the assessment of Stability Programmes and presentation of the annual Draft Budgetary Plans and the execution of national budgets.
- It should provide an *ex post* evaluation of how the governance framework was implemented.





# **Preparing for Next Steps on Better Economic Governance in the Euro Area**

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Analytical Note

**Jean-Claude Juncker**

in close cooperation with

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Informal European Council

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# Preparing for Next Steps on Better Economic Governance in the Euro Area

## Analytical Note

### Introduction

The Euro Summit of 24 October 2014 concluded that *"closer coordination of economic policies is essential to ensure the smooth functioning of the Economic and Monetary Union"*. It called for work to continue *"to develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity"*; and it invited the President of the European Commission, in close cooperation with the President of the Euro Summit, the President of the Eurogroup and the President of the European Central Bank, *"to prepare next steps on better economic governance in the euro area."*

The European Council of 18 December 2014 confirmed the mandate given to the Four Presidents. As a first step, the Four Presidents were asked to produce an Analytical Note to serve as the basis of a discussion at the informal European Council on 12 February 2015.

The present Analytical Note takes stock of the current state of Economic and Monetary Union (EMU). It identifies the main shortcomings of the EMU framework that were revealed by the crisis, describes the measures taken so far to address them and prepares the ground for a discussion about the next steps. Nothing in this note prejudices the final content of the Four Presidents' Report, which will be drafted in the light of the outcome of the discussion between Heads of State and Government on 12 February and further work and consultations ahead of the European Council in June.

### 1. The nature of Economic and Monetary Union

The euro is a currency shared today by 19 EU Member States and more than 330 million citizens. In spite of the crisis, it is the second most important currency in the world, with a 24.4 % (1999: 18 %) share in global foreign exchange reserves, compared to the U.S. Dollar's 61.2 % share. Globally, 59 countries and territories have either directly or indirectly pegged their currency to the euro.

The euro is more than a currency. It is also a political project. Our monetary union requires Member States give up their previous national currencies once and for all and permanently share monetary sovereignty with the other euro area countries. The euro has thus created a *"community of destiny"* between the 19 Member States that share the euro as their currency; this requires both solidarity in times of crisis and respect by all for commonly agreed rules.

The euro area has a unique institutional setup. While monetary policy is decided jointly at European level, economic and fiscal policies remain, to a large extent, in the Member States' remit. In such a setup, vulnerabilities in one Member State can become vulnerabilities for the euro area as a whole. Economic success is therefore in everyone's common interest. A monetary union will only be successful if being inside monetary union brings, over time, more benefits as compared to staying outside. For this, all Member States have to take ownership by considering their economic and fiscal policies as a matter of common concern.

The Treaties set out a clear set of goals – inclusive and sustainable growth, price stability, sound fiscal positions and high levels of employment –, and the EMU framework foresees a set of common rules



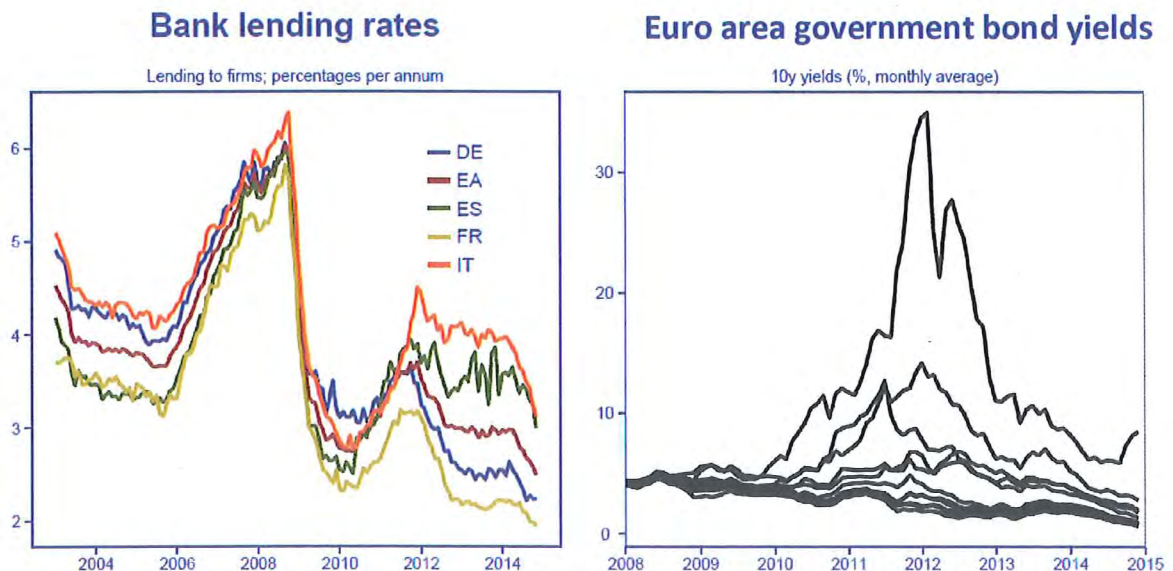
to coordinate these policies closely. The crisis has shown that if there are weaknesses in the framework or if it is not sufficiently implemented, the integrity of the euro area as a whole is at stake and the objectives stipulated by the Treaties cannot be attained. It is for this reason that making sure the EMU framework is fully compatible with the requirements of sharing a common currency was the key challenge faced in recent years and remains a hurdle that has not yet been fully overcome.

## 2. Looking back: the manifold roots of the crisis

The crisis that started to hit the euro area as of summer 2007 and which continues to impact the economic development of several euro area members until today, had many roots and origins. While several of them are common to all industrialised countries, some of them are more strongly present in the euro area where they prolonged and intensified the effects of the crisis.

At the onset, the crisis was primarily a *financial crisis*. It originated in the U.S. subprime market and spread rapidly across the globally interconnected financial system, including to European banks and other financial institutions, notably in euro area countries where the good times of the first decade of the euro had led to financial and housing bubbles. A feature of particular relevance to the euro area was the negative feedback loop between bank and government sovereign debt: as banks that had become too systemic to fail got into financial difficulties and turned to their sovereign for help, the stability of the banking system could only be guaranteed to the detriment of the public finances of the countries concerned and at the cost of increased financial fragmentation (see [Chart 1](#)). Thus, in these countries, a crisis of banks quickly became a crisis of public finances, with a direct impact on the real economy.

**Chart 1**

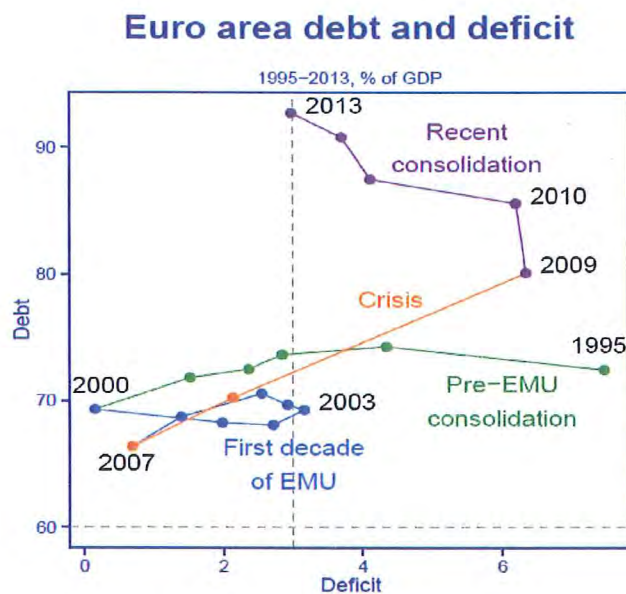


Source: ECB, Reuters, ECB Staff calculations

The crisis then turned into a *sovereign debt crisis*. The first decade of the euro had not led to a sustainable reduction of public debts and deficits below the reference values of 3 % and 60 % of GDP required by the Maastricht Treaty. Government debt in the euro area, which had stood at 72.8 % of GDP in 1998, could only be reduced to 66.2 % of GDP on average in 2007, even though mostly benign macroeconomic conditions would have allowed for stronger fiscal consolidation. Deficits in the euro area stood on average at 1.9 % of GDP in the period from 1999 to 2007, peaking at 3.1 % of GDP in 2003. The common policy objective of national budgets which are in balance or in surplus – meant to reduce public debt levels – could not be reached. The fiscal rules meant to contain excessive public deficits (the so-called "Stability and Growth Pact") were often not respected and not implemented.

Since 1997, most euro area countries (all except Estonia and Luxembourg) were once or even repeatedly subject to an excessive deficit procedure. In 2003, the rules of the Pact were partly suspended by a qualified majority in the Council in the specific case of excessive deficit procedures against Germany and France. In 2005, the Pact was reformed in a manner widely perceived as a weakening of the rules. Both moves undermined the credibility of the Pact. When the crisis started to impact the euro area, its Member States reacted with important stimulus packages and injections of public money into their banking systems, which, while necessary to safeguard financial stability and soften the impact of the crisis, in many countries increased public debt and deficit well beyond the Maastricht reference values. Public deficits in the euro area peaked at 6.2 % of GDP in 2010 before they could be reduced to 2.6 % of GDP in 2014. While public debt continues to increase as a result of the measures taken during the crisis, in 2014, it stood at 94.3 % of GDP on average in the euro area, way above pre-crisis levels (see [Chart 2](#)).

**Chart 2**



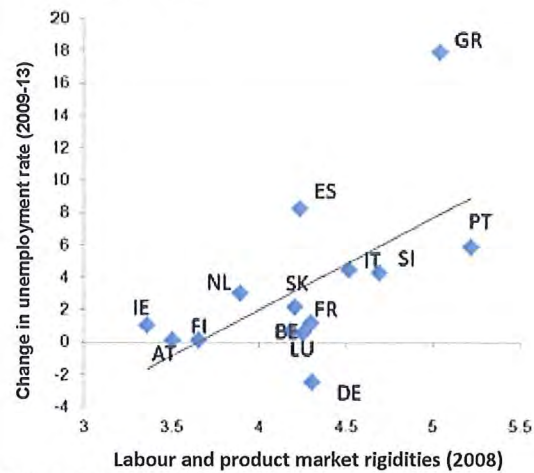
Source: European Commission, ECB

The crisis in the euro area, triggered by the global financial turmoil, can also be said to have been a *competitiveness crisis*, with several weaknesses predating the crisis. While there had been some catching up with the U.S. in terms of productivity until the 1990s, this process has stopped over time. Several euro area countries did not use the boom period to tackle existing rigidities in product and labour markets.

By contrast, deep-rooted vulnerabilities did not allow the supply side to catch-up with demand. At the same time, significant nominal and real rigidities prevented an efficient allocation of resources, including between the tradable and non-tradable sectors, and thereby hampered the functioning of the competitiveness channel (see [Chart 3](#)).

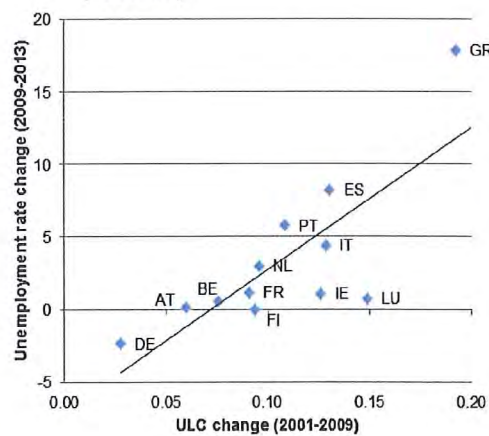
Against this background, during the first decade of the euro, the cost of labour (measured in unit labour costs) grew significantly in a number of euro area countries, making their products more expensive, thereby reducing their competitiveness and leading to a negative balance of payments vis-à-vis other euro area countries which had kept labour unit cost stable or even lowered them.

**Chart 3: Rigidities in product and labour market and changes in the unemployment rate (2009-13)**



Source: Eurostat and OECD  
 Note: labour and product market rigidities measured as average of employment protection legislation and product market regulator OECD indicators.

**Chart 4: Changes in Unit Labour Costs (2001-09) and in the unemployment rate (2009-13)**



Source: Eurostat  
 Note: Data shown for euro area countries that have joined the EMU before 2002; for unemployment rate September data is used.

This brought about higher unemployment rates during the crisis (see [Chart 4](#)). In addition, the relatively favourable financing conditions in the first years of the euro led to a misallocation of sources of financing towards less productive forms of investment, such as real estate, and to a greater risk-taking and indebtedness of many private and public actors. When the crisis hit the euro area and markets reappraised the risk and growth potential of individual countries, the loss of competitiveness became visible and led to outflows of sources of finance strongly needed for investment, thereby further intensifying the impact of the crisis in these countries. While several stakeholders at the European level had warned about such developments, the governance framework at the time did not provide for a systematic detection and correction of imbalances and hence it could not prevent their build-up.

Last but not least, the crisis can also be said to be a *crisis of markets* in terms of their capacity to price country risk correctly. While the Maastricht Treaty was based on the assumption that market discipline would be a key element in preventing a divergent development of the euro area economies and their fiscal positions, with increasing government bond interest rates having a signalling effect, this was not the reality of the euro area from 1999 to 2008. Instead, investors treated the euro area as one, without taking into account diverging economic and financial risks. The crisis made these divergences transparent; the ensuing reappraisal of risks then led to bond interest rates for certain euro area countries which were well above those of certain developing countries (see [Chart 1](#)).

All of these developments showed that there was a significant gap between the objectives and the actual performance of the pre-crisis governance framework of EMU, as well as a persistent failure to comply with and implement commonly agreed policies.

### 3. Measures taken since 2010 to strengthen the resilience of Economic and Monetary Union

The crisis has revealed that significant structural weaknesses and rigidities and unsustainable fiscal and economic policies in some Member States can undermine the economic development the euro area as a whole and thereby put the benefits of being inside EMU at risk. It has also uncovered major shortcomings of the governance framework, which was not able to prevent these developments.

At euro area level, significant reforms have been adopted since 2010 with a view to addressing and remedying these deficiencies:

- The **European Stability Mechanism (ESM)** was created as a permanent crisis mechanism tool that had not been available before the crisis.
- **Banking Union** was established, with the ECB taking up the role of the Single Supervisory Mechanism, directly supervising all significant banks in the euro area since 1 November 2014. The Single Resolution Mechanism and the new bail-in rules of the EU Bank Recovery and Resolution Directive now provide a framework for the orderly resolution of banks and for burden-sharing between shareholders and creditors. These steps, coupled with the Single Resolution Fund, are important contributions to reducing the detrimental sovereign-bank nexus and to protecting, alongside harmonised national deposit-guarantee schemes, depositors.
- The new **Macroeconomic Imbalance Procedure (MIP)** is now in place to detect the development of macroeconomic vulnerabilities early on and provide instruments to correct them.
- The **reform of the "Stability and Growth Pact" in 2011/2013 and the agreement on the "Fiscal Compact"** reinforced the fiscal framework in order to prevent the building up of large fiscal imbalances in the future. The monitoring of expenditure developments became more important under the preventive arm and the procedures in the preventive and corrective arm were strengthened – not least by new, earlier and gradually increasing sanctions. One major lesson from the crisis was the need to introduce a numerical debt benchmark aiming to ensure convergence towards sound debt ratios, below the Maastricht reference value of 60 % of GDP. The introduction of the reverse qualified majority voting modalities (RQMV) in the Council for decisions under the excessive deficit procedure was intended to increase the quasi-automaticity of the procedures.
- **Eurostat** powers were strengthened in 2011 with regard to statistical data used for the excessive deficit procedure. Under the amended regulation, today Eurostat is entitled to examine Member States' public accounts and to make on-the-spot investigations in the Member State concerned.

These are important steps which would likely have improved the euro area's performance considerably, both before and during the crisis, had they already been in place a decade ago. Nonetheless, these new structures will only be effective if fully implemented both at EU and national level.

#### 4. Where do we stand now?

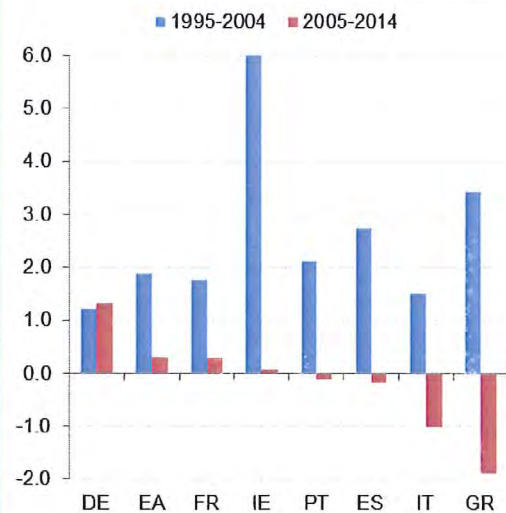
Although a significant adjustment of fiscal and economic imbalances has started, in particular in countries under EU/IMF financial assistance and other more vulnerable euro area countries, the legacy of accumulated imbalances remains painfully visible: unemployment rates have soared and public and private sector debt increased very significantly in just a few years. Unemployment in the euro area has been above 10 % since 2009 and stood at 11.6 % in 2014, up from 7.5 % in 2007. Youth unemployment in the euro area even stands at 23 % (up from 16.6 % in 2007).

High indebtedness and unemployment and the still significant obstacles to flexible markets, hamper countries' growth potential (see [Chart 5](#)). Moreover, while high debt usually has a negative effect on growth (see [Chart 6](#)), low growth and low inflation also make it difficult for a country to reduce its indebtedness, with the aim of increasing resilience and sustainability. In this context, some of the highly indebted euro area countries with low rates of potential output growth may find it particularly difficult to reduce their debt levels quickly. Increased shock resilience and higher potential growth demand further action in terms of national structural reforms.

According to international indicators of labour and product market flexibility, euro area countries still exhibit significant rigidities which need to be tackled. Moreover, national governments need to create an environment which is favourable for entrepreneurs wanting to start a new firm or for existing firms to grow. International indicators suggest that there is significant scope for improvement in the euro area: currently, when looking at its overall position in the world, the euro area ranks far behind the UK and the U.S. on average.

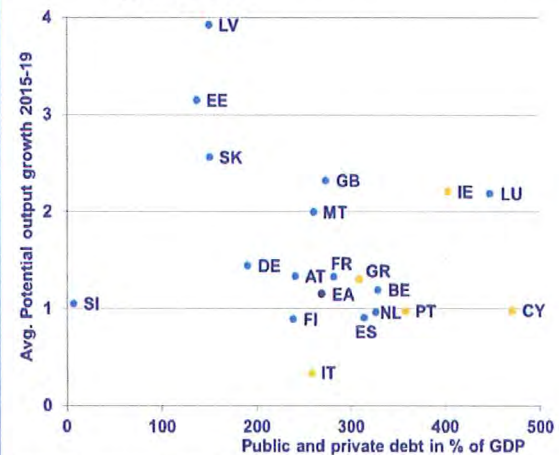
In the World Bank rankings on the ease of doing business, there is only one euro area country (Finland) in the top 10, and several countries are not even in the top 50. Measures to improve this are not only in the best interest of each Member State – because of the strong links between Member States' economies – but they are also in the interest of the euro area as a whole.

**Chart 5: Real GDP per capita (average growth)**



Source: European Commission

**Chart 6: Average potential growth vs. public and private debt**



Source: European Commission, Eurostat

Note: Last observation refers to June 2014 for public and private sector debt and 2019 for potential output.

## 5. Looking forward: towards a deep and genuine Economic and Monetary Union

In view of the current weak economic environment in the euro area as a whole and the remaining vulnerabilities and rigidities in a number of individual countries, there is a need to move gradually towards *"concrete mechanisms for stronger economic policy coordination, convergence and solidarity"*. Such mechanisms should be based on the reality of the economic, employment and social situation of euro area Member States, the nature of the interdependency which exists between them, and their capacity to converge over time.

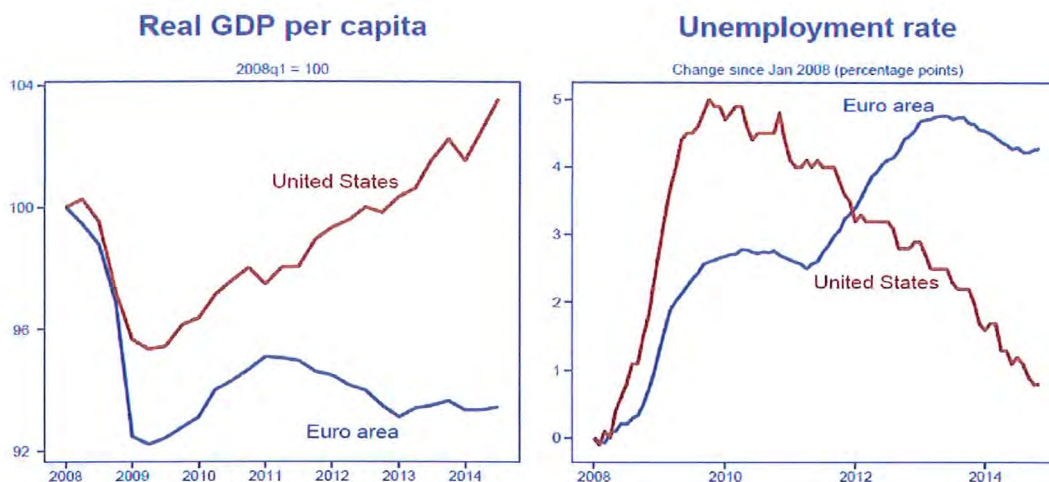
In the short run, it is important to implement a consistent strategy around the "virtuous triangle" of structural reforms, investment and fiscal responsibility and in this context move **towards more effective commitments to growth-enhancing structural reforms in the euro area**. The policy commitments of euro area countries, made individually or collectively, to growth-enhancing structural reforms have not been implemented satisfactorily. Often, commitments are strong in crisis times and then weakened again when the overall economic climate has improved. In this sense, the stabilising effect of the single currency has certain counterproductive effects with regard to the willingness of national governments to start and implement the necessary structural reforms with decisiveness, though these would be urgently needed. A renewed political consensus at the highest political level is necessary to proceed with those structural reforms which should be tackled as a priority across the euro area.

Moreover, **the functioning of the Single Market** needs to be improved, in particular in areas that are vital to increase the adjustment capacity of the euro area economies. **Enhancing labour mobility** is key in this respect. In addition, to complement Banking Union and diversify and extend sources of financing of the European economy, we need to address remaining barriers to investment and the free movement of capital and **make capital market integration a political priority**, including by considering issues like taxation, insolvency and company law. A well-integrated financial system in the EU, as a result of a Capital Markets Union, can make a monetary union more resilient against shocks by providing an element of private risk-sharing, and more efficient when it comes to generating jobs, growth and investment. Further initiatives to complete the Single Market, for example, in the areas of the digital economy and energy, are essential to strengthen growth prospects.

Tangible progress on these two blocks – growth-enhancing structural reforms and deepening the Single Market – will contribute to the smooth functioning of Economic and Monetary Union in the short term (within the next 18 months), provided that they receive strong political backing.

However, it remains **necessary, for citizens and markets alike, to develop a long-term perspective on how the framework of EMU should develop**, where it could be considered complete, and where further work will be necessary to develop stronger common governance, as already called for by the 2012 Four Presidents' Report and by the Commission's Blueprint, which both remain valid. The euro area has not recovered from the crisis in the same way as the U.S., which might point to the fact that an incomplete monetary union adjusts much slower than one with a more complete institutional setup in place (see [Chart 7](#)).

**Chart 7**



Source: Eurostat

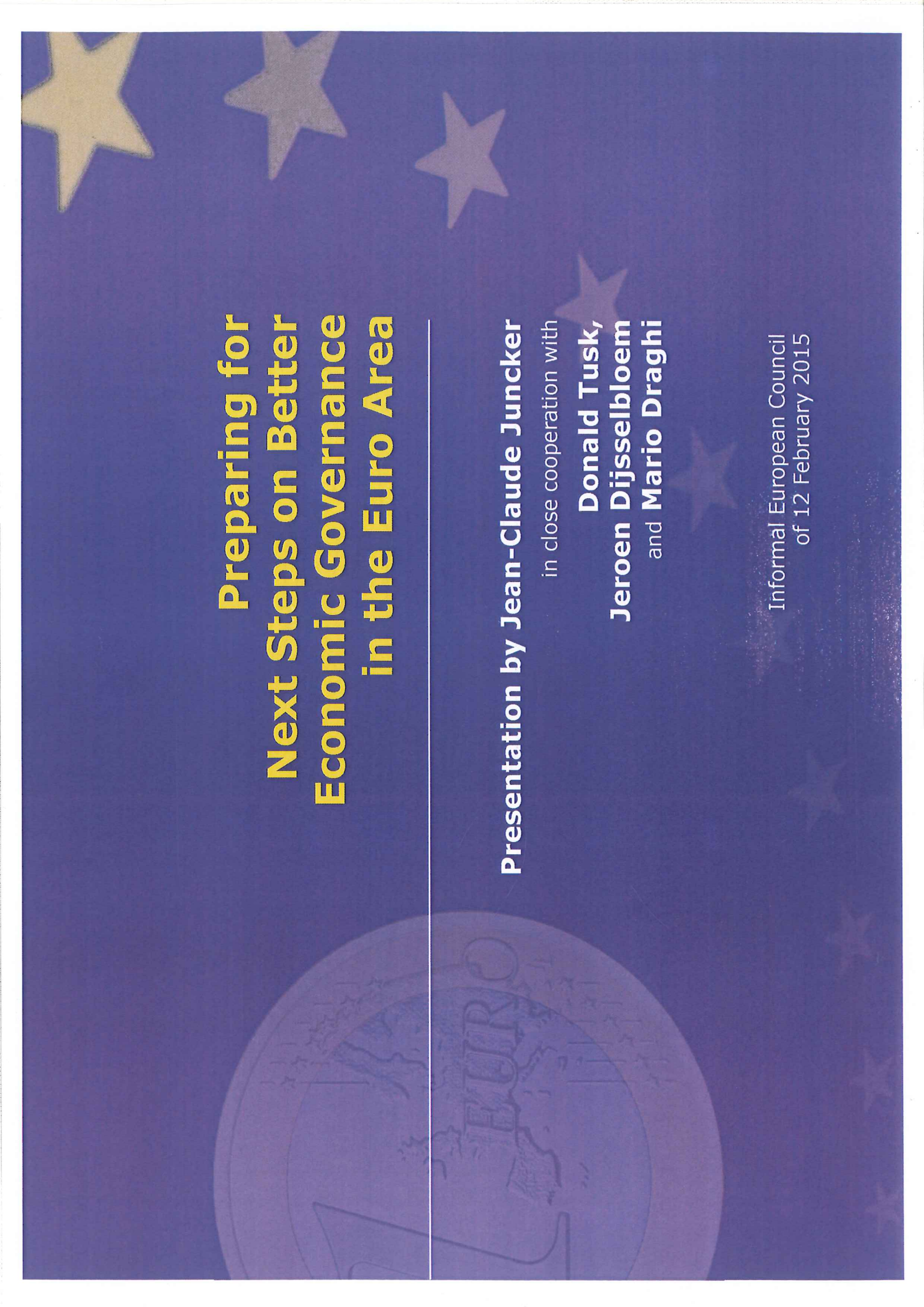
In this respect, this Analytical Note is intended to start a discussion process that will feed into a forward-looking report by the Four Presidents, in the preparation of which all Member States will be closely involved<sup>1</sup> and which could in particular address the following questions:

- How can we ensure sound fiscal and economic positions in all euro area Member States?
- How could a better implementation and enforcement of the economic and fiscal governance framework be ensured?
- Is the current governance framework – if fully implemented – sufficient to make the euro area shock-resilient and prosperous in the long run?
- To what extent can the framework of EMU mainly rely on strong rules and to what extent are strong common institutions also required?
- What instruments are needed in situations in which national policies continue – despite surveillance under the governance framework – to go harmfully astray?
- Has the fiscal-financial nexus been sufficiently dealt with in order to prevent the repetition of negative feedback loops between banks and sovereign debt?
- How could private risk-sharing through financial markets in the euro area be enhanced to ensure a better absorption of asymmetric shocks?
- To what extent is the present sharing of sovereignty adequate to meet the economic, financial and fiscal framework requirements of the common currency?
- Is a further risk-sharing in the fiscal realm desirable? What would be the preconditions?
- Under which conditions and in which form could a stronger common governance over structural reforms be envisaged? How could it foster real convergence?
- How can accountability and legitimacy be best achieved in a multilevel setup such as EMU?

<sup>1</sup> The President of the European Commission has indicated his intention to draw on input from the President of the European Parliament in his reflections during the preparation of the report.







**Preparing for  
Next Steps on Better  
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in the Euro Area**

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**Presentation by Jean-Claude Juncker**

in close cooperation with

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Informal European Council  
of 12 February 2015

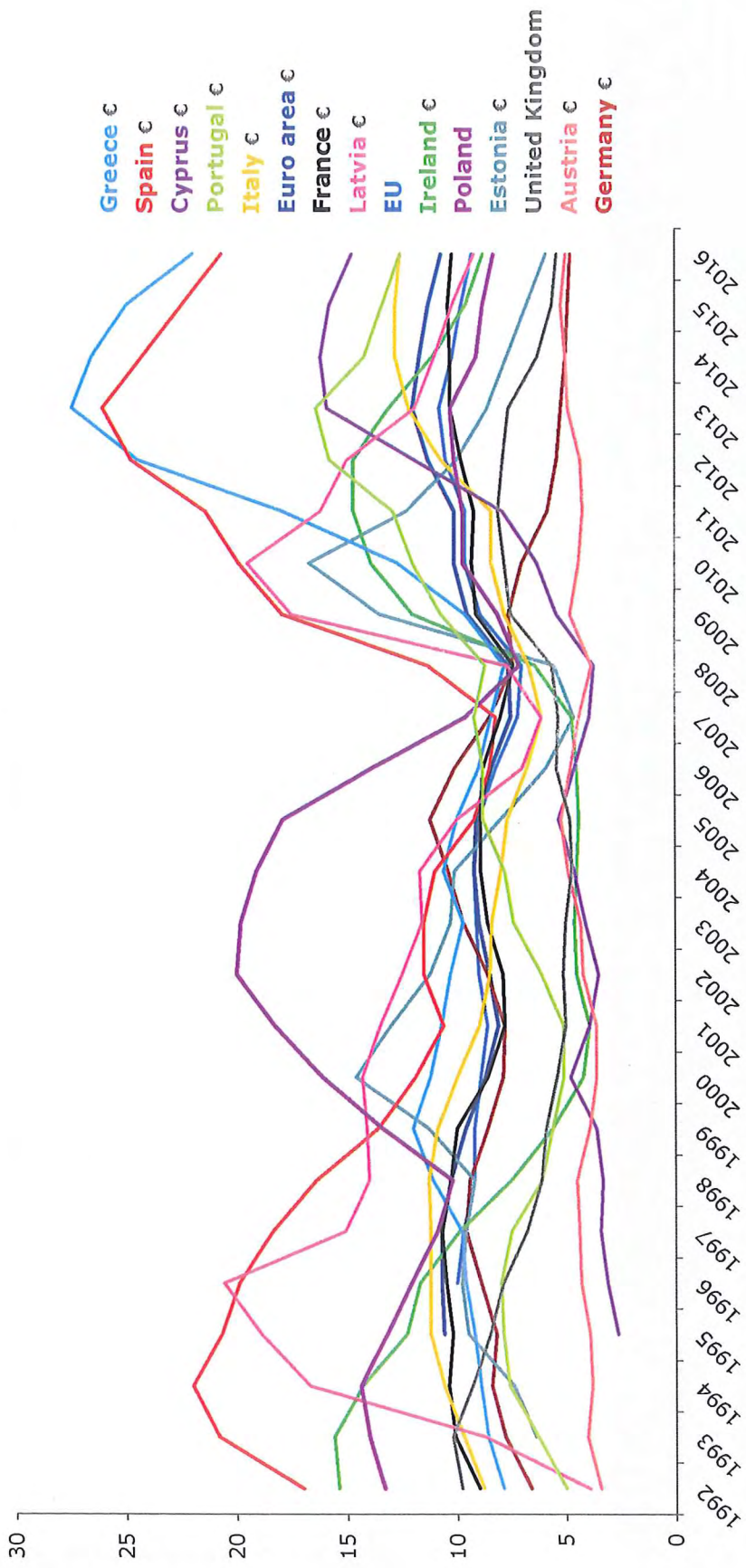
# GDP per capita

**Gross domestic product per capita**  
(EUR 1000 of 2014, adjusted for purchasing power)



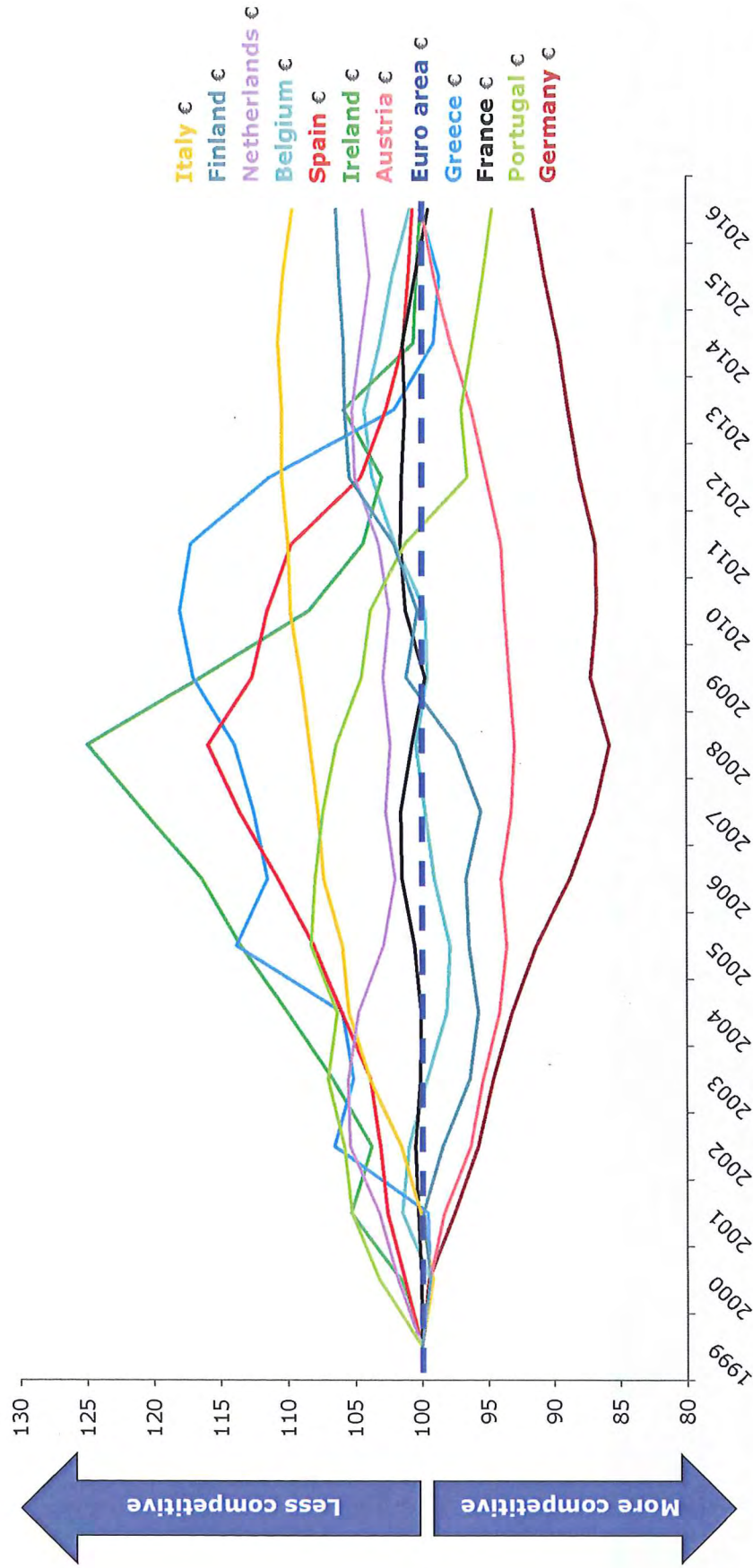
# Unemployment rate

**Unemployment rate**  
Annual average percentage



# Cost-competitiveness

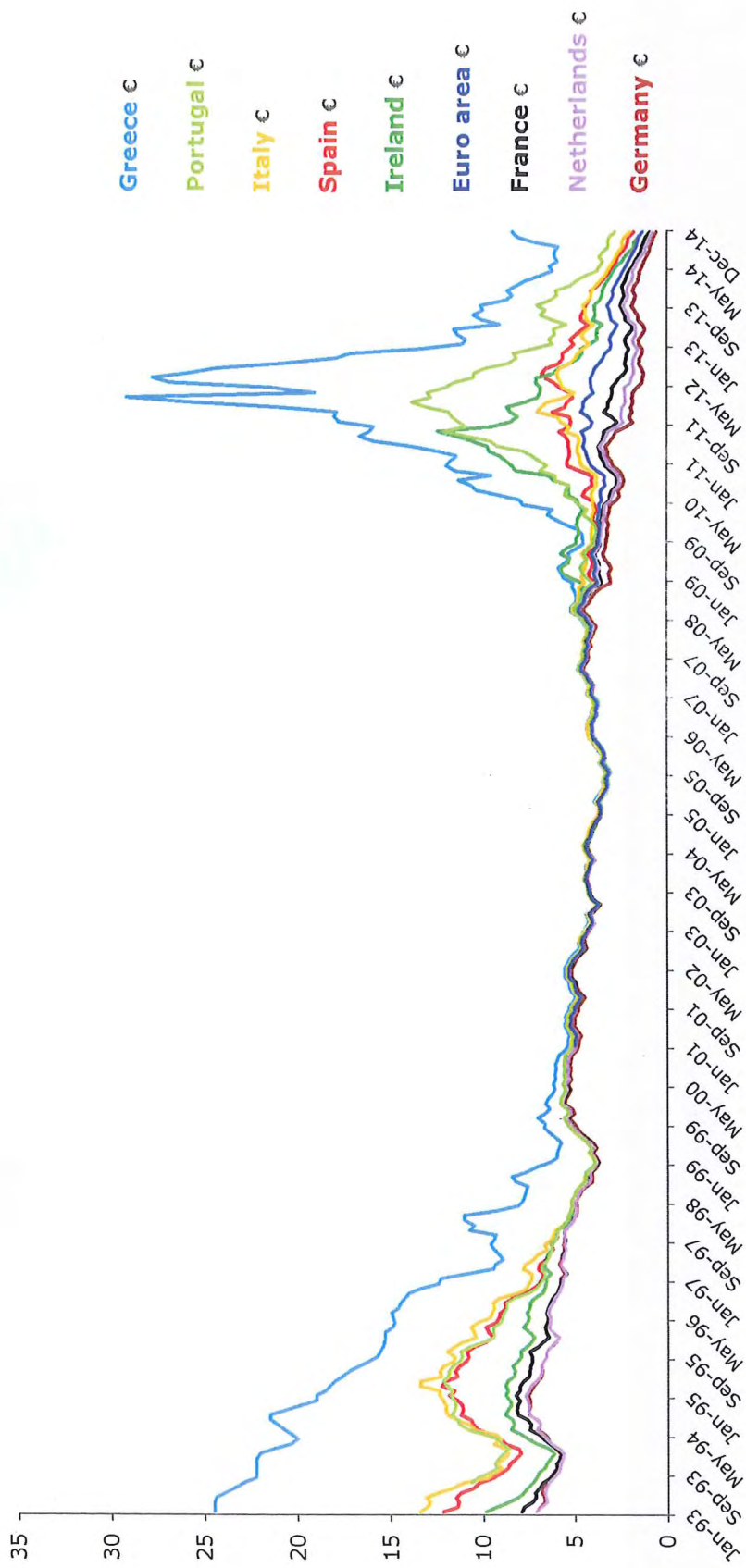
**Unit labour costs**  
(Euro Area (18) = 100, index: 1999)



Source: European Commission

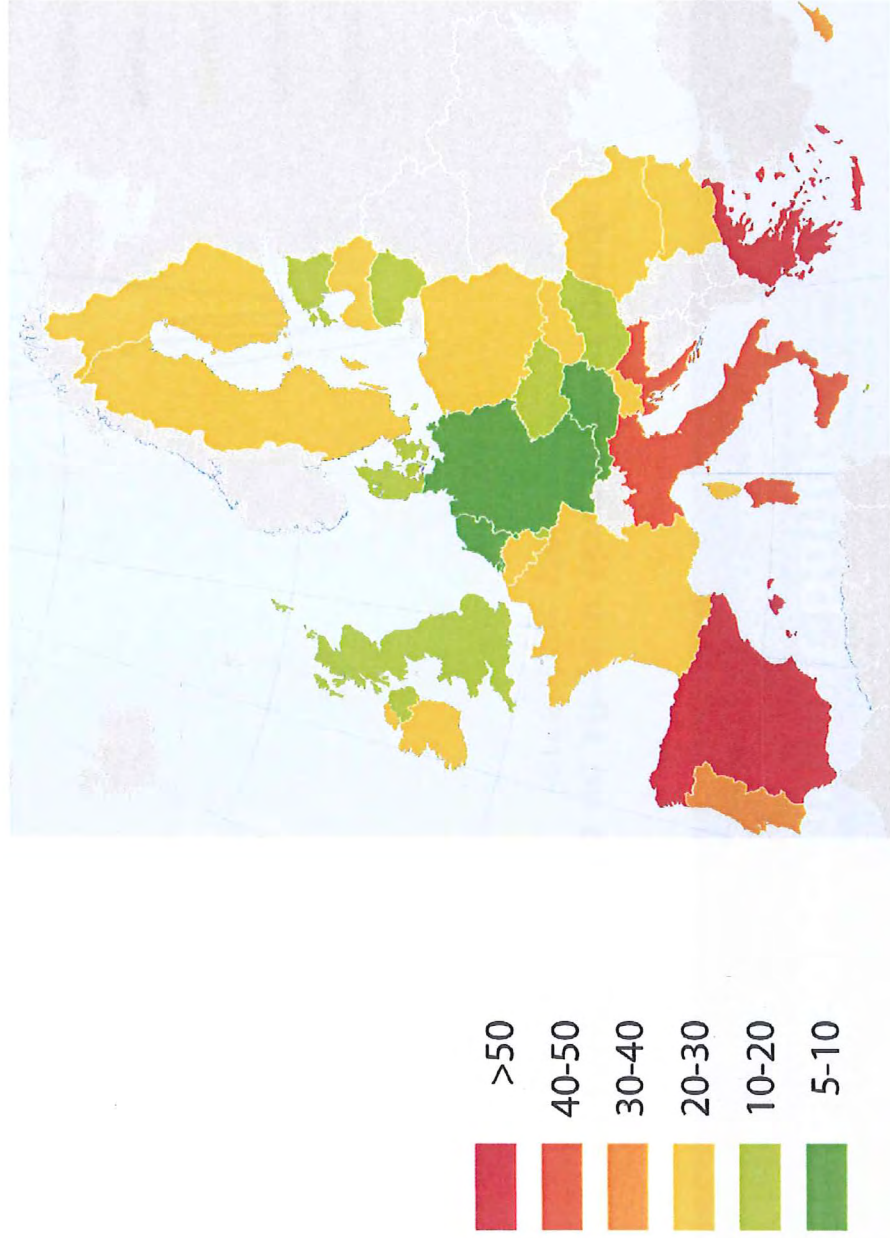
# Interest rates on Government bonds

Interest rates on 10-year Government bonds  
Percentage yield



# Youth unemployment

Youth (under 25s) unemployment rate (%), December 2014

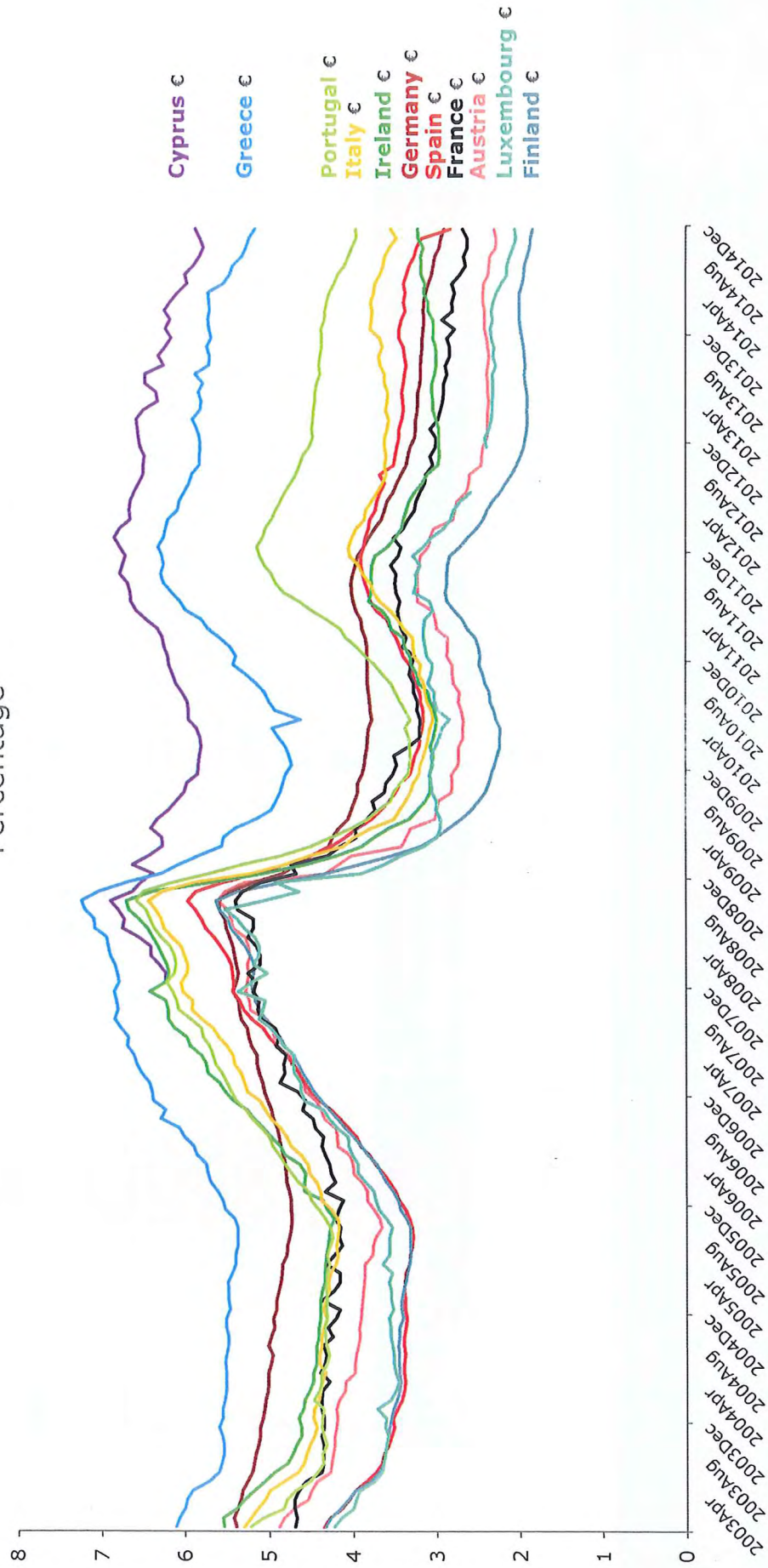


Source: European Commission

# Interest rates to firms

Interest rates to firms (non-financial corporations)





























Percentage



Source: ECB

# Respecting our rules

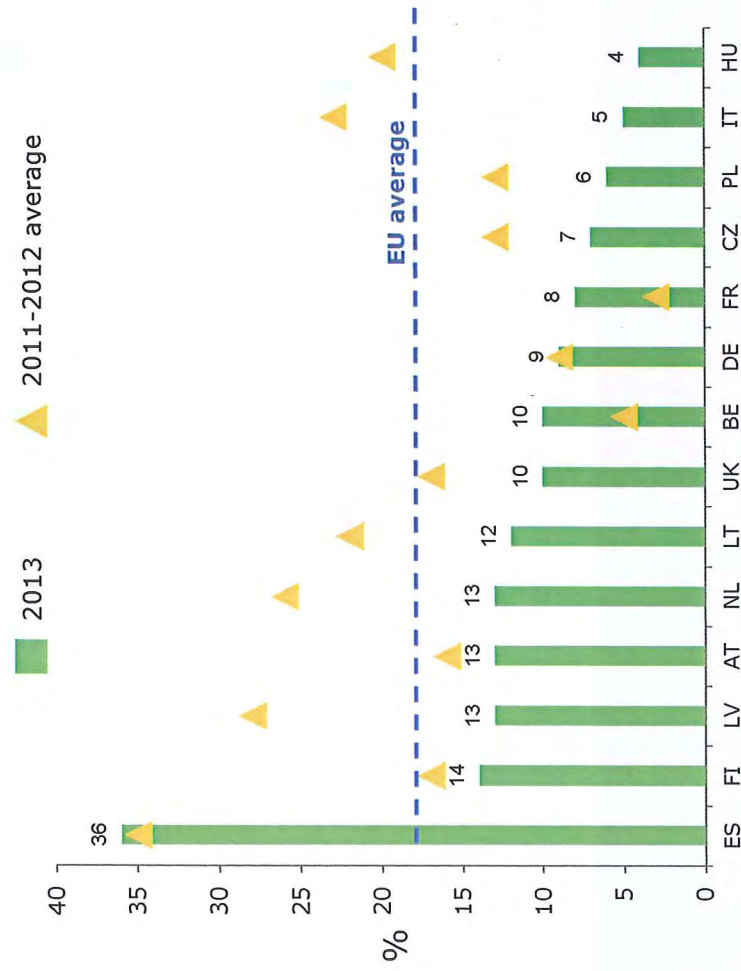
## Number of years in Excessive Deficit Procedure since 1997 (including ongoing deadlines)

Country		Number of years in EDP	Country	Number of years in EDP	
	AT	€		IE	€
	BE	€		IT	€
	BG			LT	€
	CY	€		LU	€
	CZ			LV	€
	DE	€		MT	€
	DK			NL	€
	EE	€		PL	
	EL	€		PT	€
	ES	€		RO	
	FI	€		SE	
	FR	€		SI	€
	HR			SK	€
	HU			UK	

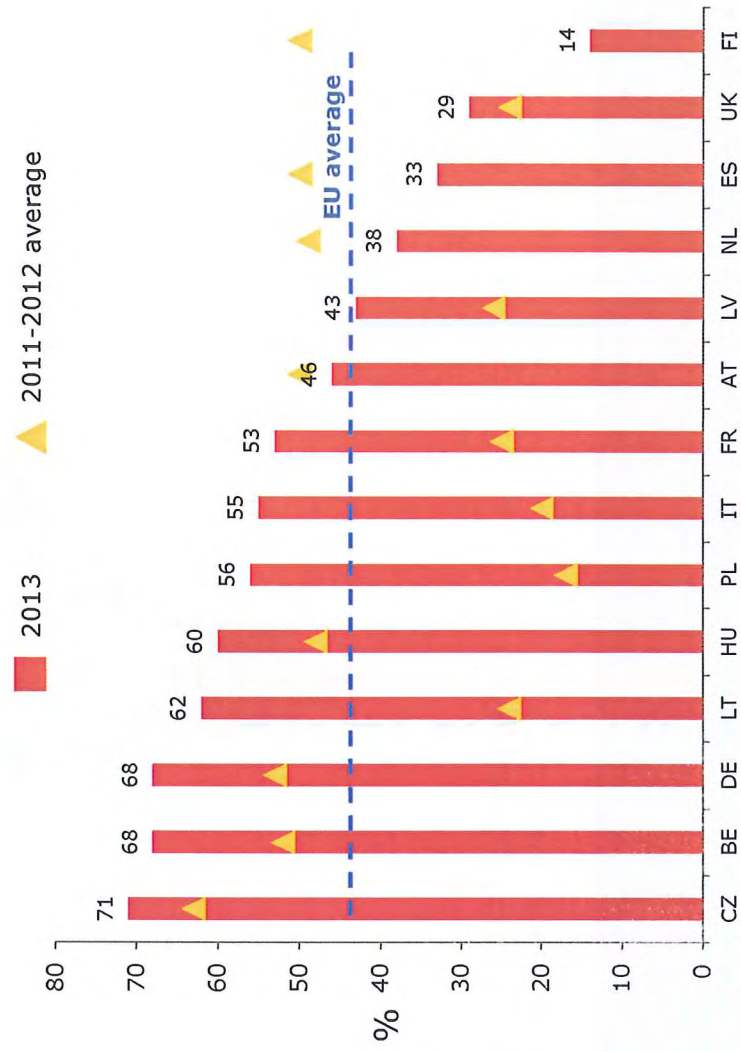


# Implementing reforms

Full implementation of EU country-specific recommendations

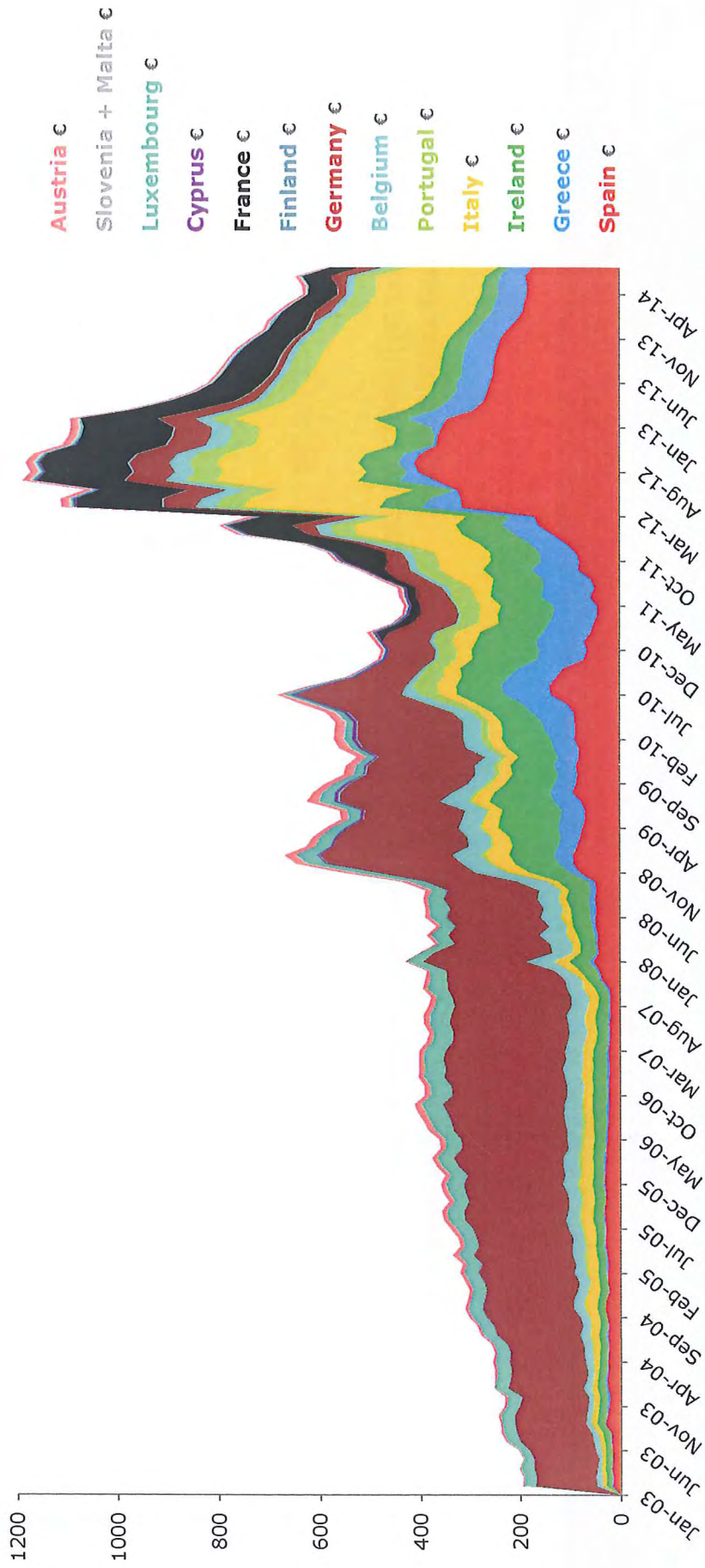


Non-implementation of EU country-specific recommendations



# Absorbing shocks

Eurosystem Main and  
Longer-Term Refinancing Operations  
(EUR bn)

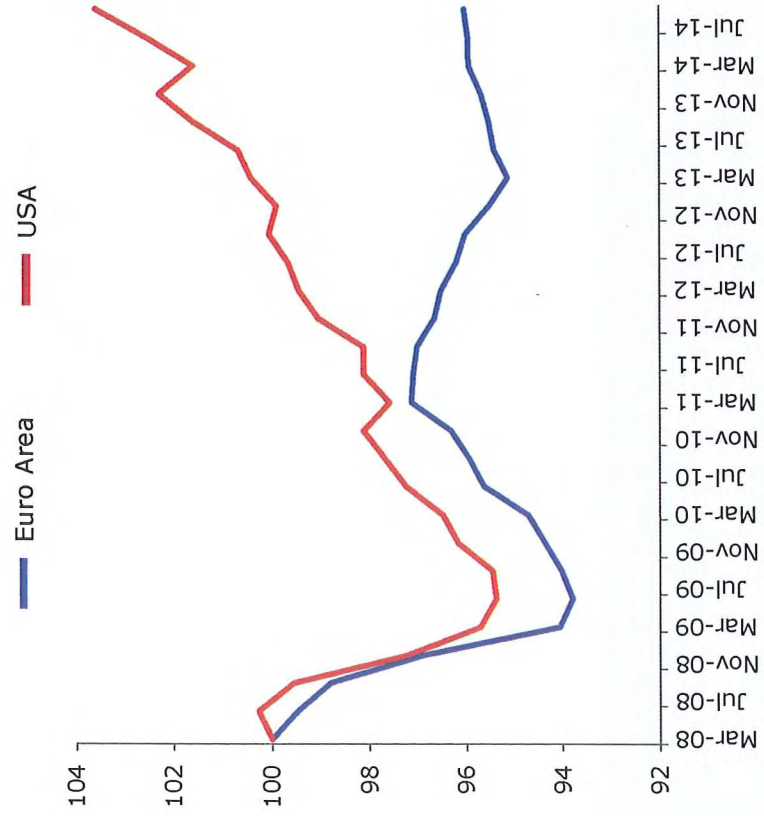


Source: Bruegel based on ECB and national central banks

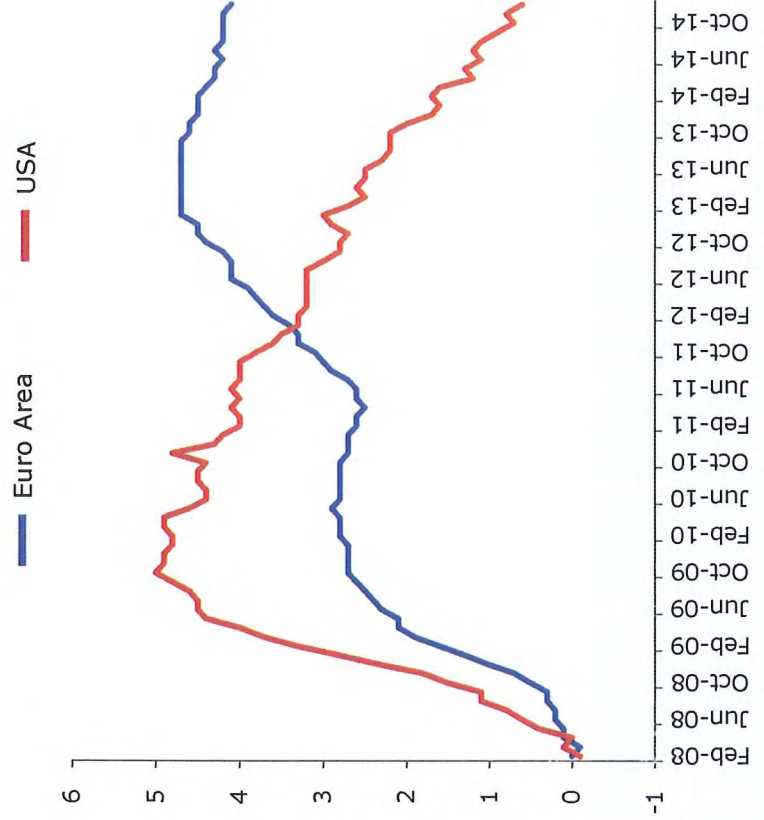
# Regaining ground



**Real GDP per capita  
Index, first quarter 2008 = 100**



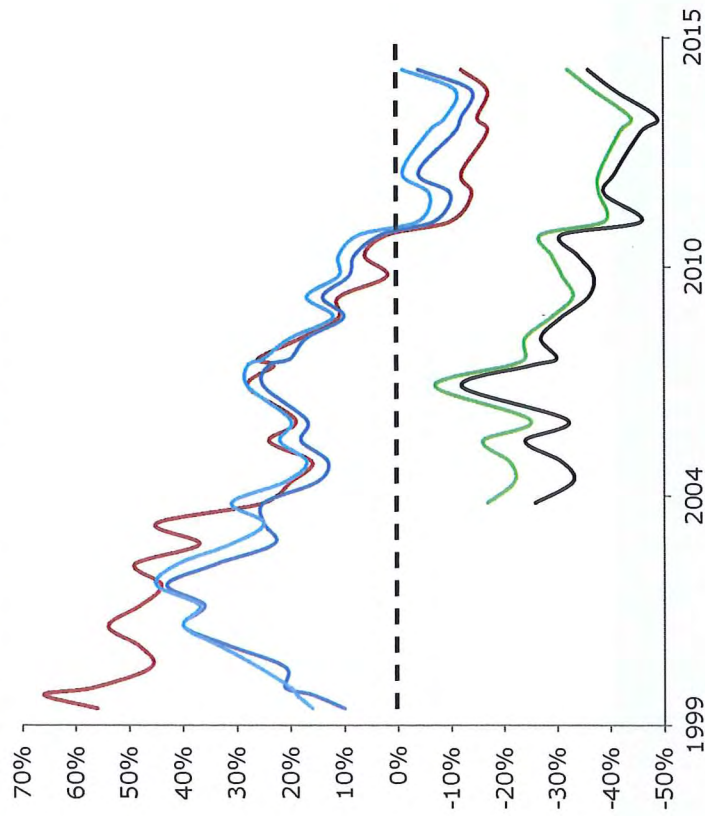
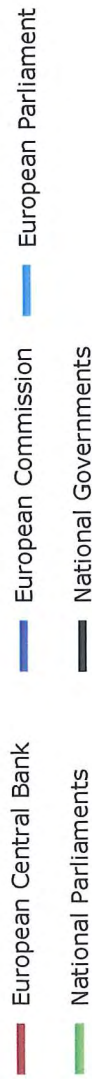
**Unemployment rate  
Change since January 2008, percentage points**



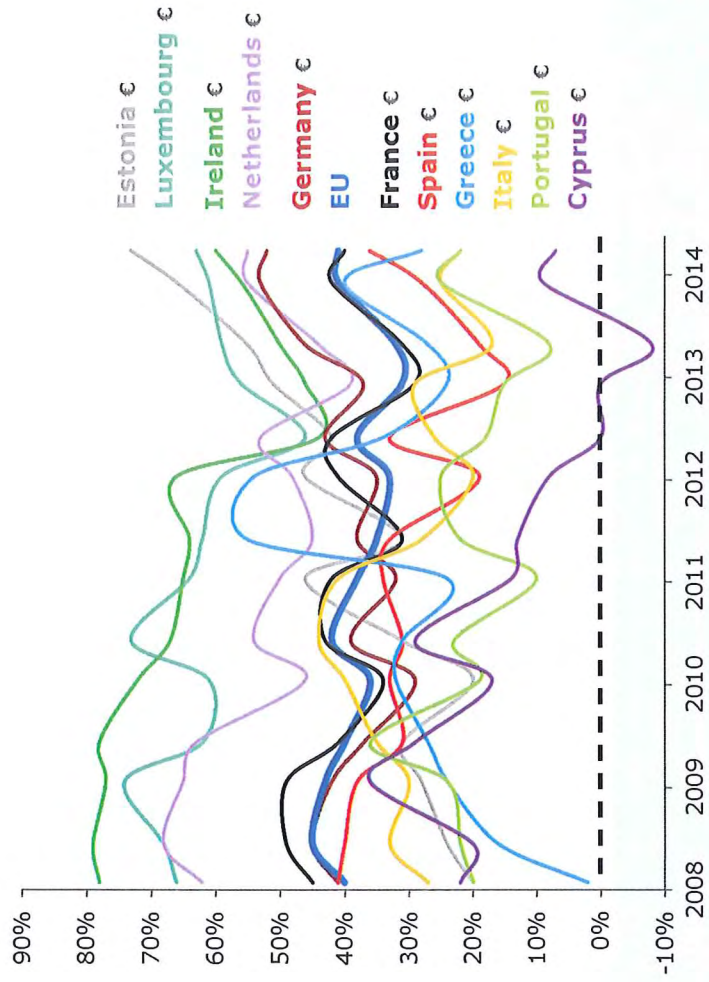
Source: Eurostat, Bureau of Economic Analysis, Bureau of Labor Statistics, US Census

# Rebuilding trust

## Trust in the Institutions



## Support for the euro



Reading: net trust/support is defined as "tend to trust/support" minus "tend not to trust/support" in percentage points





5 DECEMBER 2012

## **TOWARDS A GENUINE ECONOMIC AND MONETARY UNION**

Herman Van Rompuy, President of the European Council

In close collaboration with:

José Manuel Barroso, President of the European Commission

Jean-Claude Juncker, President of the Eurogroup

Mario Draghi, President of the European Central Bank

## TOWARDS A GENUINE ECONOMIC AND MONETARY UNION

At the June 2012 European Council, the President of the European Council was invited *“to develop, in close collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union”*. Building on the Interim Report and the Conclusions of the October 2012 European Council, this Report provides the background to the roadmap presented at the December 2012 European Council. It suggests a timeframe and a stage-based process towards the completion of the Economic and Monetary Union (EMU) covering all the essential building blocks identified in the report *“Towards a genuine Economic and Monetary Union”* presented at the June European Council. It incorporates valuable input provided by the Commission in its communication *“A Blueprint for a deep and genuine EMU – Launching a European Debate”* of 28 November 2012. The European Parliament has also made a valuable contribution. As requested by the European Council, this report explores further mechanisms in the context of an integrated budgetary framework, including an appropriate fiscal capacity for the EMU, as well as the idea of euro area Member States entering into arrangements of a contractual nature with the EU institutions on the reforms they commit to undertake and their implementation.

Under the Treaty, the Union has established an Economic and Monetary Union whose currency is the euro. The views set out in this report focus on the euro area Member States as they face specific challenges by virtue of sharing a currency. The process towards a deeper EMU should be characterised by openness and transparency and be fully compatible with the Single Market in all aspects.

This report lays down the actions required to ensure the stability and integrity of the EMU and calls for a political commitment to implement the proposed roadmap. The urgency to act stems from the magnitude of the internal and external challenges currently faced by the euro area and its individual members.



The euro area needs stronger mechanisms to ensure sound national policies so that Member States can reap the full benefits of the EMU. This is essential to ensure trust in the effectiveness of European and national policies, to fulfil vital public functions, such as stabilisation of economies and banking systems, to protect citizens from the effects of unsound economic and fiscal policies, and to ensure high level of growth and social welfare.

The euro area is confronted with a rapidly evolving international environment characterised by the rise of large emerging economies. A more resilient and integrated EMU would buffer euro area countries against external economic shocks, preserve the European model of social cohesion and maintain Europe's influence at the global level.

Together, these challenges make indispensable a commitment to, and subsequent implementation of, a roadmap towards a genuine EMU. They underscore that 'More Europe' is not an end in itself, but rather a means for serving the citizens of Europe and increasing their prosperity.

The actions deemed necessary to ensure the resilience of the EMU are presented therein as a staged-process. Irrespective of their time horizon, all policy proposals have been conceived and designed as elements of a path towards a genuine Economic and Monetary Union. Given the strong linkages between the building blocks, they should be examined as part of a mutually reinforcing comprehensive package. The creation of an integrated financial framework has important fiscal and economic implications and therefore cannot be envisaged separately. Similarly, the proposals put forward in the fiscal and economic policy sphere are closely intertwined. And, as all the proposals imply deeper integration, democratic legitimacy and accountability are essential to a genuine Economic and Monetary Union.

## **Overview of sequencing**

The process could rest on the following three stages (see also diagram in annex):

### ***Stage 1 (End 2012-2013)***

#### ***Ensuring fiscal sustainability and breaking the link between banks and sovereigns***

The completion of the first stage should ensure sound management of public finances and break the link between banks and sovereigns, which has been one of the root causes of the sovereign debt crisis. This stage would include five essential elements:

- The completion and thorough implementation of a stronger framework for fiscal governance ('Six-Pack'; Treaty on Stability, Coordination and Governance; 'Two-Pack').
- Establishment of a framework for systematic *ex ante* coordination of major economic policy reforms, as envisaged in Article 11 of the Treaty on Stability, Coordination and Governance (TSCG).
- The establishment of an effective Single Supervisory Mechanism (SSM) for the banking sector and the entry into force of the Capital Requirements Regulation and Directive (CRR/CRDIV).
- Agreement on the harmonisation of national resolution and deposit guarantee frameworks, ensuring appropriate funding from the financial industry.
- Setting up of the operational framework for direct bank recapitalisation through the European Stability Mechanism (ESM).

### ***Stage 2 (2013-2014)***

#### ***Completing the integrated financial framework and promoting sound structural policies***

This stage would consist of two essential elements:

- The completion of an integrated financial framework through the setting up of a common resolution authority and an appropriate backstop to ensure that bank resolution decisions are taken swiftly, impartially and in the best interest of all.
- The setting up of a mechanism for stronger coordination, convergence and enforcement of structural policies based on arrangements of a contractual nature between Member States and EU institutions on the policies countries commit to undertake and on their implementation. On a case-by-case basis, they could be supported with temporary, targeted and flexible financial support. As this financial support would be temporary in nature, it should be treated separately from the multiannual financial framework.

### *Stage 3 (post 2014)*

#### *Improving the resilience of EMU through the creation of a shock-absorption function at the central level*

This stage would mark the culmination of the process. Stage 3 would consist in:

- Establishing a well-defined and limited fiscal capacity to improve the absorption of country-specific economic shocks, through an insurance system set up at the central level. This would improve the resilience of the euro area as a whole and would complement the contractual arrangements developed under Stage 2. A built-in incentives-based system would encourage euro area Member States eligible for participation in the shock absorption function to continue to pursue sound fiscal and structural policies in accordance with their contractual obligations. Thereby the two objectives of asymmetric shock absorption and the promotion of sound economic policies would remain intrinsically linked, complementary and mutually reinforcing.
- This stage could also build on an increasing degree of common decision-making on national budgets and an enhanced coordination of economic policies, in particular in the field of taxation and employment, building on the Member States' National Job Plans. More generally, as the EMU evolves towards deeper integration, a number of other important issues will need to be further examined. In this respect, this report and the Commission's "Blueprint" offer a basis for debate.

#### **I. Integrated financial framework**

The current European arrangements for safeguarding financial stability remain based on national responsibilities. This is inconsistent with the highly integrated nature of the EMU and has certainly exacerbated the harmful interplay between the fragilities of sovereigns and the vulnerabilities of the banking sector. The set-up of the Single Supervisory Mechanism (SSM) will be a guarantor of strict and impartial supervisory oversight, thus contributing to breaking the link between sovereigns and banks and diminishing the probability of future systemic banking crisis.

In its October 2012 Conclusions, the European Council invited the legislators to proceed with work on the legislative proposals on the SSM as a matter of priority, with the objective of agreeing on the legislative framework by 1 January 2013. It called for the rapid conclusion of the single rule book, including agreement on the proposals on bank capital requirements by the end of the year. It also called for the rapid adoption of the provisions relating to the harmonisation of national resolution and deposit guarantee frameworks.

The SSM will constitute a first step towards a financial market union. It is imperative that the preparatory work can start in earnest at the beginning of 2013, so that the SSM can be fully operational from 1 January 2014 at the latest. It will be crucial that the ECB is equipped with a strong supervisory toolkit, and that the ECB's ultimate responsibility for banking supervision is coupled with adequate control powers. In this regard, establishing an appropriate framework for macro-prudential policy that takes due account of both national and Europe-wide dimension will be important. The ECB has confirmed that it will establish organisational arrangements guaranteeing a clear separation of its supervisory functions from monetary policy.

Once an effective single supervisory mechanism is established, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly. The legal and operational framework for ESM direct bank recapitalisation should be finalised by end-March 2013. In order to move towards an integrated financial framework, the SSM will need to be complemented by a single resolution mechanism, as well as more harmonised deposit guarantee mechanisms.

#### *Single resolution mechanism*

Since the beginning of the crisis, support to financial institutions has been substantial. It has unduly weighed on public finances and reduced the ability to use fiscal policy to stave off the effects of the recession. A strong and integrated resolution framework would contribute to limiting the cost of bank failures to taxpayers. The current legislative proposal on recovery and resolution will ensure that harmonised tools necessary for orderly bank resolutions are available in all EU Member States, including early interventions, bailing-in and the creation of bridge banks.

In a context where supervision is effectively moved to a single supervisory mechanism, it is however essential that the responsibility of dealing with bank resolution is also moved to the European level. The Commission has already announced its intention to propose a single resolution mechanism once the proposals for a Recovery and Resolution Directive and for a Deposit Guarantee Scheme Directive have been adopted. This single resolution mechanism – built around a single resolution authority – should be established as the ECB assumes its supervisory responsibility in full. This mechanism covering all banks supervised by the SSM should be based on robust governance arrangements, including adequate provisions on independence and accountability, as well as an effective common backstop, which is indispensable to complete an integrated financial framework.

### **The need for a single resolution mechanism**

Establishing a single resolution mechanism is indispensable to complete an integrated financial framework:

- It would ensure a timely and impartial decision-making process, focused on the European dimension. This would mitigate many of the current obstacles to resolution, such as national bias and cross-border cooperation frictions. This would reduce resolution costs, as early and prompt actions contribute to maintaining the economic value of banks that need to be resolved.
- It would make resolution costs as low as possible and break the bank-sovereign nexus. A strong and independent resolution authority, backed by an efficient resolution regime, would have the financial, legal and administrative capability as well as the necessary independence to carry out effective and least-cost resolution. By ensuring that the private sector bears the primary burden of bank resolution costs, the authority would increase market discipline, and minimise the residual costs for the taxpayers of bank failures.
- The single resolution mechanism would complement the SSM by making certain that failing banks are restructured or closed down swiftly. The SSM would provide a timely and unbiased assessment of the need for resolution, while the single resolution authority would ensure actual timely and efficient resolution.

Under the single resolution mechanism, resolution actions should follow a least-cost strategy and could be financed according to a pecking order of bailing-in shareholders and some creditors, and relying on the banking industry. The latter would be organized through a European Resolution Fund, which would be a crucial element of the new resolution regime. It would be funded through *ex ante* risk-based levies on all the banks directly participating in the SSM. The single resolution mechanism should include an appropriate and effective common backstop. This could possibly be organized by means of an ESM credit line to the single resolution authority. This backstop should be fiscally-neutral over the medium-term, by ensuring that public assistance is recouped by means of *ex post* levies on the financial industry.

## *Deposit guarantee mechanisms*

The history of financial crises has illustrated the destabilising effect uncertainty surrounding bank deposits could have on individual financial institutions and on entire banking systems. The proposal on the harmonisation of national deposit guarantee schemes includes provisions to ensure that sufficiently robust national deposit insurance systems are set up in each Member State, thereby limiting the spill-over effects associated with deposit flight between institutions and across countries, and ensuring an appropriate degree of depositor protection in the European Union. A rapid adoption of this proposal is important.

## **II. Integrated budgetary framework**

The crisis has revealed the high level of interdependence and spill-overs between euro area countries. It has demonstrated that national budgetary policies are a matter of vital common interest. This points to the need to move gradually towards an integrated budgetary framework ensuring both sound national budgetary policies and greater resilience to economic shocks of the euro area as a whole. This would contribute to sustainable growth and macroeconomic stability. The October Interim Report stressed the need for stronger economic governance and suggested, as an additional step, the possibility to develop gradually a fiscal capacity for the EMU, which could facilitate adjustment to economic shocks. Following the conclusions of the October European Council, this section explores the options for a euro area fiscal capacity and its guiding principles.

### *Sound national budgetary policies are the EMU's cornerstone*

The near term priority is to complete and implement the new steps for stronger economic governance. In the past few years, significant improvements to the rules-based framework for fiscal policies in the EMU have been enacted ('Six-Pack') or agreed (Treaty on Stability, Coordination and Governance), with greater focus on prevention of budgetary imbalances, on debt developments, on better enforcement mechanisms, and on national ownership of EU rules. The other elements related to strengthening fiscal governance in the euro area ('Two-Pack'), which are still in the legislative process, should be finalised urgently and be implemented thoroughly. This new governance framework will provide for ample *ex ante* coordination of annual budgets of euro area Member States and enhance the surveillance of those experiencing financial difficulties.

## *Towards a fiscal capacity for the EMU*

The history and experience of other currency unions shows that there are various ways of progressing towards a fiscal union and the EMU's unique features would justify a specific approach. Yet, while the degree of centralisation of budgetary instruments and the arrangements for fiscal solidarity against adverse shocks differ, all other currency unions are endowed with a central fiscal capacity. In this respect, the European Council in October 2012 asked to explore further mechanisms, including an appropriate fiscal capacity, for the euro area. It would support new functions which are not covered by the multiannual financial framework from which it is clearly separated.

In stage 2, structural reforms could, in specific cases, be supported through limited, temporary, flexible and targeted financial incentives as Member States enter into arrangements of a contractual nature with EU institutions. These arrangements would be mandatory for euro area Member States and voluntary for the others (see section III below). The Commission intends to make a proposal on specific ways to put in place such contractual arrangements and on the means to support their implementation, building on EU procedures.

The implementation of contractual arrangements and the associated incentives would support a convergence process, leading in stage 3 to the establishment of a fiscal capacity to facilitate adjustment to economic shocks. This could take the form of an insurance-type mechanism between euro area countries to buffer large country-specific economic shocks. Such a function would ensure a form of fiscal solidarity exercised over economic cycles, improving the resilience of the euro area as a whole and reducing the financial and output costs associated with macroeconomic adjustments. By contributing to macroeconomic stability, it would usefully complement the crisis management framework based on the European Stability Mechanism.

Since a well-functioning shock absorption function would require a further degree of convergence between economic structures and policies of the Member States, the two objectives of supporting growth-enhancing structural reforms and cushioning country-specific economic shocks are complementary and mutually reinforcing.

### *Economic rationale for such a fiscal capacity*

In a common currency area, the burden of adjusting to country-specific economic shocks falls on labour and capital mobility, price and cost flexibility, and fiscal policy. In order to protect against negative fiscal externalities, it is important that fiscal risks are shared where economic adjustment mechanisms to country-specific shocks are less than perfect. This is clearly the case in the euro area, where labour mobility is comparatively low, capital flows are susceptible to sudden swings that can undermine financial stability, and structural rigidities can delay or impede price adjustments and the reallocation of resources. In such cases, countries can easily find themselves pushed into bad equilibria with negative implications for the euro area as a whole.

In this context, setting up risk-sharing tools, such as a common but limited shock absorption function, can contribute to cushioning the impact of country-specific shocks and help prevent contagion across the euro area and beyond. However, this needs to be complemented with a mechanism to induce stronger economic convergence, based on structural policies aiming at improving the adjustment capacity of national economies and avoiding the risk of moral hazard inherent to any insurance system. Hence, in addition to fulfilling their intrinsic purpose, successfully implementing reforms specified in a contractual arrangement could also serve as a criterion for participating in the asymmetric shock absorption function established in stage 3. This would provide countries with an additional strong incentive to implement sound economic policies both before and once they join the shock absorption mechanism. In the transition towards establishing this automatic stabilisation function, and depending on their specific circumstances, limited, temporary and flexible financial incentives could be provided to Member States to promote structural reforms. In order to avoid the relapse or emergence of macroeconomic imbalances once countries have gained access to the shock absorption function, the contractual approach to reforms would continue. In addition, net transfers under the shock absorption function could be modulated to reflect ongoing compliance with the commitments undertaken under the contractual arrangements.



### *Options for the shock absorption function of the euro area fiscal capacity*

An EMU fiscal capacity with a limited asymmetric shock absorption function could take the form of an insurance-type system between euro area countries. Contributions from, and disbursements to, national budgets would fluctuate according to each country's position over the economic cycle.

The specific design of such a function could follow two broad approaches. The first would be a macroeconomic approach, where contributions and disbursements would be based on fluctuations in cyclical revenue and expenditure items, or on measures of economic activity. The second could be based on a microeconomic approach, and be more directly linked to a specific public function sensitive to the economic cycle, such as unemployment insurance. In this case, the level of contributions/benefits from/to the fiscal capacity would depend directly on labour market developments. In this scenario, the fiscal capacity would then work as a complement or partial substitute to national unemployment insurance systems. Transfers could, for example, be limited to cyclical unemployment by covering only short term unemployment.

Assessing the individual merits of each approach would require a more in-depth analysis. Importantly, the magnitude of the shock absorption function assigned to the fiscal capacity would depend largely on its size, and the financial implications for national budgets would depend on its precise design and parameters. However, it will be important to ensure that, irrespective of the approach that is followed, establishing this function does not affect the overall level of public expenditure and tax pressure in the euro area. Equally, the exact conditions and thresholds for the activation of transfers would need to be studied carefully, as only country-specific shocks of a sufficient magnitude should be absorbed centrally. For example, in the case of the microeconomic approach, unemployment-related transfers could be activated only once the increase in short-term unemployment exceeds a certain threshold.

## *Financial resources of the fiscal capacity and ability to borrow*

Specific resources would have to be raised to finance both functions – promoting structural reforms and absorbing asymmetric shocks. These resources could take the form of national contributions, own resources, or a combination of both. In a longer term perspective, a key aspect of a future fiscal capacity, which would need to be examined carefully, would be its possible ability to borrow. A euro area fiscal capacity could indeed offer an appropriate basis for common debt issuance without resorting to the mutualisation of sovereign debt. The question of applying a fiscal golden rule, such as the balanced budget rule enshrined in both the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance, to this fiscal capacity should then be explored. Finally, an integrated budgetary framework would require the establishment of a Treasury function with clearly defined responsibilities.

### *Guiding principles for the shock absorption function of an EMU fiscal capacity*

Irrespective of the approach – macro or micro-economic – the design of such a shock absorption function should rest on a number of guiding principles reflecting also the EMU's specific features:

- Elements of fiscal risk-sharing related to the absorption of country-specific shocks should be structured in such a way that they do not lead to unidirectional and permanent transfers between countries, nor should they be conceived as income equalisation tools. Over time, each euro area country, as it moves along its economic cycle, would in turn be a net recipient and a net contributor of the scheme.
- Such a function should neither undermine the incentives for sound fiscal policy making at the national level, nor the incentives to address national structural weaknesses. Appropriate mechanisms to limit moral hazard and foster structural reforms should be built in the shock absorption function. Linking it tightly to compliance with the broad EU governance framework, including possible arrangements of a contractual nature (see section III below), should be envisaged.
- The fiscal capacity should be developed within the framework of the European Union and its institutions. This would guarantee its consistency with the existing rules-based EU fiscal framework and procedures for the coordination of economic policies.
- The fiscal capacity should not be an instrument for crisis management, as the European Stability Mechanism (ESM) has already been established for that purpose. By contrast, the fiscal capacity's role should be to improve the overall economic resilience of the EMU and euro area countries. It would contribute to crisis prevention and make future ESM interventions less likely.
- The design of the fiscal capacity should be consistent with the principle of subsidiarity, and its operations transparent and subject to appropriate democratic control and accountability. Equally, it should be cost-effective and not lead to the undue development of costly administrative procedures or unnecessary centralisation. It should not lead to an increase in expenditure or taxation levels.

### **III. Integrated economic policy framework**

The sovereign debt crisis painfully exposed that the unsustainable economic policies pursued by some euro area countries in the past and the rigidities existing in their economies have negative repercussions for all members of the EMU. An integrated economic policy framework is necessary to guide at all times the policies of Member States towards strong and sustainable economic growth to produce higher levels of growth and employment.

In the near term, it is essential to complete the Single Market as it provides a powerful tool to promote growth. In addition, there is a need for a thorough assessment of the performance of labour and product markets in the euro area. In the absence of exchange rate adjustments, a well functioning EMU requires efficient labour and product markets. This is essential to fight large scale unemployment, and to facilitate price and cost adjustments that are key for competitiveness and growth. Urgent attention should be paid to promoting labour mobility across borders and addressing skills mismatch in the labour market. The Commission could undertake this assessment as a matter of priority. Finally, a framework for systematic ex-ante coordination of major economic policy reforms, as envisaged in Article 11 of the Treaty on Stability, Coordination and Governance (TSCG), should be put in place.

In order to remain a highly attractive social market economy and to preserve the European social models, it is important for the Union to be globally competitive and to avoid excessive divergences in competitiveness among EMU members. The reforms introduced to the EU surveillance framework through the creation of the European Semester with country-specific recommendations and of a new Macroeconomic Imbalances Procedure with possible sanctions are a step in the right direction. But there is a need to go further and to put in place a stronger framework for coordination, convergence and enforcement of structural policies. In this context, the October European Council Conclusions called for further exploration of the idea of arrangements of a contractual nature between Member States and the EU institutions on reforms promoting competitiveness, growth and jobs that countries commit to implement. A staged approach would be used to put in place these arrangements.

### *Arrangements of a contractual nature need to address vulnerabilities at an early stage*

Macroeconomic imbalances tend to build up slowly and are often masked by favourable economic growth and liquidity conditions. But given structural rigidities in labour, product and services markets, and institutional settings, once identified they are often difficult to correct quickly. It is therefore important to address the root causes of imbalances at an early stage, including by ensuring that these essential markets can adjust quickly to shocks and that national frameworks facilitate growth and employment. Contractual arrangements would thus need to focus on microeconomic, sectoral and institutional bottlenecks, and aim at enhancing the competitiveness and growth potential of the economy. The future contractual arrangements should therefore be mandatory for all euro area countries, but voluntary for other Member States.

### *Contractual arrangements need to focus on key weaknesses*

Not all economic inefficiencies represent a burden for the functioning of the EMU. Also, the degree of competitiveness and growth challenge varies across countries. Content and breadth of the reform agreements would reflect this diversity and would adapt to country-specific needs (e.g. efficient labour market to fight youth unemployment; improve judicial systems). However, for these arrangements to take this heterogeneity into account, an intense dialogue between each Member State and the EU institutions, both at technical and political levels, would be essential. This would take the form of an in-depth analysis by both parties, providing the basis for a tailor-made and detailed agreement on some specific reforms. Depending on the type of measures necessary, the length of these agreements would vary for each country, but would likely be of a multiannual nature. In order to maintain the focus on key weaknesses, such arrangements would need to allow for some flexibility to deal with major shocks and changing economic circumstances and priorities. Depending on the specific situation of each country, in stage 2, this could be supported by targeted, limited and flexible financial support under the fiscal capacity.

### *Contractual arrangements need to be integrated into existing EU processes*

The crisis has led to a strengthening of the EU economic governance framework. Every year, integrated country-specific recommendations by the Council, based on a proposal by the Commission, are addressed to all Member States. In addition, a Macroeconomic Imbalances Procedure (MIP) has been put in place to detect and correct imbalances at an early stage. To avoid inconsistencies and duplication, contractual arrangements should be included in the European Semester. They should be consistent with and support the overall policy mix resulting from the Annual Growth Survey and should be based on the country-specific recommendations. In accordance with the objective of early detection, the in-depth reviews would be generalised to all EMU countries. In-depth reviews would need to be based on a very thorough and on-the-ground dialogue and on analysis of Member States' economies. Based on the conclusions of the in-depth review, the Commission's country-specific recommendations would be the basis for a dialogue with each country on the specific and detailed measures contained in the reform arrangements, including a timeframe for implementation. For Member States under the corrective arm of the MIP, the agreement would be the corrective action plan, and as foreseen in the current regulation non-compliance would lead to sanctions.

### *Contractual arrangements need to benefit from full domestic and European ownership and accountability*

National ownership is pivotal to implementation of structural reforms. A national debate on the priority measures and approval of reform agreements by national parliaments are essential to ensure national ownership. The Commission should be able to inform the European and national parliaments of the necessity of these measures from an EMU perspective. Both contractual parties would be responsible for content and implementation of their part of the convergence and competitiveness agreement, and for reporting to their respective parliaments (national and European) on progress achieved. Full accountability of both parties can only be ensured if the agreed reform agenda is specific, detailed and measurable. This requires *ex ante* agreement on concrete timelines, on the specific modalities for monitoring and on access to information. The agreements and compliance reports would be published on a regular and timely basis. Significant economic changes or altering political circumstances, such as the election of a new government, could lead to a renegotiation of the precise measures and steps to reach the reform objectives.

### *Key elements of arrangements of a contractual nature on structural reforms*

In summary, such arrangements embedded in the EU governance framework could rest on the following principles:

- They would be embedded in the European Semester, be consistent with and support the overall euro area policy mix; they would be mandatory for euro area Member States but voluntary for the others, on the basis of thorough, on-the-ground reviews of the main bottlenecks to growth and employment. These reviews would be conducted by the Commission.
- They would cover a multiannual, specific and monitorable reform agenda jointly agreed with the EU institutions and focussed on competitiveness and growth that are crucial for the smooth functioning of the EMU.
- Member States and the Commission would be accountable, respectively, to national parliaments and the European Parliament on the content and implementation of their duties under the agreements.
- Structural reforms would be supported through financial incentives and would result in temporary transfers to Member States with excessive structural weaknesses. This targeted support should be financed through specific resources.
- Compliance with the agreements can be ensured by an incentive-based framework. Compliance could be one of the criteria for participating in the shock absorption function of the fiscal capacity. In addition, national contributions to the fiscal capacity could be increased in case of non-compliance.

## **V. Democratic Legitimacy and Accountability**

In its October Conclusions the European Council stressed the need for strong mechanisms for democratic legitimacy and accountability. One of the guiding principles is that democratic control and accountability should occur at the level at which the decisions are taken. The implementation of this guiding principle is key to ensuring the effectiveness of the integrated financial, budgetary and economic policy frameworks. This implies the involvement of the European Parliament as regards accountability for decisions taken at the European level, while maintaining the pivotal role of national parliaments, as appropriate.

Decisions on national budgets are at the heart of Member States' parliamentary democracies. At the same time, the provisions for democratic legitimacy and accountability should ensure that the common interest of the union is duly taken into account; yet national parliaments are not in the best position to take it into account fully. This implies that further integration of policy making and a greater pooling of competences at the European level should first and foremost be accompanied with a commensurate involvement of the European Parliament in the integrated frameworks for a genuine EMU.

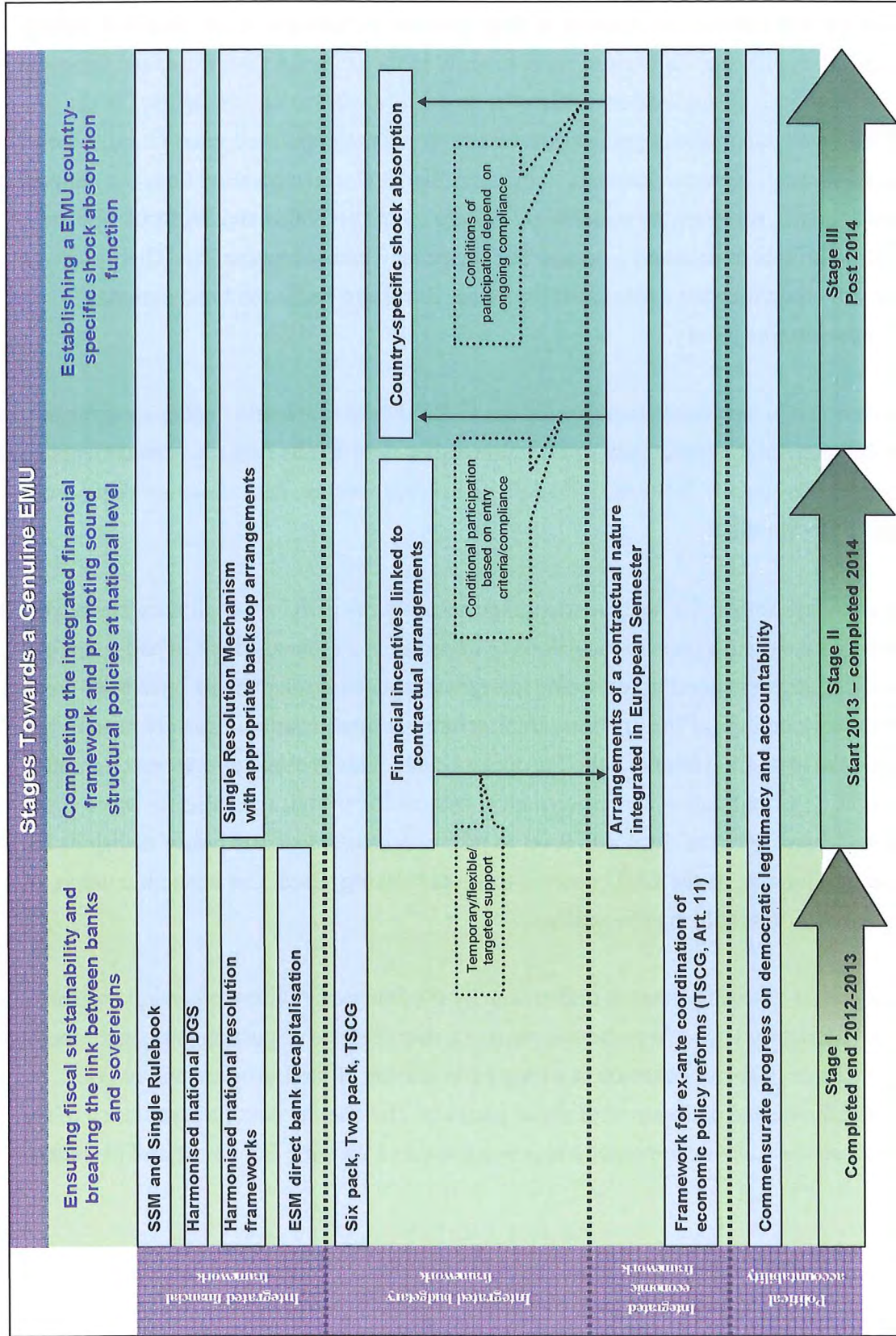
First, in an integrated financial framework: while accountability of both the European Central Bank as single supervisor and of a future single resolution authority should take place at the European level, this should be complemented by strong mechanisms for information, reporting and transparency to national parliaments of the participating Member States.

Second, in the context of integrated budgetary and economic policy frameworks: Member States should ensure the appropriate involvement of their national parliaments in the proposed reform arrangements of a contractual nature and more broadly in the context of the European Semester. In this spirit, the European Council asked in October to explore ways to ensure debates in the European Parliament and national parliaments on the recommendations adopted in the context of the European Semester. New mechanisms to increase the level of cooperation between national and European parliaments, for example building on Article 13 of the TSCG and Protocol 1 of the Treaty, could contribute to enhancing democratic legitimacy and accountability. Their precise organisation and modalities are a responsibility of the European Parliament and national parliaments to determine jointly.

Third, the creation of a new fiscal capacity for the EMU should also lead to adequate arrangements ensuring its full democratic legitimacy and accountability. The details of such arrangements would largely depend on its specific features, including its funding sources, its decision-making processes and the scope of its activities.

Finally, the crisis has shown the need to strengthen not only the EMU's surveillance framework but also its ability to take rapid executive decisions to improve crisis management in bad times and economic policymaking in good times. Some intergovernmental arrangements have been created as a result of the shortcomings of the previous architecture but these would ultimately need to be integrated into the legal framework of the European Union. This is already foreseen under the Treaty on Stability, Coordination and Governance, and could be envisaged also for other cases. Reinforcing the capacity of the European level to take executive economic policy decisions for the EMU is essential. Finally, as the EMU evolves towards banking, fiscal and economic union, its external representation should also be unified.

Ultimately, these far-reaching changes undertaken by the European Union in general and the Economic and Monetary Union in particular require a shared sense of purpose amongst Member States, a high degree of social cohesion, a strong participation of the European and national parliaments and a renewed dialogue with social partners. The openness and transparency of the process as well as the outcome are crucial to move towards a genuine Economic and Monetary Union.









## ACADEMIC PAPERS



# *Working paper*

2015-11

## **BACK TO FISCAL CONSOLIDATION IN EUROPE AND ITS DUAL TRADEOFF: NOW OR LATER, THROUGH SPENDING CUTS OR TAX HIKES\***

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# **Back to fiscal consolidation in Europe and its dual tradeoff: now or later, through spending cuts or tax hikes\***

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## **Abstract**

The European consolidation process has raised a few questions. The most frequent one has been how large are the costs of consolidation and has the Eurozone fiscal stance improved or achieved debt sustainability? Second, do these costs and sustainability depend on the composition (tax vs. spending) of the consolidation process? Third, do risk premia matter? Fourth, which of the two following strategies, backloading vs. frontloading, is superior to the other? The aim of the paper is to shed light on these questions using a multi-country reduced-form model. It considers explicitly that the Eurozone member states are facing a dual trade-off, first between labor market outcomes of consolidation and public debt dynamics and, second, between reducing public expenditures and increasing taxes. The main conclusion is that a tax-based backloaded consolidation is superior to all other strategies, be they spending-based or frontloaded, or both. Introducing risk premia endogenously does not alter the conclusion.

**Keywords:** fiscal consolidation, fiscal multiplier, composition effect, public debt, frontloading, backloading.

**JEL Codes:** E61, E62, E47.

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## 1. Introduction

After a short period of expansionary fiscal policy in 2008-2009, most Euro area countries reversed the fiscal stance and entered into a period of fiscal consolidation. Austerity was notably required to comply with the 3%-of-GDP rule, enshrined in the Stability and Growth Pact and reinforced after the adoption of the Treaty on stability, coordination and governance. Besides, the outbreak of the Greek crisis in late 2009 created fears of a possible sovereign default and contagion among Eurozone member states, leading to a panic-driven austerity as described by De Grauwe and Ji (2013).

It has been obvious that substantial domestic austerity measures coupled with a synchronised wave of fiscal consolidation in the Eurozone since 2011 have had a strong negative impact on growth that paved the way for a double-dip recession. The fact that fiscal consolidation has been implemented though the output gap had not yet recovered from the recession has made the former more costly and even self-defeating, like in Greece. A new consensus had indeed emerged about the size of fiscal multipliers since the Great Recession and they are now supposed to be time-varying and higher in time of crisis. The consolidation process has thus raised a few questions. The most frequent one has been how large are the costs of consolidation and has the Eurozone fiscal stance improved or achieved debt sustainability? Second, do these costs and sustainability depend on the composition (tax vs. spending) of the consolidation process? Third, do risk premia matter? Fourth, taking into account risk premia, which strategy among the following two, backloading vs. frontloading, can achieve the sharpest reduction in European public debts at the lowest real cost? The aim of the present paper is precisely to deal with these issues. It considers explicitly that the Eurozone member states have been facing a dual trade-off, first between labour market outcomes of consolidation and public debt dynamics and, second, between reducing public expenditures and increasing taxes.

According to the first trade-off, the frontloading strategy has relied on the argument that the gains from consolidation in terms of lower debt and interest rates have outweighed the costs in terms of lower activity and higher unemployment. Nevertheless, the size of the impact of fiscal consolidation on long-term interest rates remains disputable. This point is investigated in this paper.

According to the second trade-off, the fiscal multiplier effect is often shown stronger after a spending cut than after a tax hike. Nevertheless, in the consolidation context, political economy arguments can help to explain why spending cuts are more frequent than tax hikes. Moreover, public expenditures like investment are less visible to the public in the short run than some others and can be cut without short-run social costs<sup>1</sup>. The impact of the composition effect will be investigated in this paper, on a country basis. Once all Eurozone countries are included, and their composition effect characterized, it is possible to

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<sup>1</sup> See e.g. Balassone and Franco (2000).

compare the output outcomes of consolidation plans with different compositions of the fiscal effort. Thus the cost of spending-driven consolidation is assessed.

To investigate this dual trade-off, we extend the simple reduced-form model of 11 Eurozone countries (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain) developed in Blot et al. (2014a). The model is sufficiently detailed to explicitly link all macro elements of debt sustainability and output dynamics, the composition effects and the external trade linkages. The model also includes time-varying fiscal multipliers in a dynamic macroeconomic model and assesses their consequence in terms of public debt sustainability and real costs of consolidation. It is important to acknowledge that debates continue about the value of multipliers, the evaluation of recent output gaps, and hysteresis effects. For these reasons, the choice of a reduced-form model makes it possible, after some changes in the parameters, to conduct a large array of a sensitivity tests. Finally, the model also addresses the question of the optimal fiscal stance, defined as the fiscal consolidation producing the smallest real costs and achieving meanwhile public finance sustainability. The international dimension of the model also makes it possible to account for the interdependencies between Eurozone member states.

## **2. A brief and selective literature review**

We mobilise two types of literature: the frontloading vs. backloading and the composition effect. The former depends extensively on the multiplier effect. In a chapter of the World Economic Outlook (2010), the IMF had concluded early that the costs of fiscal consolidation would be important, though not substantial. A fiscal multiplier around 0.5 was found at this time. In 2012 however, in the new issue of the Outlook, the tone was radically different. Assertions were made that fiscal multipliers had been formerly underestimated and were in a range of [0.9;1.7]. Blanchard and Leigh (2013), in a sequel of their box in WEO 2012, acknowledged that during downturns, fiscal multipliers were certainly above unity. While the former value of the fiscal multiplier urged a frontloading strategy, the latest one rather urged a backloading one. As a matter of fact, the growing body of evidence on the time-varying properties of the fiscal multiplier along the business cycle highlighted the importance in the timing of fiscal consolidation: a frontloading strategy when the output gap was widely and negatively open would become a "self-defeating strategy" (Holland and Portes, 2012). Not only would there be large real incurred costs but the debt to GDP ratio would not fall and debt sustainability would recede.

We have reviewed elsewhere the body of evidence on time-varying fiscal multipliers (Blot et al., 2014b). The list of factors which make the fiscal multiplier non-linear includes the zero-lower bound (e.g. Eggertsson, 2010), financial stress for households and firms (e.g. Corsetti et al., 2012), unemployment and the business cycle (e.g. Auerbach and Gorodnichenko, 2012), and public debt thresholds (Corsetti et al., 2013). A general



conclusion of this literature is that the fiscal multiplier is higher in times of crisis than in good times (see the recent meta-analysis by Gechert and Rannenberg, 2014).

As regards the composition effect, the seminal contribution of Alesina and Perotti (1995) concluded that spending-based consolidation had smaller adverse effects than tax-based consolidation. Stated differently, the spending multiplier appeared smaller than the tax multiplier. While Erceg and Lindé (2012) achieve a similar result in a two-country Dynamic Stochastic General Equilibrium (DSGE) model with independent monetary policy, they obtain the contrary once they introduce either a monetary union or a zero-lower-bound on monetary policy. Their argument is that spending cuts require sharp falls in interest and exchange rates to crowd-in private demand. In a monetary union and under the ZLB, both channels disappear and a spending-based consolidation is costlier than a tax-based one. This is consistent with the empirical findings of, e.g. Batini et al. (2012) who conclude that spending multipliers are significantly larger than tax multipliers during downturns. According to Gechert and Rannenberg (2014, baseline estimation, figure 2), the tax multiplier is only weakly different between downturns and upturns, whereas the spending multiplier can be multiplied by 3; during downturns, the spending multiplier can therefore be on average 5 times higher than the tax multiplier. In't Veld (2013), with consideration of spillover effects of fiscal consolidation in the Eurozone, and Coenen et al. (2012), without consideration for the time-varying property of fiscal multipliers, also showed that spending multipliers were higher than tax multipliers.

### 3. Presentation of the model

We extend the model developed in Blot et al. (2014a) to account for a composition effect of the fiscal stance. The model is a simple macroeconomic framework combining structural and reduced-form non-linear equations. It is able to embrace alternative insights of the literature, including time-varying fiscal multipliers and hysteresis effects. It remains tractable for a large set of Eurozone countries and calibrations are consistent with actual data. Thanks to tractability, we can model supply and demand complex mechanisms which are possibly heterogeneous across countries. The model is also able to make a large set of sensitivity analyses which give rise to different scenarios.

In contrast with DSGE models, this reduced-form model does not derive from optimal behaviours. It remains that, despite optimization, DSGE models are not devoid of strong assumptions, be it e.g. on the properties of households (which part of them is liquidity constrained? which part is not? The answer to these questions is important because it has implications on the effectiveness of fiscal policy)<sup>2</sup> or on expectations, which are often forward-looking though a mix of backward-looking and forward-looking expectations

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<sup>2</sup> See for example Wieland et al. (2012) for a comparison of fiscal policy effects on output gap for a large set of DSGE models.

might be preferred, or alternative approaches to expectations like those discussed by Woodford (2013). Moreover, these models generally do not allow to model nonlinearities such as variable fiscal multipliers over the business cycle, because they are linearized around a single point<sup>3</sup>, or to model hysteresis effects which mean that the steady-state (potential) output changes over time.

The key features of the model are that it allows for an explicit representation of the main countries of the Eurozone: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain. An aggregated Eurozone is also computed in order to deal with global analysis and monetary policy. On the demand side, an open economy aggregate demand function is modelled which depends on fiscal and monetary policies, external demand (a channel for intra EU interdependencies) as well as exogenous shocks on the output gap. Hysteresis effects are introduced but they only affect the level of output in the long run whereas the growth rate of the potential output reverts to baseline path. External demand is represented using a bilateral trade matrix taking into account interdependencies between Eurozone countries. Prices are given by a Phillips curve relating current inflation to expected inflation, economic activity, imported inflation and exogenous shocks. Expectations are supposed to be backward-looking<sup>4</sup>. A non-linear Taylor rule is used to set the stance of monetary policy. Fiscal balance is the sum of interest payments, cyclically-adjusted balance and cyclical components. This simple definition helps to properly assess the fiscal stance, *i.e.* the part of fiscal policy which is under the direct control (or discretion) of current governments. We disentangle between fiscal impulses based on expenditures and taxes. The focus is also put on the time-varying dimension of the fiscal multiplier. The model allows to compute public debt projections for Eurozone countries, taking into account the impact of the market interest rate (government-bond yield), and to assess debt sustainability. A risk-premium on long-term public interest rates is also introduced. It depends on public debt and the structural primary balance.

### 3.1. A simple model for open economies

To sum up, the model may boil down to 4 main equations describing demand<sup>5</sup>, potential output, inflation and long-term interest as a weighted sum of future short-term interest rates. The output gap ( $y$ ) (defined as the difference between current output ( $\check{y}$ ) and potential output ( $y^*$ )) is given by the following equation:

$$(1) \quad y = EFG + EFT + \delta_l \cdot (R - \bar{R}) + \beta_l \cdot ad$$

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<sup>3</sup> Recent exceptions are papers by in't Veld (2013) drawing on a structural multi-country model and Bi et al. (2013) drawing on a small, open economy, DSGE model.

<sup>4</sup> More precisely, expected inflation depends on the gap between past inflation and the inflation target.

<sup>5</sup> More details on the equations of the model are described in Blot et al. (2014a), as major changes stem from the introduction of a composition effect of the fiscal multiplier.

It is driven by the usual variables, like real interest rates, external demand and fiscal policy, which is captured here by  $EFI^G$  and  $EFI^T$ , the effective fiscal impulses, cumulating past and current *ex ante* fiscal impulses on public expenditures and taxes.<sup>6</sup>  $R$  is the long term real interest rate and  $\bar{R}$  is the long run equilibrium value of interest rate. The term  $\delta_t \cdot (R - \bar{R})$  captures the effect of monetary policy on aggregate demand *via* its impact on financial markets and expectations of future inflation. The term  $(\beta_t \cdot ad)$  stands for the impact of external demand by trade partners. The dynamics of the current level of output is represented by an error correction equation. Yet, with a large negative output gap, the error correction model implies growth rates which can be very large and unrealistic. Therefore, a 2.5%<sup>7</sup> *ad-hoc* restriction is introduced in the dynamics of current output.

The dynamics of the potential output is described by the following equation:

$$(2) y_t^* = y_{t-1}^* + H \cdot y_t + \varepsilon_t^s$$

where  $H$  is an hysteresis parameter and  $\varepsilon_t^s$  is an exogenous shock on aggregate supply. GDP prices are set according to a New Keynesian hybrid Phillips curve. Inflation depends on past inflation, expected inflation, output gap, and imported inflation and we rely on estimates by Fuhrer and Moore (1995), Rudd and Whelan (2006), and Paloviita (2008) for calibration:

$$(3) \pi_t = \eta_1 \cdot \pi_{t-1} + (1 - \eta_1) \cdot \pi_{t+1}^e + \eta_2 \cdot y_t + \eta_3 \cdot \sum_j w_{m,j,c} (\Delta \pi_t^c) + \varepsilon_t^\pi$$

Actually, a distinction is made between short-term (or one-period ahead forecast) entering the Phillips curve equation (3) and long-term forecasts, which is used for the long term real interest rate. For one-period ahead forecasts ( $\pi_t^e$ ), we rely on backward-looking expectations, and we assume that inflation is expected to converge to the ECB target at a given speed. For financial markets, long-run expected inflation is modelled as the discounted sum of forward-looking inflation rates, in a similar fashion as nominal long-term rates, in order to keep expectations consistent at this (more than one-year ahead) horizon.

Monetary policy is described through a non-linear Taylor rule where, under non-ZLB circumstances, the short term interest rate moves with the gap between Eurozone inflation  $\pi_t^{EA}$  and the ECB target  $\pi^*$  on the one hand, and with the Eurozone output gap  $y_t^{EA}$  on the other hand. The ZLB is fixed at 0 %. According to the expectations theory, the long term interest rate for German public bonds is set equal to the expected sum of future short term interest rates for which expectations are supposed to be rational (following Shiller, 1979).

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<sup>6</sup> It is an *ex ante* multiplier in the sense that it does not take into account monetary policy effects and spillover effects from external trade on GDP.

<sup>7</sup> It does not imply that growth rate is strictly bounded at 2.5% during a recovery since short-term dynamics resulting from monetary and fiscal policy or external demand can also drive growth.

$$(4) i_t^{Taylor} = r^* + \pi_t^{EA} + \Psi_1 \cdot (\pi_t^{EA} - \pi^*) + \Psi_2 \cdot y_t^{EA}$$

The long-term public may include a risk premium  $\varepsilon_t^{pub}$  zero in the baseline scenario where we consider that long term interest rates all converge as observed in the pre-crisis period. A sensitivity analysis accounts for an endogenous linear risk premium, increasing with public debt. The assumption that the risk premium is sensitive to public debt rather than deficits is consistent with results reported by Beirne and Fratzscher (2013) after 2008. The risk premium is zero when public debt is below 60% and when the country reaches a structural primary balance which stabilizes debt.

$$(5) \varepsilon_t^{pub} = \kappa B_t \text{ if } B_{t-1} > 60\% \text{ and if } SPS_t < \overline{SPS}_t$$

where  $\overline{SPS}_t$  is the primary structural balance stabilizing public debt. It must be noticed that for countries that entered the EFSF, the long term interest rate is supposed to be exogenous. The real long term interest rate, entering equation (1) is equal to the nominal long term rate minus long run expected inflation.

Finally, imports of each country increase with the output gap (eq.(6)). Then, as imports in each country are exports for other countries, we define external demand to country  $c$  as the weighted sum of imports of the other EMU countries (eq.(7)). As the model considers only Eurozone countries, the external demand only accounts for intra-Eurozone trade.

$$(6) m_t = \Omega \cdot y_t$$

$$(7) ad_t = \sum_j w_{m,j,c} m_t$$

Calibration of the model is described in the appendix.

### 3.2. Public finances and fiscal policy

The fiscal block of the model includes public debt dynamics and hinges extensively on the structural primary balance. The latter evolves according to the differentiated impulses on public spending ( $FI^G$ ) and taxes ( $FI^T$ ) but also according to changes in taxes which are due to variations in the gap between potential production and the baseline. As a matter of fact, a permanent downward shift in potential output relative to the baseline entails a permanent fall in taxes, then a permanent fall in the structural primary balance. The cyclical balance depends on the overall sensitivity of revenues and expenditures to the business cycle. The average interest rate on debt evolves according to the long term nominal interest rate on newly issued public bonds.

The impact of fiscal policy depends on the state of the economy as emphasized by the growing literature surveyed by Parker (2011). Hence, we build a time-varying fiscal

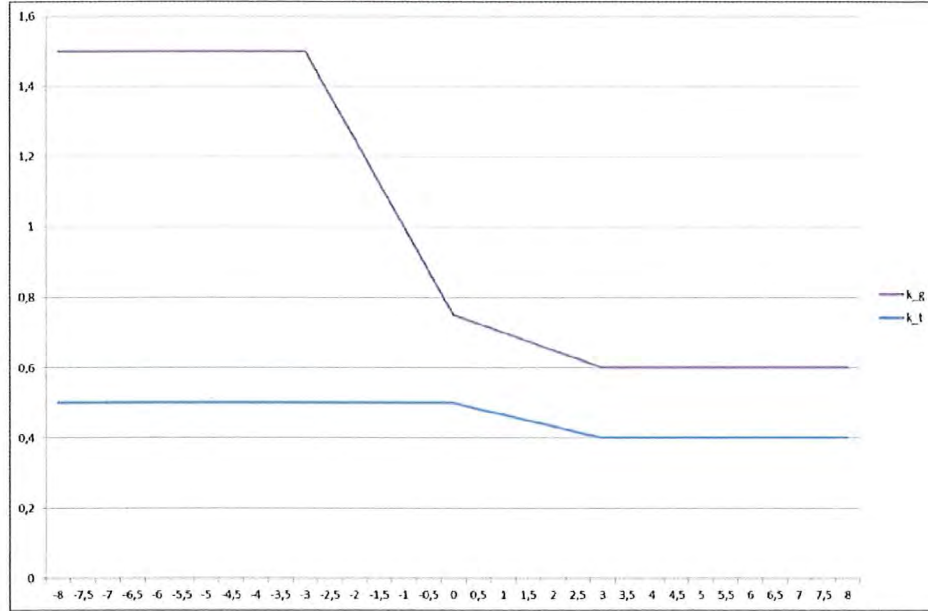
multipliers  $\mu_t$  which depends on the output gap and on the composition of the adjustment. Tax-based and spending-based multipliers can be described by the illustrative figure 2. We consider the same shape for the two fiscal multipliers. Yet  $\mu_{max}^T$  (respectively  $\mu_{min}^T$  and  $\mu_0^T$ ) may differ from  $\mu_{max}^G$  (respectively  $\mu_{min}^G$  and  $\mu_0^G$ ). The calibrated values for the fiscal multipliers are based on the meta-regression analysis provided by Gechert and Rannenberg (2014) where they show that the spending-based multiplier is very sensitive to the state of the economy whereas the tax-based multiplier is flatter.

The values of fiscal (tax and spending) multipliers are maximal in very bad times, whereas they are minimal in very good times. Such a representation of the fiscal multiplier does not directly account for all the possibilities highlighted in the empirical literature. Yet, as monetary policy is endogenous and constrained by the zero lower bound, the effect of fiscal policy becomes stronger when the output gap is negative and monetary policy constrained by the ZLB since there is no increase in the interest rate that can mitigate the impact of fiscal policy. Since the banking sector is not represented in the model, the state of the financial system has no incidence on the fiscal multiplier<sup>8</sup>. Nevertheless, we may suppose that a situation of distressed banking system would be accompanied by a negative output gap, a feature which is explicitly introduced in the model via the time-varying nature of the fiscal multiplier. Besides, fiscal multipliers are higher when the unemployment rate is high as liquidity constraints become more stringent for firms and households. In such a case, the Ricardian hypothesis does not hold. Finally, there is one situation that seems to be more controversial if public debt is high or increases quickly: Corsetti et al. (2013) argue that the fiscal multiplier would be low. The analyses will yet also include a situation where a risk premium in the interest rate increases with public debt. Though it may not strictly correspond to the effect illustrated by Corsetti et al. (2013), it will mitigate our conclusion on the cost of consolidation when public debt is high.

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<sup>8</sup> We thank Pablo Hernandez de Cos for raising this issue.

Figure 2. Example of the value of the multiplier for public spending and taxes according to the output gap



Note:  $\mu_{max}^G = 1.5$ ,  $\mu_{min}^G = 0.6$ ,  $\mu_0^G = 0.75$ ,  $\mu_{max}^T = 0.5$ ,  $\mu_{min}^T = 0.4$ ,  $\mu_0^T = 0.5$ .  $y_{inf} = -3\%$ , and  $y_{sup} = 3\%$ . Values are supposed to be identical across countries.

Source: OFCE.

Beyond fiscal impulses which represent discretionary decisions (in % of GDP) on government spending and taxes, we compute effective fiscal impulses (EFI, based on public spending and taxes), as the *ex ante* cumulative real effect of current and past fiscal impulses at time  $t$ . Thus, with  $\psi_k \cdot \mu_{t-k}^j$  (for  $j = G, T$ ) the fiscal multiplier at time  $t$  of a fiscal impulse that occurred  $k$  years ago, one has:

$$(8) \Delta EFI_t^j = \psi_0 \cdot \mu_t^j \cdot FI_t^j + \psi_1 \cdot \mu_{t-1}^j \cdot FI_{t-1}^j + \psi_2 \cdot \mu_{t-2}^j \cdot FI_{t-2}^j + \psi_3 \cdot \mu_{t-3}^j \cdot FI_{t-3}^j + \psi_4 \cdot \mu_{t-4}^j \cdot FI_{t-4}^j + \psi_5 \cdot \mu_{t-5}^j \cdot FI_{t-5}^j + \psi_6 \cdot \mu_{t-6}^j \cdot FI_{t-6}^j + \psi_7 \cdot \mu_{t-7}^j \cdot FI_{t-7}^j$$

$$(9) \Sigma FI_t^j = \Sigma FI_{t-1}^j + \mu_t^j \cdot FI_t^j$$

Equation (8) ensures that the impact of a fiscal impulse depends on the fiscal multiplier that prevailed when the fiscal impulse occurred. Seven lags are retained to account for the possibility of long lasting effects of fiscal impulses. The total impact of a sequence of fiscal impulses is then computed using the accumulation of fiscal impulses times the multiplier (eq.(9)).

## 4. Public Debt and output gap dynamics under alternative compositions of fiscal adjustment

We aim to provide simulations on the paths of public debt and output gap of Eurozone member states according to the path of consolidation and the composition of the adjustment under different scenarios.

The baseline scenario incorporates time-varying fiscal multipliers and hysteresis effects, but does not introduce the risk premium effect on long-term interest rates. First, we take into account the *observed* amount of fiscal consolidation from 2011, which is the starting year for all simulations, and derive the public debt dynamics until 2034. We investigate whether, under *observed* fiscal stances, Eurozone countries may achieve the 60% debt-to-GDP target.

Then, we analyze different paths of consolidation with three alternative instruments: purely expenditure-based adjustment, purely tax-based adjustment and a mixed-adjustment. Finally, in a third step, we introduce an endogenous risk premium.

### 4.1. Public debt in 2034 under the current adjustment

In the baseline scenario, we simulate the path of public debt-to-GDP ratios until 2034, which is the horizon of the 1/20<sup>th</sup> debt rule incorporated in the revised SGP and in the Fiscal Compact. The simulated path of public debt depends on the fiscal impulses which have been forecasted in the Eurozone from 2011 to 2016<sup>9</sup>. We then assume zero fiscal impulses beyond 2016. Under this scenario, the fiscal multiplier is supposed to be time-varying as described in figure 2. Hysteresis effects are also introduced in the model so that a negative (respectively positive) demand shock will have negative (respectively positive) long-term effects on GDP. We suppose that sovereign spreads will vanish after 2015. Results are reported in Table 1 and hypotheses regarding the set of initial conditions are described in box 1.

Columns (1)-(4) report public debt and structural balance respectively in 2020 and 2034 (20-year horizon). 2020 is the year for which the output gap has returned to zero for almost all countries. The cumulative fiscal impulse for 2011-2016, is reported in column (5) and sums up the short-term fiscal stance for all Eurozone countries. Growth performances (GDP growth rates) are reported in columns (6) and (7). For GDP growth, we report the average growth rate over the period for which we have information on realized fiscal stance (2011-2014). Beyond 2020, GDP growth converges to the long-term growth rate.

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<sup>9</sup> For 2015 and 2016, we consider planned fiscal impulses.

Table 1. Public finance and output performances under the baseline scenario

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse	GDP growth rate (%)		Sovereign yield (%)
	(1)	(2)	(3)	(4)		(5)	(6)	
	2020	2034	2020	2034	2011-2016'	2011-2014	2015-2034	2012-2018
Germany	51	6	1,9	3,0	-1.8	1,5	1,1	1,9
France	93	99	-3,1	-3,9	-2.5	0,8	1,6	2,3
Italy	112	57	1,1	2,9	-2.1	-0,8	0,5	3,4
Spain	92	71	-1,4	-1,0	-5.7	-0,4	1,7	3,3
Netherlands	71	66	-1,6	-1,8	-2.3	0,0	1,5	2,1
Belgium	86	52	-0,3	0,5	-1.1	0,8	1,7	2,4
Portugal	115	83	-1,0	-0,2	-7.4	-1,4	1,4	3,2
Ireland	82	8	2,4	4,6	-6.3	1,5	2,2	2,8
Greece	148	58	1,7	4,9	-11.1	-4,8	1,7	3,4
Finland	65	74	-2,3	-3,3	-1.8	0,1	1,9	2,1
Austria	69	56	-1,1	-1,0	0.3	1,3	1,5	2,2
Eurozone	82	54	-0,3	0,2	-2.8	0,4	1,3	2,6

Source: iAGS model

': Fiscal impulses are null beyond 2016.

Given initial conditions and realized and expected fiscal impulses, table 1 shows that public debt would significantly decrease between 2020 and 2034 for all countries but France and Finland. Moreover, Germany, Italy, Belgium, Ireland, Greece and Austria would meet the 60% target by 2034.

In 2020, despite substantial fiscal efforts, France, Spain, the Netherlands, Portugal, Finland and Austria would not be able to bring their cyclically-adjusted deficit under the Fiscal Compact limit of 0.5% of GDP. Among these countries, France, Spain, the Netherlands, Portugal and Finland would not comply with the fiscal rule on public debt and would stand above the 60 % threshold in 2034 despite their fiscal efforts to bring back debt to this ratio.

Finally, the baseline scenario questions the issue of public debt sustainability in the Eurozone. Sustainability is assessed regarding the ability of countries to meet the objective of bringing back the debt ratio to 60 % of GDP by 2034, consistently with the recent fiscal framework which fixes a 20-year horizon for assessing debt evolution. Sustainability refers to the ability of the general government to pay back its domestic debt. Its ability depends on the future available scope for spending cuts and tax hikes, but also on future economic growth. Though some countries in our baseline simulations do not reach this 60% threshold, it is noticeable that they achieve substantial reductions in public debt-to-GDP



ratios. This downward trend in public debt implies enhanced debt sustainability *stricto sensu*. However the social costs as well as the cost in terms of fiscal balance could make this adjustment unrealistic (see Buiters and Rahbari, 2014). For Greece, Italy and Ireland, it would require structural primary surpluses close or above 3% of GDP for many years. This obviously questions the ability of these countries to maintain such a high primary surplus, a situation which has rarely been observed in the history of fiscal consolidations.

For countries, where public debt would fall significantly below 60 %, it raises the opportunity to pursue a fiscal stimulus as existing fiscal rules state that public debt must remain below 60 %, hence leaving some possible leeway to expand in the future. One may consider that the baseline scenario is economically, politically and socially costly: it goes beyond the requirements of fiscal sustainability, beyond the requirements of EU fiscal rules and beyond the social resilience of European citizens. For Germany, the primary surplus would reach 3.0% by 2034 under the current scenario. As the optimal level of public debt is unknown *a priori*, there is no reason to consider that this situation will correspond to a long-term equilibrium. The German government may decide to expand fiscal policy in the years after 2016.<sup>10</sup>

It must be acknowledged that the projections can be sensitive to alternative hypotheses. Blot and al. (2014a) notably show that the value of fiscal multipliers and the hysteresis effect play a significant role to gauge the dynamics of public debt. Initial output gap and long-term growth are also critical hypotheses.<sup>11</sup> Fiscal impulses have been high for most of Eurozone countries and sometimes exceeding 5% in Spain, Portugal, Ireland and Greece. They may be even larger if years 2015 and 2016 are excluded as the fiscal stance would turn positive for some countries according to AMECO forecasts (see table 3). For most countries average growth rates have been low during the 2011-2014 period. It must be recalled that over these years, the model has been calibrated to mimic the *observed* growth, public debt, public balance and interest rates. Thereafter, due to less contractionary or even expansionary fiscal impulses in 2015 and 2016, GDP would recover faster: Eurozone growth rate would reach 1.3% and 2.9% respectively. It would also result from a more expansionary monetary policy and to the error correction effect introduced in the model.

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### Box 1: Main hypotheses for the baseline simulations

All simulations begin in 2011. To do so, we need to set starting point values in 2010 for some key variables. Output gaps for 2010 come from OECD database. We have taken the

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<sup>10</sup> Blanchard et al. (2014) report the different channels through which a fiscal stimulus in Germany may be fruitful in the periphery. In't Veld (2013) reports a positive impact of a fiscal stimulus in Eurozone surplus countries (e.g. Germany) but does not report a comparison with a fiscal stimulus in deficit countries. Blot et al. (2014a) show that such a fiscal stimulus in Germany, which would not jeopardize public debt sustainability, would be less effective than if it happened in Spain: the almost close output gap in Germany does neither favor a strong impact of fiscal policy in Germany nor in the Eurozone via spillover effects.

<sup>11</sup> Simulations also depend on starting debt levels. In the present context, however, initial debt levels are *actual* ones, and cannot therefore be modified.

Economic Outlook 88 database (December 2010) which was the latest information available to policymakers when they decided upon domestic fiscal stances for 2011 and beyond. Output gaps are frequently revised and an alternative calibration might be to use more recent OECD estimates. Long-term projections for growth rates are OFCE hypotheses (see Table 2) where long-term growth is decomposed between the growth of the labor force and labor productivity. These hypotheses are necessarily open to debate but they may only be seen as exogenous projections since the model does not properly account for a long term analysis of the growth rate equilibrium. Concerning fiscal policy and budget variables, the main hypotheses are as follows:

- Public debts and fiscal balances in 2010 come from Eurostat;
- Fiscal impulses and the composition of the adjustment are taken from AMECO database (see Table 3). For 2015-2016, fiscal impulses are planned ones. Fiscal impulses take into account the one-off measures and correspond to the underlying primary cyclically-adjusted fiscal balance.
- Sovereign spreads for 2015-2016 are supposed to vanish progressively in the baseline scenario. It is assumed that the announced ECB program of unlimited debt-buying on the secondary market (Outright Monetary Transactions, up to a 3-year maturity) has been effective and achieves its goal of bringing down interest rates for Italy and Spain. Regarding countries relying on the ESM (formerly EFSF) for debt financing, we assume that Ireland gets full access to financial markets in 2014, Portugal in 2015 and Greece in 2016. We discuss a scenario with endogenous risk premium hereafter.

**Table 2. Main hypotheses for 2010**

in %

	Public debt	Fiscal balance	output gap	potential growth
Source	Eurostat	Eurostat	OECD	OFCE
Germany	82.5	-4.2	-3.7	1.0
France	82.8	-6.8	-3.3	1.4
Italy	115.3	-4.5	-4.4	0.2
Spain	61.7	-9.4	-6.5	1.4
Netherlands	63.4	-5.1	-2.4	1.3
Belgium	96.6	-3.8	-3.8	1.5
Portugal	94.0	-11.2	-2.3	1.0
Ireland	91.2	-9.1	-11.7	1.8
Greece	148.3	-10.9	-7.3	1.5
Finland	48.8	-2.5	-6.0	1.6
Austria	72.5	-4.5	-2.5	1.4

Source: OECD, Eurostat and OFCE

**Table 3. Fiscal impulses – 2011-2016**

in % of GDP

	2011 – 2014		2015-2016	
	Expenditures	Taxes	Expenditures	Taxes
Germany	-1.5	-0.7	0.1	0.3
France	-3.9	1.1	0.4	-0.1
Italy	-2.2	-0.5	0.5	0.2
Spain	-1.9	-4.1	-0.1	0.4
Netherlands	-1.7	-1.3	0.5	0.2
Belgium	-2.9	1.4	0.6	-0.3
Portugal	-3.9	-4.4	0.3	0.6
Ireland	-1.3	-4.8	1.7	-1.9
Greece	-7.0	-5.5	1.3	0.1
Finland	-3.9	4.0	-0.4	0.6
Austria	-1.6	0.0	-0.2	0.0

Sources: OECD, Eurostat and AMECO.

## 4.2. Does composition matter?

We assess whether countries can achieve the public debt target in 2034 by resorting to alternative instruments of consolidation. For the sake of simplicity and with regard to the literature on fiscal multipliers, we consider an instrument for which the fiscal multiplier is high, called here expenditure-based adjustment and the other for which the fiscal multiplier is low, called tax-based adjustment as emphasized in figure 2.

For each instrument, we calculate a sequence of fiscal impulses over 2011-2034 and we assess whether or not the country achieves the target and what is the output dynamics under the adjustment. For simplicity, we set fiscal impulses at - / + 0.5 from 2011 on. Austerity (a negative impulse) is reversed once the public debt-to-GDP ratio falls below 60% in 2034. For example, Spanish public debt stands at 71% of GDP in 2034 in the baseline scenario. We start with replacing the 2011 *observed* fiscal impulse by -0.5 and then, by iteration, we introduce additional negative fiscal impulses of -0.5 until the debt-to-GDP ratio reaches 60% in 2034. Once the target has been reached, we introduce positive impulses insofar as they do not breach the target.

The ability to comply with the debt objective is analyzed separately with three instruments (expenditure-based, tax-based and mix-adjustment). In the mix-adjustment case, we consider that countries for which consolidation is needed resort to the instrument with the lowest fiscal multiplier (taxes) whereas countries where an expansionary fiscal policy is possible resort to the instrument with the highest multiplier (expenditures). In all cases, it is assumed that interest rates converge among Eurozone countries.

First, with maximum yearly consolidation of -0.5% of GDP based only on expenditures from 2011 on (table 4a), only three countries (Spain, Portugal and Greece) would not reach the debt target in 2034. For those countries the cumulative fiscal impulse would amount to 11.5% of GDP. For France, the Netherlands and Austria, a significant additional amount of consolidation is needed when compared to table 1. In the case of Italy, reaching 60% with -0.5 point of consolidation per year would involve 3.1 points of consolidation which is close to the -2.1 that were realized between 2011 and 2016.<sup>12</sup> For Germany, fiscal stance would turn to a positive figure reflecting the fiscal space of the country. With a neutral fiscal stance, Belgium would also be able to reach the 60% debt-to-GDP ratio. Finally, it must be stressed that average growth would be significantly higher between 2011 and 2014, in comparison with the baseline scenario, thanks to lower requirements for consolidation. For the Eurozone as a whole, average growth would have been 0.6 point higher. The most striking difference would concern Greece, with an averaged recession of -0.9 instead of -4.8. Yet it must be reminded that under this adjustment path, Greece would still be unable to reach the debt target. Under this scenario, the cumulative fiscal impulse would be substantially higher than under the baseline (incorporating observed and planned fiscal stances between 2011 and 2016), but since it would be spread over a longer horizon, the gains in terms of short-term growth would be relatively substantial, whereas the long-term costs would be minimal.

Turning to the case of purely tax-based adjustment (table 4b), only Portugal would not comply with the debt target. Public debt would reach 92%, which is significantly lower than in the expenditure-based adjustment, where it stood at 150%. This scenario is certainly and not surprisingly better for all Eurozone countries since, needed adjustment is lower and consolidation is less costly. Average growth in the Eurozone would now have reached 1.2 between 2011 and 2014, with average growth between 2015 and 2034 similar with the baseline scenario.

This conclusion certainly hinges on the assumption that the tax multiplier is always lower than the spending multiplier. Resorting to the instrument associated with the lowest multiplier in times of consolidation is optimal, all else equal. This is of course untrue when an expansion is possible. Thus, we consider a fourth scenario of mixed-adjustment (table 4c). Here, countries with fiscal room for maneuver resort to expenditure-based expansion whereas countries implementing consolidation resort to tax-based adjustment. The differences with the pure tax-based adjustment are rather small. Public debt for Portugal is only reduced by 1 percentage point. Average growth for the Eurozone is 0.1 point higher

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<sup>12</sup> Here we also take into account planned consolidation or expansion for 2015 and 2016.

between 2011 and 2014 and similar on average afterwards. It must be stressed that the main country for which there is fiscal room for maneuver is Germany. Though it is the biggest Eurozone country, the spillover effects from a German expenditures-based expansion are found to be small (see footnote 10).

Let us briefly return to the superiority of tax-based adjustment over spending-based adjustment in the model. It shall not be considered tautological. Indeed, the model introduces spillover effects via trade which do not modify the discrepancy between both types of adjustment: the adjustment with the assumed lowest real costs (tax-based adjustment) also produces the lowest spillover effects on partners, hence the lowest (negative) feedback effects from partners. However, the model includes a monetary policy setting which reduces the discrepancy: the adjustment with the assumed lowest real costs produces the smallest reduction in the nominal interest rate, hence the lowest compensation for demand. The argument that spending-based consolidation should be the preferred strategy during consolidation episodes drew extensively on the reversed crowding-out effect: a fall in expenditure would be followed by a fall in interest rate and a consecutive increase in private investment<sup>13</sup>. This argument is strongly dependent on the existence of the ZLB (unless the liquidity trap is driven by shock on households' confidence, as in Mertens and Ravn, 2010): once the ZLB has been reached, spending-based consolidations cannot produce a compensating increase in private demand. Moreover, the higher the fiscal multiplier, the faster a ZLB episode is reached. Consequently, the time frame for a reversed crowding-out effect to happen is shorter under a spending-based consolidation than a tax-based one.

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<sup>13</sup> The argument is present in, e.g. Giudice et al. (2003) and Corsetti et al. (2013).

Table 4a. + / - 0.5 adjustment - expenditure-based adjustment

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse 2011-2034	GDP growth rate (%)	
	2020	2034	2020	2034		2011-2014	2015-2034
Germany	70	60	-1,1	-1,1	1,2	2,2	1,0
France	95	60	-1,1	0,8	-6,8	1,4	1,4
Italy	122	60	1,1	3,4	-3,1	-0,7	0,4
Spain	127	100	-3,6	2,0	-11,5	0,1	1,4
Netherlands	85	60	-0,6	-0,3	-5,0	0,1	1,4
Belgium	87	60	-1,0	-0,2	0,0	1,7	1,6
Portugal	160	150	-4,6	0,1	-11,5	-0,1	0,9
Ireland	122	60	-0,8	2,4	-7,0	1,9	1,9
Greece	163	110	-2,2	4,4	-11,5	-0,9	1,0
Finland	58	60	-1,8	-2,4	0,9	1,3	1,7
Austria	74	60	-1,4	-1,2	-2,1	1,1	1,5
Eurozone	96	67	-1,1	0,5	-3,8	1,0	1,1

Source: iAGS model

Table 4b. + / - 0.5 adjustment - tax-based adjustment

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse 2011-2034	GDP growth rate (%)	
	2020	2034	2020	2034		2011-2014	2015-2034
Germany	72	61	-1,1	-1,1	1,0	2,1	1,0
France	84	60	-0,9	-0,5	-4,2	1,8	1,4
Italy	114	60	0,7	2,8	-1,7	-0,2	0,4
Spain	111	60	-2,4	2,8	-9,2	0,6	1,6
Netherlands	72	60	-1,3	-1,2	-2,6	0,6	1,4
Belgium	88	63	-1,1	-0,5	0,2	1,7	1,6
Portugal	142	92	-3,2	3,8	-11,5	0,4	1,0
Ireland	105	60	-0,6	0,7	-3,8	2,6	2,0
Greece	139	60	-0,4	4,6	-7,6	-0,2	1,1
Finland	59	61	-1,8	-2,4	0,7	1,1	1,8
Austria	71	60	-1,4	-1,3	-1,5	1,5	1,4
Eurozone	89	61	-1,0	0,3	-2,6	1,2	1,2

Source: iAGS model

Table 4c. + / - 0.5 adjustment - mix-adjustment (expenditure-based expansion and fiscal-based consolidation)

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse 2011-2034	GDP growth rate (%)	
	2020	2034	2020	2034		2011-2015	2016-2034
Germany	70	60	-1,1	-1,1	1,2	2,2	1,0
France	84	60	-0,9	-0,5	-4,2	1,8	1,4
Italy	114	60	0,7	2,8	-1,7	-0,2	0,4
Spain	111	60	-2,4	2,8	-9,2	0,6	1,6
Netherlands	72	60	-1,3	-1,2	-2,6	0,6	1,4
Belgium	87	62	-1,1	-0,4	0,2	1,8	1,6
Portugal	142	92	-3,2	3,8	-11,5	0,4	1,0
Ireland	105	60	-0,6	0,7	-3,8	2,6	2,0
Greece	139	60	-0,4	4,6	-7,6	-0,2	1,1
Finland	58	61	-1,8	-2,5	1,0	1,3	1,7
Austria	71	60	-1,4	-1,3	-1,5	1,5	1,4
Eurozone	89	61	-1,0	0,3	-2,5	1,3	1,2

Source: iAGS model

### 4.3. Does credibility matter?

The assumption that interest rates will converge across Eurozone member states was included in the former scenarios. Yet, recent experience has shown that countries with high public debt underwent a sharp loss of credibility which materialized in risk premia increases. This situation has induced countries to implement sharper consolidation to restore credibility *vis-à-vis* financial markets, a situation already described by, e.g. Guichard et al. (2007). Thus we consider scenarios with endogenous risk premia on sovereign debts, as shown in eq. (5)<sup>14</sup>. We focus on pure expenditure-based and pure tax-based scenarios. Results are reported in tables 5a and 5b, in difference with results reported in tables 4a and 4b respectively. The endogenous risk premium, given by eq. (5) on the national interest rate appears in the last-but-one column of each table. It might not be directly compared with the sovereign yield given in table (1) as the scenario is not the same. The relevant comparison would be with tables (4a, 4b and 4c) where risk premium is zero by construction. It may also be stressed that a zero risk premium does not mean that there is no spread with the safe asset (here the German sovereign bond) as convergence is supposed to occur slowly in the model as explained for the baseline scenario.

<sup>14</sup> Dewachter and Wouters (2014) introduce endogenous financial risk in a DSGE model via a perturbation-based approach, but they do not model either a multi-country setting or risk premia on sovereign bonds.

It should be straightforward that the ability to reach the debt target when there is an endogenous risk premium is lower because positive risk premium increases the debt burden and weighs down on growth, reducing the advantage of a smoother path of consolidation.

In the case of an expenditure-based policy (table 5a), the introduction of a risk premium requires a sharper consolidation of 1.1 percentage point of GDP for the Eurozone, with a strong discrepancy between France (with an additional cumulative fiscal impulse of almost -5 percentage points) and Belgium (with an additional cumulative fiscal impulse of +0.5). Despite stronger consolidation, the Eurozone average public debt increases by 5 percentage points of GDP, in comparison with the previous scenario, and Greece, Portugal and Spain are still unable to reach the debt target in 2034. Real GDP growth rates are almost similar, on average between 2011 and 2014 and between 2015 and 2034 though these average figures hide some real costs which may cumulate in output gaps. Indeed, in the case of France and Portugal, between 2011 and 2034, the negative output gap would widen by 16 and 22 percent respectively. On average for the Eurozone, the output gap would widen by 5 percent. Risk premia would be higher for France or Finland, compared to a situation without endogenous risk premium but yet sovereign spreads with German interest rate would still be close or above 100 basis points in Greece, Italy, Portugal and Spain between 2012 and 2018.

The real costs of a tax-based adjustment (table 5b) would be substantially lower than after a spending-based one, once a risk premium is introduced. The cumulative fiscal impulse would reach a mere -0.3 percentage points of GDP for the Eurozone, and the cumulative loss of output gap would be 0.5 percent. In this case again, risk premia would be lower compared to the expenditure-based consolidation but may still be substantial for France and Portugal. Finally the debt target would not be achieved in 2034 for Spain, Portugal and Greece.

The response of sovereign spreads to increases in public debt in the simulations are quite in line with the literature which reports relatively low values, e.g. Gruber and Kamin (2012). Results of the simulations concerning the peripheral countries of the Eurozone can be brought close to the empirical conclusions of Schaltegger and Weder (2015), though they study only developing countries. They show that fiscal adjustments do not have a strong impact on the probability of default, and that a composition effect exists: spending-based adjustments are not successful at reducing the probability of default, whereas tax-based ones are. In a scenario of endogenous risk premia, spending-based and tax-based adjustments give almost similar sovereign spreads (they are a bit higher in the latter than in the former, though the difference is probably not significant), but public debt increases less in the latter than in the former case. A composition effect thus arises.



Table 5a. +/- 0.5 fiscal impulses - endogenous risk-premium - expenditure-based adjustment

*In difference with table 4a*

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse	GDP growth rate (%)		Risk premium (pts)	Cumulative OG
	2020	2034	2020	2034	2011-2034	2011-2014	2015-2034	2012-2018	2011-2034
Germany	0	0	-0,1	0,0	0,1	0,0	0,0	0.1	0,9
France	6	0	-1,0	3,2	-4,7	0,0	-0,2	0.9	-16,1
Italy	5	0	0,2	0,4	-0,9	-0,2	0,0	0.4	-4,5
Spain	7	32	-1,3	-1,8	0,0	-0,1	0,0	1.1	-6,4
Netherlands	2	0	-0,3	0,4	-0,3	0,0	0,0	0.6	-1,0
Belgium	0	0	-0,1	-0,1	0,5	0,1	0,0	0.0	2,9
Portugal	12	102	-2,4	-9,7	0,0	-0,2	-0,2	1.4	-22,1
Ireland	2	0	-0,2	0,3	-0,4	0,1	0,0	0.3	1,1
Greece	0	0	-0,1	0,1	0,0	0,0	0,0	0.6	1,6
Finland	0	0	-0,1	0,1	0,0	0,1	0,0	0.0	2,5
Austria	0	0	-0,1	0,0	0,4	0,0	0,0	0.0	1,1
Eurozone	3	5	-0,4	0,4	-1,1	0,0	0,0		-5.0

Source: iAGS model

Table 5b. +/- 0.5 fiscal impulses - endogenous risk-premium - tax-based adjustment

*In difference with table 4b*

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse	GDP growth rate (%)		Risk premium (pts)	Cumulative OG
	2020	2034	2020	2034	2011-2034	2011-2014	2015-2034	2012-2018	2011-2034
Germany	2	2	-0,1	0,0	0,2	0,0	0,0	0.1	0,9
France	3	0	0,0	0,2	-0,5	0,0	0,0	0.6	-0,5
Italy	0	-1	0,0	0,1	-0,2	-0,1	0,0	0.2	-0,8
Spain	6	7	-1,1	1,7	-2,3	-0,1	0,0	1.1	-5,2
Netherlands	0	0	-0,1	0,0	0,2	0,1	0,0	0.1	1,6
Belgium	-1	-4	0,2	0,3	0,0	0,0	0,0	0.0	0,4
Portugal	10	42	-2,0	-2,4	0,0	-0,2	0,0	1.4	-7,6
Ireland	1	0	-0,1	0,0	0,0	0,1	0,0	0.2	2,4
Greece	0	0	-0,1	0,0	0,0	0,0	0,0	0.4	1,0
Finland	0	0	-0,1	-0,1	0,0	0,1	0,0	0.0	1,8
Austria	1	1	-0,1	0,0	0,3	0,0	0,0	0.0	0,5
Eurozone	2	2	-0,2	0,2	-0,3	0,0	0,0		-0,5

Source: iAGS model

## 5. Backloading vs. frontloading

In this section, we address the issue of frontloading according to the choice of instruments (expenditures or taxes). In the case of a frontloaded adjustment, countries implement the bulk of the fiscal consolidation early. This is clearly the choice that has been made in the Eurozone since 2011. Despite negative output gaps, Eurozone countries have engaged massive consolidation plan as emphasized in table 3 where it appears that for some countries fiscal consolidation between 2011 and 2014 exceeded 10 percentages points of GDP. On the one hand, under the assumption that fiscal multipliers are high in time of crisis, this strategy may be ill-designed, implying high output losses. It may even be counterproductive for very high value of fiscal multiplier since public debt is hardly reduced because of the feedback effect from bad growth performance. On the other hand, spreading (or postponing) the adjustment may undermine the credibility of government and trigger speculative attacks on sovereign debt markets. Interest rates would go up. We illustrate the trade-off between backloading and frontloading by comparing the scenario of +/- 0.5 percentage point of GDP with a scenario where the adjustment amounts to +/- 1 percentage point of GDP. We keep on distinguishing between spending-based and tax-based adjustments, and also retain the endogenous risk premium. As in previous scenarios, adjustments start in 2011 and are pursued until debt-to-GDP ratios reach 60%.

The frontloading strategy under a spending-based consolidation would substantially alleviate the debt problem in Greece, Portugal and Spain though in the former two countries, the debt target would remain unreachable in 2034, despite strong negative fiscal impulses. This setback is all the more unfortunate that it would be accompanied by a high real cost: Greece and Portugal would face a negative output gap of 3 and 4% per year during 20 years respectively. For the Eurozone, frontloading would be preferable to backloading in terms of public debt and real activity in the long run, at the expense of the short-run where real growth would be reduced by 0.4%.

Frontloading under a tax-based adjustment gives better outcomes. All countries are able to reach the debt target in 2014 and in the Eurozone, the requirement to implement a contractionary fiscal policy is relieved by almost 1 percentage point of GDP between 2011 and 2034. The cumulative output gap is improved by 2% during the same period. Relief is substantial for Portugal and Spain who gain 0.5% per year during 20 years. In the short-run however, there is a minor real cost with frontloading in comparison with backloading.

It remains to be acknowledged that sovereign spreads are substantially reduced by the recourse to a frontloading strategy. In countries where interest rates spreads are high, like Italy, Spain and Portugal, the fall amounts to an average of 0.4 if consolidation is spending-based. Stronger austerity measures means that the peak for public debt and the stabilizing primary surpluses are reached more rapidly reducing the risk premium.

Table 6a. +/- 1 fiscal impulses - endogenous risk-premium - expenditure-based adjustment

*In difference with the scenario described in table 5a*

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse 2011-2034	GDP growth rate (%)		Risk premium (pts) 2012-2018	Cumulative OG 2011-2034
	2020	2034	2020	2034		2011-2014	2015-2034		
Germany	0	-1	0,0	0,0	0,0	0,0	0,0	-0,1	-0,1
France	-10	-1	1,3	-4,1	5,4	-0,8	0,3	-0,8	16,8
Italy	-7	1	-0,3	-0,6	0,9	-0,3	0,1	-0,4	4,0
Spain	-4	-72	4,3	3,8	-1,9	-0,8	0,1	-0,3	-11,0
Netherlands	-10	1	-0,5	-0,9	1,6	-0,5	0,2	-0,6	8,2
Belgium	0	0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Portugal	10	-168	7,2	26,5	-23,0	-1,6	-0,5	-0,3	-93,3
Ireland	-6	0	0,7	-1,2	1,4	-1,0	0,2	-0,3	1,4
Greece	18	-22	2,5	7,8	-11,5	-1,1	-0,4	0,1	-65,2
Finland	0	0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Austria	-1	0	0,0	0,0	0,0	0,0	0,0	0,0	-0,3
Eurozone	-5	-11	0,9	-0,2	0,8	-0,4	0,1		0,9

Source: iAGS model.

Table 6b. +/- 1 fiscal impulses - endogenous risk-premium - tax-based adjustment

*In difference with the scenario described in table 5b*

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse 2011-2034	GDP growth rate (%)		Sovereign yield (%) 2012-2018	Cumulative OG 2011-2034
	2020	2034	2020	2034		2011-2014	2015-2034		
Germany	0	0	0,0	0,0	0,0	0,0	0,0	-0,1	0,0
France	-10	0	-0,3	-0,7	1,0	-0,1	0,0	-0,6	3,1
Italy	-1	0	-0,1	-0,1	0,1	0,0	0,0	-0,2	0,2
Spain	-21	-7	2,8	-4,0	5,0	-0,2	0,1	-0,9	9,1
Netherlands	-3	0	0,0	-0,2	0,1	0,0	0,0	0,0	0,0
Belgium	0	0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Portugal	-27	-74	6,1	1,4	2,1	-0,2	0,1	-1,0	10,0
Ireland	-5	0	-0,2	-0,3	0,3	-0,2	0,0	-0,2	0,2
Greece	-13	0	1,1	-1,6	1,8	-0,3	0,1	-0,4	2,2
Finland	0	0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Austria	0	0	0,0	0,0	0,0	0,0	0,0	0,0	0,1
Eurozone	-6	-2	0,4	-0,7	0,9	-0,1	0,0		2,1

Source: iAGS model.

There are two arguments which may make a frontloading strategy preferable to a backloading one.<sup>15</sup> The first one relates to uncertainty. Of course, if one knows today that the fiscal multiplier will be much lower tomorrow, backloading consolidation is always a superior strategy. But a question arises: can one be sure that the fiscal multiplier will be significantly lower in a reasonable number of years? As a matter of fact, if the lower multiplier tomorrow is not confirmed, backloading may make public finances worse, because it maintains the cumulative consolidation needs. The second argument relates to the political economy of reforms. It is hard to argue that newly elected governments in the future will or should commit to the commitments of incumbent governments. Hence, consolidation should be implemented as soon as possible.

A counter-argument can be given by the baseline scenario (table 1): it shows that the real costs of a sharp consolidation when the output gap is negative are not negligible and produce a self-defeating strategy where public debts continue to grow in countries which implemented the most negative impulses.

<sup>15</sup> We thank Pablo Hernandez de Cos for clarifying this point.

## Conclusion

Turning back to the questions raised in the introduction, it is time for answers.

First, the simulations performed with the iAGS model showed that there have been quite substantial costs with the fiscal stance endorsed by Eurozone member states since 2011. It involves unrealistic improvements in public finances which stop the recovery under way after the Global Financial Crisis. Meanwhile the model confirms that this fiscal strategy will be unable to achieve, or sometimes to improve, public finance sustainability. Second, the simulations show that a composition effect is at work. Despite an active monetary policy, but only until the short-run nominal interest rate hits the zero-lower-bound, spending-based consolidations are less effective than tax-based ones in terms of public finance sustainability; they are also more costly in terms of economic growth. Third, introducing endogenous risk premia does not alter these results, nor does the simulation of a frontloading strategy.

The conclusion is that it is not only important to implement a fiscal adjustment based on the instrument associated with the lowest fiscal multiplier but also to neutralize the risk premium through an accommodative monetary policy. Our results show that fiscal consolidations do not prove themselves very effective at improving credibility. Indeed, though Spain or Greece implemented strong measures to reduce their public balance, risk premia kept rising in 2011 and 2012 and went down only after Mario Draghi declared that the ECB would do “whatever it takes” to save the Euro.

The introduction of different shapes for the multiplier effect on tax and spending, and the inclusion of a banking and financial systems with frictions in the model are left to future research.

## Appendix - Calibration

### A1. Aggregate demand and supply

We calibrate the error-correction equation stemming from equation (3) by distinguishing short run and long run effects of monetary policy and external demand on GDP. Long run effect of long term yields ( $\lambda$ ) is higher than the short run one ( $\lambda_s$ ), to take into account delays in the transmission of monetary policy. As for heterogeneity between Eurozone member states in the transmission of interest rate shocks, empirical literature has not provided very conclusive results to date. Peersman (2004) reports diverging results so that any calibration remains hazardous. We choose to avoid a strong heterogeneity, which is consistent with the convergence in the transmission process before the crisis emphasized by Boivin et al. (2008) or Barigozzi et al. (2014). Boivin et al. (2008) notably suggest that the effect of an increase in the interest rate is higher for Spain and Italy than for France and Germany. The effect of interest rate shocks is therefore supposed to be lower for “Northern

countries". We set  $\beta_l$  (the long-run impact of foreign demand on output) equal to the share of exports in the country's GDP, and  $\beta_s$   $\beta_l$ .

**Table A1. Calibration of monetary policy and external demand effects on output**

	$\delta_s$	$\delta_l$	$\beta_s$	$\beta_l$
Austria	-0.40	-0.60	0.29	0.58
Belgium	-0.40	-0.60	0.40	0.81
Finland	-0.40	-0.60	0.23	0.46
France	-0.30	-0.50	0.13	0.27
Germany	-0.30	-0.50	0.25	0.50
Greece	-0.40	-0.60	0.13	0.25
Ireland	-0.40	-0.60	0.50	1.00
Italy	-0.30	-0.40	0.14	0.28
Netherlands	-0.40	-0.60	0.40	0.79
Portugal	-0.40	-0.60	0.17	0.34
Spain	-0.30	-0.40	0.15	0.30

Source: iAGS Model, OFCE.

The critical point in calibrating the error-correction equation is to set the speed of convergence of output to its long run equilibrium. The speed depends on values of  $\lambda$  (impact of variables in level) and  $\alpha$  (impact of past growth rate), which are set equal across countries. We fix  $\alpha$  at 0.1 and  $\lambda$  at -0.3. These values ensure that the speed of convergence of output to its long-run value is comparable under normal times to that of a standard DSGE model. With these values, the output gap is closed about 5 years after a shock.

Concerning equation (2), long run effects on potential GDP come from hysteresis effects. The risk-premium effect depends on the sensitivity of the sovereign yield on public debt as described in eq. (5).

Hysteresis	Risk-premium
$H$	$\kappa$
0.15	0.01

Source: iAGS Model, OFCE

The hysteresis effect parameter is fixed at 0.15 in order to obtain qualitatively similar impacts of transitory and permanent fiscal impulses on potential growth, as those obtained with QUEST III (see Blot et al. (2014a) for a comparison with QUEST III model). For the simulation, fiscal rules are unplugged and shocks occur on the share of government consumption to GDP ratio.

## Public finances

The most important parameter to set for public finances is  $\Phi$ , the overall sensitivity of revenues and expenditures to the business cycle. To do so we use the European Commission estimates. To compute the average interest rate on public debt, we compute an average maturity (MAT) of public debts using national sources on public debt maturity structures in 2011.

Table A.3. Calibration of public finances parameters

	$\Phi$	MAT
Austria	0,47	8,1
Belgium	0,54	6,8
Finland	0,50	5,0
France	0,49	6,9
Germany	0,51	6,1
Greece	0,43	11,3
Ireland	0,40	6,9
Italy	0,50	6,6
Netherlands	0,55	7,0
Portugal	0,45	6,1
Spain	0,43	6,8

Sources: European Commission (2005), OFCE.

## External trade and finance

We set the sensitivity of imports to output gap equal to the share of imports in country's GDP. The matrix of trade exchanges between countries comes from the Chelem Database for year 2003.

**Table A.4. Calibration of the sensitivity of imports to output gap**

	$\Omega$
Austria	0.5
Belgium	0.8
Finland	0.4
France	0.3
Germany	0.4
Greece	0.3
Ireland	0.8
Italy	0.3
Netherlands	0.7
Portugal	0.4
Spain	0.3

Source: Chelem (CEPII).

As regards the parameters of the Taylor rule, they are set according to Taylor (1993). The sensitivity of forward-looking expectations in long-run expected inflation is set at 0.82 which makes the long-run nominal interest rate equal to 4% (see Shiller, 1979; Fuhrer and Moore, 1995).

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# The constitutional conundrum of the European Union

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**ABSTRACT** The euro crisis has called into question the constitutional compromises formalized in and by the Lisbon Treaty. The compromise between different (supranational and intergovernmental) interests, the compromise between member states engaged in building the Economic and Monetary Union (EMU) and those allowed to opt out of it and the compromise, within the EMU, between a centralized approach to monetary policy and decentralized economic policy. Unions of states, as the European Union (EU) is interpreted to be, are necessarily structured on interstate compromises, because they derive from the aggregation of states with different demographics/capabilities and national identities. However, in the EU, contrary to the other unions of states (as the United States and Switzerland), the aggregation has not been supported by an agreed constitutional framework from which to derive procedures and discourse for solving disputes and constituting new interstate compromises. This is why the wrecking of those compromises by the euro crisis has led the EU to a constitutional conundrum. From the analytical perspective used in the article, Treaty reform seems to be the necessary, although contrasted, strategy for escaping from the conundrum.

**KEY WORDS** Constitutional compromises; differentiation; euro crisis; Lisbon Treaty; treaty reform.

## 1. INTRODUCTION

It is generally accepted that the euro crisis has dramatically shaken the structure of the European Union (EU) as it emerged from the 2009 Lisbon Treaty (Craig 2010). However, the interpretation of the crisis's effects can differ substantially according to the analytical model used for assessing them. One might argue that, from the perspective of the EU as a multi-level or multi-centred system of governance, those effects consist in the deepening of the internal differentiation of the EU. However, if one considers the EU as union of states with federal features, then those effects have rather constitutional implications. If the EU is a constitutionalized union, structured around compromises between its member states, then it is arguable that the euro crisis has upset those compromises, bringing the EU into a constitutional conundrum. A conundrum is thus conceptualized as a context where the interstate and inter-institutional equilibria of the EU constitutional system are no longer viable, but their

reconstitution would be unlikely resorting to that constitutional system's logics and resources.

My theoretical assumption is that the EU is not just a multilevel or multi-centred system of governance, but a federalizing project ('an ever closer union') aimed to aggregate states of different demographic size and nationally differentiated citizenries. It is a union of states, not only because it expresses the self-representation of the EU, but also because the concept of union can properly reflect the genetic foundation of the EU, making it close, but not similar, to a federal union. If democratic federalism is considered a genus to which pertains different species (Burgess and Gagnon 2010; Watts 1998), then an analytical distinction between federal unions and federal states should be stressed (Fabbrini 2015). In fact, federal unions aggregate states that were previously independent for a sufficient period of time to develop distinct national attitudes, economic patterns and institutional settings; they aggregate states that are asymmetrically correlated, where asymmetry concerns population size and material capability; they aggregate states that shared an experience of insecurity, if not of a hot or cold war between them; the aggregation implies the setting up of a centre with delimited and controlled powers, to which significant decision-making autonomy recognized by each of the aggregated states corresponds. The United States (US) and Switzerland are the only historical cases, within established democratic political systems, respecting those properties and functioning (for a long time, in the case of the former [Fabbrini 2010]) as federal unions.

Established democratic federal states have a different genesis and logic of functioning. They derive from the disaggregation of a previously unitary unit and the main political actors tend to share a common political experience; they are designed by and through a central political authority that tried to keep asymmetry and differentiation under control; they result from the need to decentralize the exercise of power and not from the necessity to face an external or internal threat; they retain significant decision-making resources in the centre, since the latter is the institutional level where decentralization is negotiated and promoted. Once institutionalized, federal unions are driven by a political logic based on interstate, and not only partisan, cleavages, whereas federal states are mainly characterized by relations between established political parties representing economic or cultural cleavages (with the partial exception of Canada, that has also the features of a coming together federation [Fossum and Menéndez 2011]). Federal unions are much weaker experiments than federal states, not only because of their lack of stateness, but mainly because they have to accommodate states with different if not contrasting interests and views. Both the US and Switzerland passed through periodical and dramatic political crises, resolved, however, through an agreed constitutional method (indeed, when the latter was non agreed, the interstate conflict degenerated into a civil war, as in 1861–65 US). Although both species of federal political system have required the existence of a constitution or fundamental law as a formal document for regulating their internal contrasts, the constitutional

pact has had a different role in the two species: regulating interstate cleavages in federal unions, presiding over societal cleavages in federal states. The latter are not based on interstate compromises, while this is the case with the former.

The EU has structural similarities with federal unions (Nicolaidis and Howse 2001), being a union of states by aggregation. Consequently, it has been structured on cleavages and compromises between its constituent units. Nevertheless the EU's lack of a formal constitution has given rise to important dissimilarities with the other federal unions, regarding the regulation of its internal divisions. Although the Lisbon Treaty might be interpreted as a material constitution, it does not have the nature of a superior constitutional pact between states, as the US and Swiss constitutions have, from which to derive agreed rules, procedures and discourses for solving interstate disputes within the same legal order. Considering the EU to be close to a federal union makes it not only possible to understand the source and the features of its constitutional crisis, but also to advance a testable hypothesis on why it has difficulty in solving that crisis; namely, that it would be unlikely, for the EU, to come out of that crisis without relying on a new constitutional pact agreed between the élites and the citizens of its member states. This approach differs substantially from an interpretation of the EU either as a multilevel or multi-centred system of governance, whose adaptation to the change of its external environment does not necessarily imply the existence of that pact.

If the EU is a union that has come to be structured around compromises between its constituent states, the first step of the analysis will be to identify them. Three are particularly relevant for my analysis. First, the compromise between a supranational union (in charge of single market policies) and an inter-governmental union (in charge of those policies traditionally close to national sovereignty, such as, *inter alia*, foreign and security policies or economic policy). Second, the compromise between member states adopting the single currency, the euro, and member states retaining their own national currency. Third, the compromise, within the euro area, between the centralization of monetary policy by a supranational institution (the European Central Bank [ECB]) and the decentralization of economic, fiscal and budgetary policies in the member states, subject to the voluntary co-ordination of their governments. All three compromises are the outcome of preferences' divergence between member states, the larger ones in particular.

These compromises have been shaken by the euro crisis. Since 2010, the EU has approved a panoply of new legislative measures through the procedures established by the Lisbon Treaty, but a number of EU member states have also approved new intergovernmental treaties (the 2011 European Stability Mechanism [ESM], the 2012 Treaty on Stability, Co-ordination and Governance in the Economic and Monetary Union, the so-called Fiscal Compact and, last but not least, the 2014 Single Resolution Fund [SRF] negotiated in the context of the banking union) outside of the Lisbon Treaty, besides executive agreements (as the 2010 European Financial Stability Facility [EFSF] and the 2011 Euro Plus Pact), binding only the signatory member states. These

legislative measures, intergovernmental treaties and special purpose's agreements, upsetting the multilayer structure of constitutional compromises institutionalized between Maastricht and Lisbon, led the EU into a stalemate. It is my argument that escaping from it would require the starting of a Treaty reform process for setting up a new constitutional order in Europe. Thus, here I will proceed as follows: in Section 2, I will analyse the constitutional compromises that have structured the Lisbon Treaty; in Section 3, I will discuss the consequences of the euro crisis on the multilayer structure of constitutional compromises; in Section 4, I will discuss the plausible exits from the conundrum; finally, in Section 5, I will draw the main conclusion from the analysis.

## 2. THE CONSTITUTIONAL COMPROMISES OF THE LISBON TREATY

The first compromise has concerned decision-making regimes. The 1992 Maastricht Treaty officially established that the economic and financial policy of the EU would be defined and regulated within a decision-making regime that was intergovernmental in nature. Organized after the end of the Cold War, the intergovernmental conference (IGC) held in Maastricht in 1991 had to deal inevitably with issues unconnected with the single market (Baun 1995–6). In that IGC, it was decided to bring those issues within the integration process, but on the condition that they should be strictly controlled by member state governments. The Treaty introduced different decision-making regimes for dealing with different policy areas. The homogeneous character of the supranational entity which emerged from the previous decades was thus altered through the formation of different institutional settings separate one from the other. The so-called 'Community method' (Dehousse 2011), that helped to institutionalize a supranational union since the 1957 Rome Treaty, was not considered the solution for solving the problems emerging with the end of the Cold War. The member states introduced an alternative constitutional model of integration for governing the policies traditionally close to their national sovereignty. Those policies were Europeanized but kept under the control of the collectivity of national governments (as represented by the Council and the European Council, with a limited involvement of the supranational institutions of the Commission and European Parliament [EP]). It was also established that, in those policies, integration would have to proceed through political, more than legal, acts. Since integration could not take place through law, in those policies the role of the European Court of Justice (ECJ), whose power was and has continued to be crucial in the supranational constitution, would have been curtailed. The two constitutional models reflected two different views of the *political union* being promoted in Europe (Laursen and Vanhoonocker 1992), based on two different national experiences. The supranational model reflected the experience of federal Germany, the intergovernmental model the experience of centralized France. The Maastricht Treaty formalized the compromise



between political supranationalism and political intergovernmentalism. Since then, integration and supranationalization have no longer necessarily coincided.

The Lisbon Treaty abolished the structure of the pillars formalized in the Maastricht Treaty, but it kept the two different decision-making regimes distinct. Certainly, previous intergovernmental policies (such as Justice and Home Affairs) moved gradually to the supranational realm. But foreign and security policy as well as economic policy have remained intergovernmental. In the management of public policies linked to the internal market, the Lisbon Treaty continues to prescribe a constitutional model where the decision-making power is *shared* by multiple institutions through the Community method. At the same time, for policies that have traditionally been sensitive to national sovereignty (*inter alia*, economic and financial policies), the Lisbon Treaty prescribes a model of intergovernmental constitution where decision-making power is *pooled* in the institutions, the European Council and the Council, representing the governments of the Union. In internal market policies, integration is based on legal acts (*integration through law*). In the new policies, integration proceeds through political acts (*integration through policy co-ordination*). In the latter case, the European Council, recognized for the first time as a formal institution of the Union and led by a permanent president, is the strategic arena for the co-ordination's institutionalization. Intergovernmental practices are diffused also in federal states (as in Canada), not only in the two other federal unions. However, they have the features of pragmatic innovations for dealing with specific policy challenges, not those of formalized distinct decision-making regimes as in the EU.

The second compromise has concerned monetary regimes. After having accepted the reunification of Germany in 1990 and in order to keep the reunified Germany within a tighter framework, the Maastricht Treaty also set the criteria for launching the Economic and Monetary Union [EMU] (Martin and Ross 2004) as the policies' regime for supporting the project of a single currency (Jabko 2006). Certainly, the project of the single currency was not thrown together in the aftermath of German reunification (Issing 2008). It was largely defined by a 1988 *ad hoc* Committee for the study of Economic and Monetary Union, chaired by the then President of the Commission Jacques Delors and constituted by the governors of the central banks of the then 12 member states. Already, in the 1970s, after the collapse of the Bretton Woods currencies exchange system, projects and proposals for promoting a European monetary system were discussed and experimented. Probably the approval of the 1986 Single European Act speeded up the necessity of rationalizing the relations between the member states' currencies. However, the Report by the *ad hoc* Committee (made public in 1989)<sup>1</sup> seemed to offer also a political solution to the question on how to envelop a reunified Germany into a stronger European framework. Through the launch of the common currency project it was thought (in particular by France, but also the smaller member states, fearing capital flight if unable to align their monetary policy with the German central bank, Bundesbank) that a reunified Germany would continue to be a European Germany.

The EMU was thus a policy regime with a political, not merely an economic, rationale (Dyson and Quaglia 2010). To promote it, however, a compromise had to be made with member states (such as the United Kingdom [UK] and then Denmark) willing to preserve their national currency. Although celebrated as the economic and monetary regime for all the EU member states, the UK and Denmark were allowed to formally opt out of the obligation to convert their national currencies into the new common currency, regardless of their macro-economic conditions. Indeed, Denmark, after having rejected the Maastricht Treaty in a popular referendum held in 1992, finally came to accept it through a new referendum held in 1993 because of the so-called Edinburgh Agreement of December 1992, which allowed the country to opt out of the need to adopt the future common currency. *De facto*, a third member state, Sweden, has been allowed to keep its own national currency, thanks to a biased algebraic calculation regularly showing its inability to fulfil the required macroeconomic criteria. The three countries contributed with others in the 1960s to develop a project of economic co-operation, the European Free Trade Association (EFTA), which was in turn heir to the Free Trade Area (FTA), the alternative project to the one begun with the 1951 Paris Treaty and the 1957 Rome Treaty.

The opting out of undesired legislation or treaty provisions gave those member states the right both not to participate in specific policy areas and not to be subject to a general jurisdiction in it. Since Maastricht, the opting out compromise has accompanied the process of integration. In addition to Denmark and the UK opting out of adopting the euro, the UK and Poland have opted out of the Charter of Fundamental Rights. The Czech Republic has joined the two member states in opting out of the Charter with the 2013 Treaty on the accession of Croatia. Regarding legislation, Denmark, Ireland and the UK have opted out of policy regulation in the area of freedom, security and justice. Ireland and the UK have opted out of the Schengen agreement on the free circulation of persons within the EU. Denmark has opted out of foreign and security policies. At the end of 2014, six member states had these opt-outs: UK (four opt-outs); Denmark (four opt-outs); Ireland (two opt-outs); Poland (one opt-out); the Czech Republic (one opt-out); and Sweden (one opt-out, but only *de facto*). The opting out of the adoption of the euro had, however, a special character: it formalized the existence of different economic constitutions within the EU (Joerges 2015), notwithstanding what the Lisbon Treaty (Treaty of the European Union [TEU], Art. 3.4) reasserted, namely that ‘the Union shall establish an economic and monetary union whose currency is the euro’. Formally, the Lisbon Treaty (Treaty on the Functioning of the European Union [TFEU], Art 139.1) recognizes this possibility only to those member states that do not ‘fulfil the necessary conditions for the adoption of the euro [and for this reason they] shall hereinafter be referred to as “Member States with derogation”, or ‘pre-ins’. This has never been the case for Denmark and the UK. Within the EMU, there were the regimes of the euro area member states (the ‘ins’) and

the regimes of those member states not yet fulfilling the macroeconomic criteria but engaged in meeting them (the 'pre-ins'). Outside the EMU, the monetary and economic regime of the member states self-excluded from the common currency (the 'outs'). The Lisbon Treaty has thus institutionalized in the same legal framework a compromise between diverging economic and monetary interests. Thus, contrary to the experience of the other federal systems (both states and unions), in the EU different monetary regimes came to coexist in the same project of integration.

There is a third constitutional compromise to consider, this time concerning the euro area member states, largely owing to the contrasting preferences of Germany and France. This compromise consisted of combining centralization (of monetary policy) with decentralization (of the economic, budgetary and fiscal policies connected to the common currency). The monetary policy of the common currency was put under the control of a federal independent institution, the ECB, but the other connected policies remained in the hands of member states. Once the process of setting up a road map for achieving the common currency was accepted, the German request of a strictly independent central bank pursuing an exclusively anti-inflationary monetary policy was accepted for the *monetary side* of the EMU and, for the *economic side* of the EMU, an intergovernmental model based on the voluntary co-ordination of policies by member state governments was chosen, as required by the French government (Touré and Touré 2014: 26–7). At the core of this compromise there was the assumption that intergovernmental decision-making, based on unanimity's criteria, would make it possible for France to balance the influence of Germany (the bigger country, demographically and economically, with the 1990 reunification). At the same time, Germany delimited national governments' discretion through the institutionalization of the Stability and Growth Pact (SGP) (Heipertz and Verdun 2010), constituted by a Resolution, two Council Regulations and the Excessive Deficit Procedure (EDP) Protocol added to the Maastricht Treaty. Indeed, the SGP and the Excessive Deficit Procedure (EDP) Protocol epitomized the German ordoliberal idea of an economic constitution structured around pre-established legal rules (an idea elaborated since the 1930s by the so called Freiburg School [Young 2012]). Although the SGP did not work as expected, its 2005 reform did not alter its legal nature (Heipertz and Verdun 2010: 2). The economic constitution of the EMU continued to exclude any supranational governance of economic policy. Also, in this regard, no other federal union has ever institutionalized such asymmetry between a federal monetary policy and an unprecedented intergovernmental economic policy.

In conclusion, this panoply of constitutional compromises substantiated the long process for accommodating divergent state interests and perspectives within the EU. With the approval of the Lisbon Treaty, it was expected that those constitutional compromises would finally be consolidated.

### 3. THE EURO CRISIS AND THE CONSTITUTIONAL CONUNDRUM

The financial crisis has not, however, vindicated that expectation. Indeed, it has upset the complex structure of compromises built within the Treaty. First, it upset the equilibrium between the supranational and intergovernmental constitutions. As provided by the Lisbon Treaty (Puetter 2014), the European Council has become the true decision-making centre for the policies adopted in response to the financial crisis (in particular the meetings of the heads of state and governments of the euro area, formalized as the Euro Summit by the Fiscal Compact). Because the financial agenda has engulfed EU policy-making, the European Council and its President have emerged as the true decision-makers (Curtin 2014; De Scoutheete 2011), not just an institution limiting itself to define the general aims of the integration process or to solve the most intricate interstate issues. Given the structure of economic governance set up in the Treaty, the Commission has come to play an administrative role, transforming the policy's indications of the European Council in technical proposals. This does not mean that the Commission has become irrelevant. Indeed, because intergovernmental co-ordination has not been able to overcome fundamental dilemmas of collective actions (Fabbrini 2013), the governmental leaders of the European Council have had to resort to the Commission. Legislative measures (the European Semester, the Six Pack, the Two Pack) and new intergovernmental treaties have indeed increased the functional role of the Commission (and even of the ECJ, but also of the domestic constitutional courts, [Fabbrini 2014]) in monitoring member states behaviour regarding their respect and enforcement of intergovernmental decisions. But agenda-setting and decision-making have remained under the control of the European Council.

At the same time, the EP has been left in a sort of institutional limbo (Crum 2013). It is true that many legislative measures were adopted through either the ordinary or the special legislative procedures that recognize a decision-making or consultative role to the EP (Rittberger 2014), but it is also true that the deepening of the euro crisis led to new treaties that do not recognize the EP as a policy-making actor. Predictably, the EP and the Commission struck back. Through the *spitzenkandidaten* strategy (the main European political parties presenting their candidate for the role of Commission President in the EP elections of 2014), the EP tried to rebalance the power relations with the European Council, affirming the principle that it would have voted as Commission president only the candidate of the party getting the plurality of votes in the elections (and not the candidate chosen by the European Council). Indeed, the election of Jean-Claude Juncker (*spitzenkandidat* of the party, the European People's Party, that got the plurality of vote in those elections) as Commission President epitomizes the EP's attempt to move the institutional equilibrium towards its special relation with the Commission. Nevertheless, the Juncker Commission's composition, for instance, was largely determined by the

European Council's preferences. In short, with the euro crisis the decision-making barycentre has moved toward the relation between the European Council (and the Euro Summit) and the Economic and Financial Affairs Council (ECOFIN) (and the Euro Group of the economic and financial ministers of the euro area member states) (Puetter 2012), although the EP and the Commission have not failed to react (e.g., with the Commission's initiative to define and launch an investment plan for growth).

Also, the compromise between the UK (and more in general the ex-EFTA area) and the EMU member states has been upset by the euro crisis. The two new treaties (the 2011 ESM and the 2012 Fiscal Compact) were established outside the legal order of the Lisbon Treaty because of the difficulties encountered by the intergovernmental constitution in solving the veto dilemma. The objectives that were set out under the Fiscal Compact in particular could have been attained through an amendment to the Lisbon Treaty. However, the euro area leaders chose to resort to international treaties for neutralizing the veto threatened by the UK government. At the same time, for promoting a fiscal union, the euro-area governmental leaders probably decided not to resort to enhanced co-operation because that would have given the Commission and the EP a voice in the project. The formation of new legal orders outside the Lisbon Treaty necessarily calls into question the constitutional compromise between the EMU and the opt-out member states, the UK in particular. The signatory states of the Fiscal Compact co-ordinate their economic, fiscal and budgetary policies, leaving on the margin only the UK (the Czech Republic, which refused to sign the Treaty in 2011, finally signed it on March 2014). Moreover, the UK is also outside of the 2011 Euro Plus Pact, a political commitment (a sort of intergovernmental agreement) between the euro area member states and several non-euro area ones (such as Denmark, Poland, Bulgaria, Romania, Lithuania and Latvia – the last two finally entered the euro area, Latvia on 1 January 2014 and Lithuania on 1 January 2015) aimed to foster stronger economic policy co-ordination between them. The new organization set up by the Fiscal Compact has made evident the distinction (indeed, the conflict) of interests between the euro area and the opt-out member states. The most crucial decisions have been taken in the meetings of the governmental leaders and ministers of the member states adopting the euro (Euro Summit and the Euro Group), with the pre-ins and the out member states only informed about their content. This separation has increased with the completion of the banking union negotiated between the euro area member states (a banking union institutionally connected to the ECB in Frankfurt and distinct from the European Banking Authority located in London). Certainly, the UK has several instruments at disposal for striking back, i.e., for neutralizing some of the effects of its being outside of the banking union. Already, in the late 1990s, it negotiated the inter-bank settlement programme for preventing discrimination between EMU and opt-out member states. Moreover, the City of London remains the major player in euro-dominated transactions. Nevertheless, the strains between the two areas of member states are not easily

manageable. As the House of Lords (2014: 3–4) recognized, ‘the Eurozone is on the road towards greater integration. The implication for the UK are immense.’

Finally, the third compromise (between a centralized monetary policy and nationalized economic policies) has not held up in the course of the euro crisis. Constrained by the intergovernmental constitution, the voluntary co-ordination of national policies has been unrelentingly challenged by its internal dilemmas. The answer to those difficulties has been a drastic reduction of intergovernmental discretion and its substitution with automatic rules. For instance, in the Fiscal Compact, the Commission’s intervention on a contracting party that disrespects the agreement has now become quasi-automatic, an automaticity that can be neutralized only by a reverse qualified majority (RQM) of the financial ministers of the signatory member states (Fiscal Compact, Art. 17). Indeed, RQM was already introduced in the Six Pack in 2011, a set of legislative measures aimed to strengthen SGP, in particular Council Regulation (EU) No. 1177/2011. Lacking an electorally legitimized political authority for the management of the single currency, policy co-ordination between national governments has been increasingly wrapped within stricter macroeconomic and legal rules. Financial aid to member states unable to respect those requirements has been accompanied by rules of conditionality that have led to the downsizing of their decision-making autonomy. National discretion has been unevenly restructured, with the debtor member states becoming less autonomous than the creditor member states for their inability to control the externalities of their policies. Within the European Council (and the Euro Summit), a decision-making hierarchy has become evident under the form of German (and its northern allies) directorate of the economic policy of EMU. The dissatisfaction of the southern member states with the current regime has grown tremendously, deepening the cleavage between debtor and creditor member states of the euro area. According to Bastasin (2014), the euro crisis has triggered the first ‘war of interdependence’ between EMU countries. If the euro was adopted in the first place for preserving a European Germany, the euro crisis has brought about the opposite effect; that is, the emergence of a German-dominated Europe in the EMU.

Upsetting the structure of multiple compromises of the Lisbon Treaty, the euro crisis has brought the EU into a proper constitutional conundrum. Different state and institutional interests are opposing each other, without having the possibility to rely on agreed criteria for justifying their claims or solving their disputes.

#### **4. HOW TO ESCAPE FROM THE CONSTITUTIONAL CONUNDRUM?**

Comparative analysis of federal unions show that unions formed through the aggregation of separated states need to rely on an agreed constitutional pact as a basis for negotiating the necessary compromises between their constituent

units (Fabbrini 2015). The EU was historically prevented from establishing its constitutional pact by the radical divergence of interests and views between its member states. The lack of this pact has constrained the EU in dealing with the effects of the euro crisis. At the same time, the pressure has increased for bringing back to the EU agenda the issue of Treaty reform, aimed to distinguish, legally and institutionally, the organization of a common market and the constitutionalization of a euro-based political union. The necessity of moving EMU towards a political end has been recurrently raised by several governments or public officials of the euro area during the euro crisis: i.e., the Westerwelle Groups of 12 foreign ministers assessed, in a Final Report made public on 17 September 2012, that, in order to give EMU ‘full democratic legitimacy and accountability’, ‘the possibility of treaty reform’ should be considered; the European Council approved, in its meeting of 5 December 2012, a document titled ‘Towards a genuine Economic and Monetary Union’ claiming the need for ‘further integration of policy making and a greater pooling of competences at the European level’; the president of ECB, Mario Draghi (2014: 7) solicited, in a daily editorial, EMU governments ‘to strengthen further the political union, defining rights and duties in a renewed institutional order’. Treaty reform has been also advocated by several think-tanks or intellectual groups, although with different institutional perspectives (CEPS 2014; De Scoutete and Micossi 2013; Group Eiffel Europe 2014; Lamond 2013; Spinelli Group and Bertelsmann Stiftung 2013; ). An influential group of German scholars (Glienicke Gruppe 2013) argued that ‘the euro area needs a new contractual basis of its own. What is called for now is a Euro-treaty to replace previous piecemeal reforms.’ The necessity of a euro–political union has been discussed also by scholars (among many, Calliess [2014]; Keleman [2014]; Somek [2013]).

The formation of a new institutional order in Europe, through the structural redefinition of the relations between euro area and non-euro area member states, would require a comprehensive Treaty reform process. It would be necessary to define, on one side, the constitutional frame of an exclusive euro area and, on the other side, the regulatory frame of an inclusive single market. In this case, the issue is no longer whether or not the UK or other opt-out member states will leave the EU. There should be no EU to leave. The EU is already an intersection of several treaties, with their multiple opportunities and obligations, not a club to enlist in or to leave. A new grand bargain would thus be necessary to establish a larger framework within which to define new relations between the two areas of member states (and other European states interested in the project). If the assumption that non-euro area and euro area member states would respectively pay dramatic costs from a reciprocal stalemate is agreed, then the institutional and legal distinction between the two areas should be necessarily formalized in two different organizations, with the authority and the resources to pursue their specific aims coherently.

This distinction cannot be interpreted as external differentiation. The EU has already implemented forms of external differentiation (through the European Economic Area, with non-member states such as Norway, Iceland and

Lichtenstein, or through bilateral agreements with a non-member state, such as Switzerland) that allow those states to participate in the single market without, however, contributing to deliberations on its policies. This solution would be unacceptable for restructuring the relations between euro area and non-euro area member states. The single market belongs to all EU member states, not only to the former or the latter. It would be unjustifiable to have the UK and other non-euro area member states outside of the Lisbon Treaty and at the same time participating in the single market without affecting the latter's policies. A negotiation should be opened in order to agree on a revised and simplified version of the Lisbon Treaty as the legal framework of the only single market of all the European states, currently in or outside the EU, on the condition that they have to meet specific requirements. At the same time, the euro area member states should have the possibility to define the constitutional foundation of their political union, on which bases to regulate their internal differences. In order to deal with the implications of the euro crisis, a euro-political union would need a formal constitutional document recomposing the supranational and intergovernmental decision-making regimes within a unitary institutional structure balancing state and citizen interests, re-establishing the euro as the exclusive currency of the union and setting up a system of public authority legitimate to take decisions across all policies. The redefinition of the legal and institutional bases of the organization of the single market and the setting up of the organization of the euro area should be concomitant. This concurrence constitutes a reciprocal assurance between the leaders of the two groups of states that they are both engaged in a positive sum game.

A process of Treaty reform would inevitably meet formidable obstacles. It would be contrasted in crucial member states as France, where in the EP elections of 22–5 May 2014 a sovereigntist reaction to the EU emerged with the spectacular success of the National Front become the first party of the country with 25 per cent of the votes, but also in other member states as shown by the same EP elections. To carve out a euro-political union from the current EU, without jeopardizing the common market framework or even without risking of activating a re-nationalization thrust in many member states, would require a formidable political leadership, in both EU institutions and member states, that cannot be artificially crafted. Nevertheless, comparative federalism's literature shows that projects of democratic aggregation of states may consolidate only if protected by an agreed constitutional document from which to derive rules, procedures and discourses for regulating divisions between those states.

On the contrary, if the EU is interpreted as a multilevel and multi-centred system, then what has been defined as constitutional conundrum might be rather viewed as policy and institutional incongruences, resolvable through the pragmatic reconstruction of the unitary order of the Lisbon Treaty, albeit internally differentiated on the basis of the measures introduced to manage the euro crisis. After all, from Maastricht to Lisbon, the EU already developed as an internally differentiated organization (Anderson and Sitter 2006; Dyson



and Sepos 2010; Leuffen *et al.* 2013). As stated by Leuffen (2013: 5), ‘differentiated integration [is] a political program’. The action of the EP during the elaboration of the Fiscal Compact, aimed to formalize a clear deadline for bringing it back to the Lisbon Treaty (European Parliament 2012; Kreilinger 2012), is an expression of that programme. Indeed, the Fiscal Compact (Art. 16) declares that ‘within five years at most following the entry into force of this Treaty ... the necessary steps shall be taken ... with the aim of incorporating the substance of this Treaty into the legal framework of the European Union’, as already happened with the Schengen Agreement. The nomination on 30 August 2014 of Donald Tusk, a previous prime minister of a member state (Poland) not belonging to the euro area, as president of both the European Council and the Euro Summit, is another expression of the attempt to reduce the dividing effects of the euro crisis. In this perspective, one might think of an EU constituted of different clusters of member states, participating permanently to different policy regimes with different degree of integration.

This political programme has, however, its weaknesses. The Fiscal Compact certainly calls for its re-incorporation in the Lisbon Treaty; however, for this re-incorporation to take place, the consent of the UK will be required once again; an unlikely outcome, given that the Fiscal Compact clauses would continue to affect London’s financial district negatively, as it would have done at the moment of the UK opposition to the Lisbon Treaty’s amendment. The alternative would be to transform the Fiscal Compact in an enhanced co-operation within the Lisbon Treaty, but this would require the initiative of the Commission and the approval of the EP, conditions disliked by few euro area member state governments. More in general, the conflict of interests between the non-euro area and the euro area member states could not be easily kept within a unitary legal order. The need for deeper integration in EMU policies would place a tremendous strain on the common legal and institutional order. Any step towards more integration within the legal framework of the Lisbon Treaty might trigger a definitive rift against the EU in the opt-out member states, the UK in particular. At the same time, differentiated integration would leave untouched the intergovernmental logic of EMU, whose decisions have lacked the necessary democratic legitimacy for being accepted by the affected citizens of the southern euro area member states. The dissatisfaction at the management of financial policy in the latter member states cannot be silenced with the confirmation of their intergovernmental source, as the Greek elections for the EP of 22–5 May 2014 and for the national parliament of 25 January 2015 plainly showed. To increase the role of national parliaments in the differentiated regime of economic governance (Chalmers 2013; Glencross 2014) will not solve the structural legitimacy deficit of the intergovernmental method. Legitimacy for decisions taken at the supranational level should come from supranational institutions, in our case the EP. However, not only has the EP been excluded from EMU’s main decisions, but its inclusion is constitutionally questionable (Heffler and Wessels 2013). In fact, because the EP ‘shall be composed of representatives of the Union’s citizens’ (TEU, Art. 14.2),

not of representatives of member state citizens, it would be extremely controversial to separate (in its internal deliberative process) representatives coming from non-euro area and euro area member states, thus allowing only the latter to have a say on the decisions taken by euro area institutions (Euro Summit and Euro Group). Finally, a differentiated EU would leave intact the technocratic (ordo-liberal) order of EMU with its institutionalized bias in favour of the economic interests and cultural values of the northern and creditor euro area member states.

## 5. CONCLUSION

The article has analysed the constitutional compromises that the EU has come to build between Maastricht and Lisbon, for thus discussing their wrecking by and during the euro crisis. Three compromises in particular had a constitutional character. The first was the compromise between member states holding different political views on the EU, the supranational and the intergovernmental. The second compromise was between the member states constituting the EMU as a political project and those opting out of it. The third compromise was within EMU between member states claiming centralization in monetary policy and member states claiming decentralization in economic policy. The euro crisis has called into question these multiple compromises. In order to face the euro crisis, the euro area member states of the EMU had to introduce legislative measures and to adopt intergovernmental treaties that have questioned the compromise with the opt-out member states. An institutional and legal separation has taken place between the non-euro area and the euro area member states. The euro crisis has also called into question the balance between supranational and intergovernmental institutions. The financial agenda has increased dramatically the power of the intergovernmental institutions of the European Council and the Council, although the Commission and the EP have not failed to react. Finally, the euro crisis has transformed the compromise between monetary policy's centralization and economic policy's decentralization, not only in a convoluted system of economic governance but also in a system of economic governance dominated by the interests and views of the bigger and creditor member state of the euro area.

Assuming the EU is a union aggregating asymmetrical and distinct states, then the formation and wrecking of its internal interstate compromises should not be surprising. Stalled in the contrasts between supranational and intergovernmental interests, different monetary regimes, debtor and creditor member states, the EU has entered into a constitutional conundrum. The US and Swiss federal unions also passed through periodical constitutional crises. However, for dealing with them, their political élites could rely on an agreed constitutional document from which to derive rules, procedures and discourses for managing those crises, a possibility historically precluded to the EU. It is this possibility that is now back on the European agenda because of the euro crisis. The pressure for restarting the Treaty reform process, notwithstanding the many

constraints that would surround it, has indeed increased. After the euro crisis, however, Treaty reform would imply the distinction between the euro area and non-euro area member states, for thus formally constitutionalizing the former area as a democratic federal union. The future of an integrated Europe will be based on a pluralism of institutional and legal arrangements, organizationally distinct and at the same time reciprocally connected within the inclusive framework of the single market. Such a Treaty reform process would have to deal with dramatically intricate legal, institutional and political issues requiring the exercise of political leadership at the highest level.

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## NOTE

- 1 Report by the Committee for the study of Economic and Monetary Union, 17 April 1989, available at [http://aei.pitt.edu/1007/1/monetary\\_delors.pdf](http://aei.pitt.edu/1007/1/monetary_delors.pdf).

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# **After the Euro Crisis: The President of Europe**

## **A new paradigm for increasing legitimacy and effectiveness in the EU**

**Sergio Fabbrini**

**No. 12 / 1 June 2012**

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### **1. The euro crisis and the economic governance of the Lisbon Treaty**

The euro crisis has placed a spotlight on the institutional system of the Lisbon Treaty for the management of fiscal and monetary policy. It would be unfair to say that the European Union has not reacted to the challenges posed by financial markets. The EU has approved two new treaties (the European Stability Mechanism and the so-called 'Fiscal Compact'), in addition to an exceptional number of legislative and regulatory measures. Each of them is, by itself, of great innovative significance, although incapable, individually, of securing the common currency. In the end, the decisions taken have turned out to arrive too late and to be too limited (relative to the quick pace and high stakes of the challenges posed by the financial markets).

Already with the Maastricht Treaty (1992) and later with the Lisbon Treaty (2009), it was officially established that the economic and financial policy of the EU would be defined and regulated within a decision-making regime that was intergovernmental in nature. The defeat of the Constitutional Treaty in the popular referendums held in France and in the Netherlands in 2005, strengthened the intergovernmental approach to the EU. As the former French President Nicholas Sarkozy said in his speech in Toulon on 1 December 2011: "the reform of Europe is not a march towards supra-nationality. (...) The crisis has pushed the heads of state and government to assume greater responsibility because ultimately they have the democratic legitimacy to take decisions. (...) The integration of Europe will go the intergovernmental way because Europe needs to make strategic political choices." One year earlier, on 2 November 2010, on the occasion of the opening ceremony of the 61th academic year of the College of Europe in Bruges, German Chancellor Angela Merkel clearly delivered her view that "the Lisbon Treaty has placed the institutional structure (of the EU) on a new foundation", to the point of making traditional distinctions between the "Community and the intergovernmental methods outdated". Indeed, she added, the EU is already functioning



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according to a “new Union method”, which consists of “coordinated action in a spirit of solidarity”. Thus, with the Merkozy leadership, it came to be believed that integration could develop only if controlled or governed by the national governments represented in the European Council by their leaders (coordinated by the now permanent president of that institution) and in the Council by their functional ministers. Furthermore, once the Union has started to take care of policies traditionally at the core of member states’ sovereignty (e.g. foreign, security, financial and fiscal policy, or electorally sensitive policies, such as employment or welfare), it seemed inevitable to promote, in those policies, an integrative model based on voluntary coordination by member states’ governments, a model necessarily free from supranational constraints. Indeed, this model was already institutionalised in the Maastricht Treaty, thus transferred in the Constitutional Treaty and then finally brought into the Lisbon Treaty.

The Lisbon Treaty has in fact institutionalised a double constitutional regime. In the management of public policies linked to the internal market (which are the majority of policies undertaken by the EU), the Lisbon Treaty prescribes a model of supranational constitution with characteristics that are similar to those of other democratic *unions of states*. Such a constitution sustains and justifies a system of government characterised by a *separation of powers* among the four institutions that participate in the decision-making process (a dual executive constituted by the European Council and the European Commission and a bicameral legislative branch constituted by the European Parliament and the Council). The European Council and the European Parliament have emerged as the strongest institutions of this constitutional setting. At the same time, for policies that have traditionally been sensitive to national sovereignty, the Lisbon Treaty prescribes a model of intergovernmental constitution with characteristics that are very similar to the model adopted by *associations of states*. Such a constitution sustains and justifies a system of governance, rather than a system of government, characterised by the control of decisions by and within the two institutions (the European Council and the Council) that represent the governments of the Union.

## **2. The outcome of the intergovernmental constitution**

The euro crisis – which became worse in Europe at the same time that the Lisbon Treaty entered in force (1 December 2009) – has presented the first test of the crisis management capabilities of the intergovernmental approach. The result has been unsatisfactory. As provided under the Lisbon Treaty, the European Council has been the true decision-making centre for the policies adopted in response to the financial crisis, with the Commission playing a technical role. But this institutional set-up has not been able to overcome the three fundamental dilemmas of the integration process: the dilemma of veto power, the dilemma of enforcement of the agreements and the dilemma of decision-making legitimacy.

If integration is based on the voluntary coordination among national policies and unanimity in decision-making, it should not come as a surprise that this has enormously slowed down the response to the euro crisis. At the same time, the crisis could develop in the first place because the intergovernmental constitution did not prevent Greece from cheating on its commitments under the Stability and Growth Pact. Greece, in turn, was only following the bad example set by Germany and France, which similarly eschewed their obligations in 2003, without paying any cost for their non-compliance. It is hardly surprising that a small state



would not respect commitments that bigger states have openly refused to respect. And, finally, the intergovernmental decision-making process, under conditions of existential crisis in the eurozone, has led to the emergence of a hierarchy within the European Council, with the creation of a German-French directorate in the financial policy of the Union, raising serious issues of legitimacy and accountability. Why should one be surprised that no one less than the outgoing president of the Euro Group would denounce such improper *directoire*?

The two new Treaties are the outcome of the difficulties encountered by the intergovernmental constitution in the management of financial policy. The objectives that were set out under those Treaties could have been attained activating a mechanism (like strengthened cooperation) already established in the Lisbon Treaty. Moreover, the legislative decisions of the so-called 'Six Pack', approved in November 2011, had already defined the policy measures required for strengthening the Stability and Growth Pact. However, the eurozone leaders have decided to make use of two international treaties out of the Union framework not only to neutralise the veto of the UK government but also to overcome the dilemmas of the intergovernmental approach. For example, unanimity is no longer necessary for the Fiscal Compact to enter into force (thus reducing the veto power of each contracting party). Similarly, the powers of third institutions (like the Commission and the European Court of Justice) have been strengthened. Their intervention *vis-à-vis* the contracting party that disrespects the agreement is now quasi-automatic, although this automaticity might be neutralised by a reverse majority of the financial ministers of the ECOFIN. Furthermore the Treaty requires the contracting parties to introduce at the constitutional level (or equivalent) the balanced-budget rule, thus also limiting from within the domestic system the possibilities for non-compliance.

These are important innovations for dealing with the veto and non-compliance dilemmas. However, they also raise new political problems, especially if the new treaties will not be approved by all of the signatory states. Moreover, if recourse to the ECJ is justifiable by the Lisbon Treaty itself, the same cannot be said for the power given to the Commission to intervene automatically with respect to the non-complaint contracting party. Indeed, in the Commission there are some European Commissioners who were nominated by member states that have not adhered to those treaties. It is true that the commissioners should not have any formal relationship of accountability with their own member state. But it is also true that a Commission made up of one commissioner per member state has ended up reflecting not only European but also national preferences or sensibilities. While it is questionable that those innovations will generate effective decisions, it is certain that they will not make decisions more legitimate. In fact, the two treaties exclude from the policy-making process the European Parliament, the institution that represents the voters who will be directly affected by the intergovernmental decisions.

Moreover, the intergovernmental method celebrated by the two treaties will expose the decisions taken to the pressure of the largest and strongest contracting parties (as has happened during the euro crisis). With the result that the citizens of the other contracting parties will come to be *de facto* governed by leaders they had never the chance to elect. Again, why should one be surprised by the fact that Greek citizens protest against the German Chancellor's policies rather than those of the EU authorities – thus deepening the divide between Europeans? Indeed, the intergovernmental approach is meeting a growing opposition in many EU member states. It remains to be seen whether the election of François

Hollande as President of France in May 2012 signals the beginning of a new political cycle characterised by new ideas on the institutional future of the EU. Should that happen, this paper aims to contribute to the debate on those new ideas.

### **3. The institutional challenge: Effectiveness and legitimacy**

The management of the euro crisis, and the new treaties that have emerged from it, show that an intergovernmental EU cannot satisfy the basic requirements of effectiveness and legitimacy. Even if it is perhaps a shared view that it is possible to meet those requirements only by extending the supranational logic to intergovernmental domains, there are still different strategies that might be pursued to move into a supranational framework. One traditional strategy has argued that it is necessary to '*parliamentarise*' the EU. The Commission should be brought back to the centre of the EU system (from which it has been excluded during the euro crisis) and, along with it, the role of the European Parliament should be strengthened as the one institution that confers political legitimacy (through its power to approve or dismiss the Commission) to the Union's executive. The main political parties should propose, on the occasion of the next elections of the European Parliament in 2014, their respective candidate for President of the Commission, transforming those elections into the arena for politicising the policies of the EU. At that point, the task of the European Council and its President would simply be to formalise a decision made by voters and institutionalised by their parliamentary representatives. The EU would have its government (the Commission), capable of acting effectively. At the same time, being the expression of parliamentary elections, the Commission and its President would have the legitimacy to act on behalf of the majority of European voters.

Although this strategy is clear and familiar, is it also plausible? My answer is negative, empirically and normatively. Empirically, at least since the Maastricht Treaty, the Union has gone in a direction incongruent with the parliamentary model. The European Parliament has strengthened itself as institution, but such reinforcement has not implied a parliamentarisation of the Union. The more the European Parliament has increased its powers, the stronger has become the European Council. Although the Lisbon Treaty gives the European Parliament the right to elect the Commission's president, in reality it is the European Council that selects the candidate for the office, leaving the European Parliament little choice but to approve him/her. This predicament makes groundless the claim that the European Parliament should play a central role in deciding the European executive.

Normatively, the Union cannot become of a federal parliamentary system because it is based on states (and their citizens) that are asymmetrically correlated. The normative puzzle the EU has to resolve (in order to survive and consolidate itself) is as follows: How to keep together in a single political system member states with millions of inhabitants and member states with a few hundred thousands of inhabitants. Turning the EU into a parliamentary system means transforming the European Parliament into the institution with the exclusive prerogative 'to form a government'. But if that is so, then the voters of the larger member states will have a much greater weight in determining the outcome than the voters of the smaller member states. Unless, of course, the elections are run on a transnational basis which would require (first) that the main divisions within all member states are between the same parties and (second) that those divisions are politically homogeneous. But this is not the case, nor could it be. In a Union of states, in addition to partisan cleavages, the divisions between

member states and regional areas are the most significant. Furthermore, the different historical national experiences make it improbable that right and left mean the same thing in all the member states, especially when dealing with the constitutive issues of the process of integration.

#### **4. The Union as a separation of powers**

But if this is so, is there an alternative paradigm for making the supranational EU more effective and legitimate? My answer is positive. The supranational EU has become *de facto* a system of separation of powers because the latter is much more congruent with the need to accommodate the asymmetries and differences between its member states. The asymmetries in capabilities and population combined with the differences in culture and language have encouraged the institutionalisation of a decision-making system that diffuses the exercise of decision-making power amongst institutions rather than concentrating it in only one institution (the European Parliament). Certainly, institutional ambiguities have been preserved, rendering in some respects the separation between executive and legislative institutions opaque. It is sufficient to recall that the General Secretary of the Council (a legislative institution) functions as a supportive structure of the European Council (an executive institution). Or that the High Representative for foreign and security affairs (who, as Vice-President of the Commission, is an executive officer) presides over the Council of Foreign Affairs (which is a configuration of the legislative Council, although it has a permanent chair while the other Council's configurations are chaired by the various ministers of the member states holding the six-month rotating presidency of the Union). Notwithstanding these ambiguities, the supranational EU has institutionalised a bicameral legislature, constituted by the Council and the European Parliament.

At the same time, the Union has established a dual executive in the European Council and the Commission, with the two respective presidents representing a two-faced Janus. The institutionalisation, with the Lisbon Treaty, of the European Council has been a key condition to advance the integration process in sensitive policies. With the election of the permanent president of the European Council, the latter has irreversibly been transformed into a decision-making institution. With the *de facto* recognition of the Charter of Rights as the third Treaty constituting (with the Treaty on the European Union and the Treaty on the Functioning of the European Union) the Lisbon Treaty, the judicial review powers of the ECJ have seen strengthened. The euro crisis has thus accelerated the transformation of the European Council into an executive institution. However, the euro crisis has also shown that the president of the European Council might be unfairly exposed to excessive pressure by the heads of state and governments of the larger member states. How can one neutralise that pressure?

If one recognises that the European Council has come to embody the political head of the Union, then, rather than trying to hide or hinder such evolution, it might be more rational to reform the process of selection of its president so as to make its role more effective and legitimate. The effectiveness of the European Council's president would have been stronger (compared to that demonstrated during the euro crisis), if he had benefited from greater decision autonomy with respect to the heads of state and government (especially of Germany and France) who make up the European Council. At the same time, the Commission and its president could have exercised a greater influence if their institutional

role had been constitutionally linked to the other head of the executive, the European Council's president. Thus, in order to avoid new *directoires* in the future, it would be necessary, firstly, to enlarge the election base of the president of the European Council and, secondly, to turn the European Commission into the true support structure of the European Council (instead of the Secretary General of the Council). This might raise fears, on the part of the Commission, that it would be dominated by the heads of state and government of the European Council. But the reverse might also be true, with the Commission able to influence the work of the European Council much more, also because of its more structured organisation. Indeed, in a dual executive, the logic of competition and the logic of cooperation may find an equilibrium point.

## **5. Towards the president of the Union**

If one wants to increase the decision-making autonomy of the president of the European Council from the members of the latter, then it is necessary to give him/her a legitimacy base distinct from them. Of course, in a union of asymmetrical states, it would be unacceptable to promote the direct election of the president by the European voters, for the same reason that it would be unacceptable to give the European Parliament the power 'to form the government'. Any direct election would favour the larger member states to the detriment of the smaller ones. For this reason, the strategy to pursue could be to constitute an *electoral college* through which to reduce the effects of member states' asymmetries.

Here is my proposal. The heads of state or government of the European Council would select two candidates for the position of the institution's president, on the basis of both national and partisan evaluations. The two candidates would then be subject to the vote of presidential electors organised into national electoral colleges. Such colleges could be constituted of representatives of national parliaments, whose composition would reflect the majorities and minorities of national legislatures. The number of presidential electors for each individual member state would be based on population weights, *with a correction favouring small and medium vis-à-vis larger member states*. The two candidates will carry out their electoral campaigns presenting their programmes to the national parliaments of the member states, and inevitably to the latter's publics. The candidate elected president of the European Council will be the one receiving a majority (inevitably absolute in this case) of the votes of the presidential electors in the various national electoral colleges. In this way, the European Council maintains its selection power, but loses its election power. The election power is assigned to national parliaments, thus making the president of the European Council relatively independent from the heads of state and government who constitute that institution. The European Parliament should not play any role in the process because of the need to preserve the institutional separation of powers between executive and legislative institutions at the EU level. The European Council would continue to meet periodically, as prescribed under the Lisbon Treaty, with the purpose of discussing the policy strategies defined by the president. It would also be necessary that the European Council would be re-named European Presidency, thus avoiding misunderstanding with the Council (legislative body) and at the same time underlying its institutional function (executive body).

The operational link between the president of the European Council and the European Commission and its president should be strengthened, transforming the latter into the true operational branch of the former. The European Council's president and the Commission

should meet on a regular (weekly) basis. It would be the Commission's duty, rather than the General Secretary of the Council's, to prepare the periodical meetings of the European Council and to structure its deliberations. The General Secretary of the Council would support the activities of the member state holding the rotating presidency and more in general the legislative activity of the Council. The procedure for the nomination and formation of the Commission's president and commissioners should remain the same, with the European Council's president proposing (with the consent of the majority of the latter's members) the candidates for those roles and the European Parliament to give its 'advice and consent'. Moreover, the Council might also be included in this process (i.e. regarding the approval of commissioners proposed for foreign and security policy or financial policy), once the need to make it a properly legislative institution, thus separated from the European Council, is duly recognised.

The role of the Commission should remain what it is: a powerful civil service organisation operating in the European interest. The Commission should formally maintain the monopoly of legislative initiative in all policy matters (and not only in the policies connected to the single market and now decided according to the so-called Community method), although politically it will have to share this function with the European Council's president. The model of separation of powers would lead to a redefinition, but not the abrogation, of the Community method. In the dual executive, there would be a combination of two legitimacies: i) the legitimacy stemming from national parliaments for the president of the European Council, and ii) the legitimacy stemming from the European Parliament for the president of the Commission. One might assume that the broader legitimacy of the president of the European Council will make him/her the political head of the executive, with the president of the European Commission leading its technical arm.

The European Parliament should become what it is already, namely a legislative institution whose main role is to check and balance the dual executive, but not to 'form the government'. It should be the constitutional duty of the European Parliament and the Council, under its specific configurations, to oversee the dual executive. Thanks to the separation between legislative and executive institutions, the activity of the bicameral legislature will not be constrained by the need to guarantee its political support to the 'government'. Indeed, legislatures are much more powerful in systems of separation rather than fusion of powers. An executive organizationally structured by the Commission and politically directed by the president of the European Council would be more effective and legitimate. However, this strengthening of the executive power would require an adequate supervision and balancing action from the legislative power. In this regard, it might be helpful to go back to a proposal that emerged from the Brussels Constitutional Convention of 2002-03, that is to differentiate the policies on which each legislative institution will have a pre-eminent role in oversight, leaving to the Council the control of those policies that are particularly sensitive to the member states (e.g. foreign, security and financial policies) and the rest to the European Parliament.

## **6. The constitutional challenge: How many treaties?**

With the multiplication of treaties, it would be also necessary to open a debate to discuss whether the Union should preserve a unitary character or whether it should institutionally differentiate itself. There are two strategies to follow. The first strategy would be that of

accelerating the transposition of the new treaties (especially the Fiscal Compact) into the EU legal system. Once the main objective has been reached (that of making the signatory states introduce, through constitutional or equivalent means, the golden rule of balanced budgets), the Fiscal Compact should become part of the Lisbon Treaty, assuming the characteristics of a constitutionalised enhanced cooperation not unlike that attained with the Schengen Treaty. The integration process would be regulated by a single legal framework, with functional internal differentiations relative to specific policies. This strategy has the merit of keeping the Union together, but also has the fault of keeping the integration process at the minimum common denominator. This might increase the dissatisfaction towards the Union from those who would seek more integration, without conquering the consensus of those asking for less. Furthermore, if not reformed, an intergovernmental Fiscal Compact, included into the Lisbon Treaty, would end up strengthening the latter's intergovernmental component constitution, thus preserving the situation that made crisis management wholly unsatisfactory.

The second strategy would be to build on the institutional differentiation introduced by the new treaties, notably the Fiscal Compact. The reform proposals that I have outlined might be applied to the latter treaty, supranationalising it through the separation-of-powers architecture described earlier: namely by changing the election procedure for the president of the Euro Summit; by deepening the cooperation between the latter and the Commission; by redefining the Euro Group as a legislative institution; by strengthening the balancing powers of the European Parliament over the dual executive. In this manner, two different European polities would be constituted, both with supranational character but with different aims: the economic Europe and the political Europe. With the latter clearly structured according to the logic of separation of powers in order to better guarantee effectiveness and legitimacy to its decisions.

IL FUTURO DELLA UE

*Ecco come far convivere Londra e Bruxelles*

Sergio Fabbrini ▶ pagina 25

# Ecco come far convivere Londra e Bruxelles

La soluzione in due Trattati: uno del mercato unico (per l'integrazione economica), l'altro per l'unione politica

**Rieletto** David Cameron ha vinto le elezioni britanniche conquistando la maggioranza assoluta di 330 voti. L'ultimo giorno di campagna elettorale si è svolto nella sua tenuta di campagna a Blenheim Palace il 10 maggio.



**La sfida. Per David Cameron non si tratta di far uscire il Paese dalla Ue ma di contribuire alla differenziazione costituzionale di quest'ultima.**

di Sergio Fabbrini

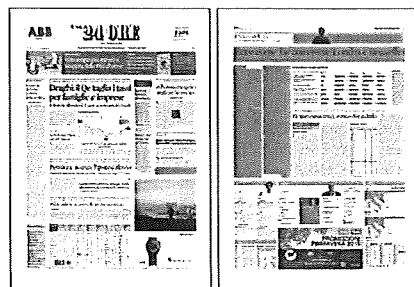
**C**i sono due treni che stanno andando l'uno in direzione dell'altro. Il primo è il treno della Gran Bretagna (GB), il secondo è quello dell'Unione Europea (UE). Il guaio è che stanno viaggiando a velocità sostenuta sullo stesso binario. Dopo lo straordinario successo elettorale del partito conservatore, il nuovo governo di David Cameron si è formalmente impegnato ad indire un referendum sulla partecipazione britannica all'UE entro il 2017, il cui esito sarà quello di allargare la distanza tra il paese e il continente. A loro volta, le autorità dell'UE, la Commissione in particolare, continuano a pensare che l'uscita della GB (il cosiddetto "Brexit") sia poco probabile, visti i densi interessi economici e commerciali che collegano la GB agli altri 27 membri dell'UE. Se il treno britannico è guidato dalla politica interna del paese, il treno dell'UE è guidato dalla logica interna ai suoi apparati. Se continua così, è difficile che i due macchinisti possano intendersi per evitare l'impatto.

La GB è in rotta di collisione con l'UE da molto tempo. Sicuramente dal Trattato di Maastricht del 1992 quando, per consentire ai paesi dell'Europa continentale di dare vita all'Unione Economica e Monetaria (UEM) che avrebbe gestito la moneta comune, riuscì ad ottenere un "opt-out" da quest'ultima (cioè la possibilità di non adottarla). Da allora, per la GB, gli "opt-out" si sono moltiplicati. Non fa parte degli accordi di Schengen sulla libera circolazione delle persone nel territorio dell'UE. Non è costretta ad adottare decisioni prese a maggioranza qualificata nel campo della cooperazione giudiziaria e di polizia ai fini del contrasto alla criminalità. Per ottenere la sua firma al Trattato di Lisbona del 2009, la GB è stata esonerata dal rispettare la Carta dei Diritti Fondamentali costitutiva di quel Trattato, sottraendosi così alla giurisdizione della Corte Europea di Giustizia in materia. Nel luglio del 2011, il parlamento di Westminster ha approvato una legge (European Union Act) che impone a qualsiasi governo britannico di indire un referendum ogni volta si verifichi un trasferimento di competenze dagli stati al centro dell'UE. Naturalmente, la GB non è l'unico paese che beneficia di opt-out, né è l'unico che si oppone ad un rafforzamento di

Bruxelles a svantaggio delle capitali nazionali. Tuttavia, è il paese che con più determinazione e consistenza ha perseguito una precisa linea sin dalla sua adesione all'UE nel 1973. Secondo la GB l'integrazione dovrebbe avere un carattere esclusivamente economico, evitando di intaccare le proprietà essenziali della sovranità nazionale. La decisione di David Cameron di indire un referendum nel 2017 deriva da una diffidenza diffusa del paese nei confronti dell'integrazione così come si è venuta sviluppando dopo Maastricht. La crescita impetuosa dell'UKIP di Nigel Farage ha radicalizzato quella diffidenza, ma non l'ha creata.

È evidente che un'uscita della GB dall'UE (e dal mercato unico) avrebbe costi molto alti per l'economia del paese. Ma oltre ai costi economici, quell'uscita porterebbe con sé anche alti costi politici. Certamente, vi sono paesi (come la Svizzera, la Norvegia, l'Islanda o il Liechtenstein) che partecipano al mercato unico pur non essendo membri dell'UE. Nel caso svizzero, ciò avviene attraverso accordi settoriali e bilaterali. Nel caso degli altri tre paesi, che insieme costituiscono la "European Economic Area", ciò avviene attraverso rapporti strutturati tra quest'ultima e l'UE. Il punto è che, in entrambi i casi, i paesi in questione debbono adottare la legislazione dell'UE per potere operare nel mercato unico, senza però contribuire ad influenzarla in quanto esterni alle istituzioni dell'UE. È poco plausibile ritenere che simili soluzioni possano essere adottate per regolare i futuri rapporti tra l'UE e la GB. Un paese dell'importanza della GB non potrà limitarsi a recepire al proprio interno la legislazione approvata al suo esterno. Se la GB non ha mai chiarito a sé stessa quale ruolo vuole avere in Europa, la diffidenza britannica è stata però regolarmente minimizzata dalle autorità dell'UE. I vertici e la tecnocrazia della Commissione hanno continuato a sostenere che l'integrazione è un processo unitario e inclusivo, anche se i singoli paesi possono adottare tempi diversi per raggiungere il fine condiviso. In realtà la GB (e con essa diversi paesi dell'est e del nord dell'Europa) persegue una finalità diversa da quella dei paesi dell'Europa continentale e occidentale. Una finalità che è inconciliabile con l'approfondimento del processo di integrazione che si è verificato all'interno dell'UEM.

Se così è, per evitare che i due treni si



scontrino, occorre avviarli su binari diverse. Tale smistamento si può fare solamente con una differenziazione dei trattati. Il processo di integrazione europea ha raggiunto una tale complessità che non è più gestibile con il paradigma funzionale del passo dopo passo. È necessario definire contestualmente un Trattato del mercato unico (inclusivo di tutti i paesi europei interessati esclusivamente all'integrazione economica) ed un Trattato dell'unione politica (basato esclusivamente sui paesi dell'eurozona). Il primo può coincidere con il Trattato di Lisbona alleggerito di quelle competenze che non sono collegate al funzionamento del mercato interno. Il secondo dovrebbe invece istituzionalizzare il processo verso un'unione sempre più stretta, come celebrato dal Trattato di Roma del 1957. In questo modo, per la GB, non si tratta di uscire dall'UE ma di contribuire alla differenziazione costituzionale di quest'ultima.

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# Un political compact per l'Europa

Per Sergio Fabbrini la molteplicità va risolta con un nuovo ordine politico

**Errore di metodo. Nell'analisi sulle difficoltà dell'euro si rinuncia a evidenziare la fragilità delle fondamenta istituzionali europee**

## LA RIFLESSIONE

Fabbrini elabora un'architettura, sulla carta ben equilibrata, in cui il carattere della condivisione di sovranità varia a seconda del potere che deve essere esercitato  
di **Carlo Bastasin**

**D**opo sette anni di crisi finanziaria, sappiamo che le istituzioni europee - e perfino le democrazie nazionali - stanno modificandosi per adattarsi a un lungo processo improvvisato di soluzioni sotto la pressione di problemi dotati di impellenza e di minacce esiziali. Alexander Hamilton si chiese se mai gli uomini sarebbero stati in grado di organizzare un buon sistema di governo in base alla loro immaginazione e discernimento, anziché far discendere le loro costituzioni dalle crisi e dalla violenza. Finora, non c'è stata sufficiente riflessione, né discernimento, sulla destinazione del progetto europeo.

In "Which European Union?", Sergio Fabbrini si pone analiticamente di fronte alla domanda su quale Europa stia emergendo. E offre una sua originale proposta. Secondo Fabbrini, direttore della School of Government della Università Luiss, l'Unione europea è sempre stata composta da più progetti di unione di diversa natura, la cui problematica coesistenza è emersa con forza nel corso della crisi e ha prodotto conseguenze ambigue in termini di efficacia e trasparenza delle decisioni. Nel corso dei decenni passati, prospettive diverse dei Paesi membri (comunità economica, unione intergovernativa o unione parlamentare) avevano dato luogo a compromessi nell'edificazione del progetto europeo, ciò ha prodotto torsioni nelle proprietà istituzionali dell'Unione europea. Queste torsioni si sono accentuate e sono arrivate vicine al punto di rottura durante la crisi.

La molteplicità va ora risolta attraverso un nuovo ordine politico: un'unione federale di Stati che si basi sulla distinzione tra Paesi euro e non-euro e che fondi l'unione più stretta dei primi su un accordo esplicito, un "political compact" basato sulla separazione dei poteri, secondo un modello di democrazia composita che richiama il linguaggio di James Madison.

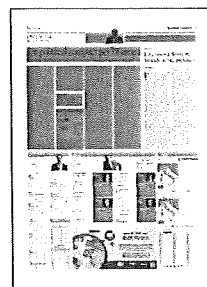
Il primo passaggio è quello dunque di scandire istituzionalmente la divisione - di fatto e di preferenze politiche - che si è sviluppata tra Paesi euro e non-euro durante la crisi. In questo quadro bisogna

accettare che l'interesse dei paesi esterni all'euro sia di semplificare le regole del Trattato di Lisbona che rappresentano una base legale troppo stringente per presiedere alla sola ordinata partecipazione al mercato unico a cui quei paesi sono primariamente interessati. Si tratta di un passaggio critico per chi è fedele alla definizione del progetto europeo di un'unione sempre più stretta - e anche per chi osserva crescere la prospettiva della politica estera e di difesa europea - ma la vicenda politica e la specifica incertezza del futuro europeo della Gran Bretagna portano Fabbrini a considerare una soluzione ordinata alla tentazione di distacco di alcuni Paesi.

Una volta accomodata la separazione, sarà possibile risolvere le ambiguità che fin dal Trattato di Maastricht caratterizzano l'ordine politico europeo, rappresentando i Paesi euro dentro un modello originale e comprensivo di unione "composita". In realtà la tradizionale contraddizione tra elementi intergovernativi e sovranazionali non viene cancellata, ma risolta assoggettandola a un principio ordinativo superiore, quello della separazione dei poteri. Fabbrini elabora quindi un'architettura, sulla carta ben equilibrata, in cui il carattere della condivisione di sovranità varia a seconda del potere che deve essere esercitato. Il potere esecutivo in particolare si basa sul riconoscimento del ruolo del Consiglio europeo (i capi di governo dei singoli Stati), ma sotto la guida e gli ampi poteri di un presidente, una specie di capo di governo dei governi. Alla Commissione europea farebbe capo il compito di implementazione delle decisioni del Consiglio.

Fabbrini resiste alla sensazione, che molti di noi hanno, di denunciare un arretramento anche morale rispetto a quando l'Europa poteva essere intesa, come direbbe Habermas, come il passo più avanzato nella storia umana lungo la strada di una società mondiale politicamente costituita. Come il luogo kantiano della legge e dell'orientamento cosmopolita, una teleologia ritrovata dopo l'offuscamento di un'era barbara e belligerante. L'autore ritiene che si debba invece prendere atto di attitudini culturali distinte che stanno allontanando alcuni paesi. Ciò sottintende che le divisioni politiche tradizionali, destra e sinistra, e quindi la parlamentarizzazione della Ue, non possano risolvere il tema europeo.

È una premessa forte per chi invece ritiene che le attitudini non rappresentino



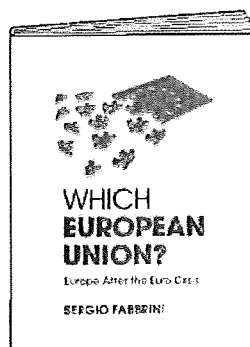
radici secolari inestirpabili, ma una declinazione di interessi rispettabili da comporre attraverso i giusti incentivi in un interesse comune. Il carattere economico della crisi inoltre ha evidenziato la forza di preferenze dei cittadini "decentrate" rispetto al controllo dei governi. Si pensi al rischio di fuga dei capitali o di corsa ai depositi bancari (avvenuta perfino in Germania). Queste "attitudini" sono per loro natura variabili.

Più in generale, tuttavia, Fabbrini riesce ammirevolmente a denudare l'errore di metodo che tutti tendiamo a compiere nell'analisi della crisi, quando rinunciamo a evidenziare analiticamente la fragilità delle fondamenta istituzionali dell'edificio europeo. Il primo errore è tipico degli economisti che, adottando modelli dinamici di equilibrio generale, danno per scontato un ritorno all'equilibrio. Gli errori sono al più "disturbi" statistici, le incoerenze di sistema sono "ritardi". Questa forma poco sofisticata di storicismo corrisponde a quello di politologi che danno per scontata la convergenza politica di tutti i paesi verso un'ever closer Union o verso la fine dell'Europa. Sottostante c'è una pigrizia ideologica, le cui finzioni analitiche entrano nel linguaggio comune e vengono sfruttate dai governi per elaborare narrazioni della crisi che difendono l'esistente, aggirando la necessità di riscrivere i limiti dei loro poteri in Europa.

Fabbrini rompe l'inerzia che trattiene tanti intellettuali dall'allontanarsi dalla costa. Non entrerà nel dettaglio dell'analisi, la cui profondità è inconsueta. Ma "Which European Union?" scandisce il processo storico istituzionale europeo fino a rivelarlo in modo inedito. Il volume organizza analisi precedenti di Fabbrini di cui molti osservatori - per primo chi scrive - hanno approfittato nei loro lavori recenti. La crisi viene descritta come coesistenza problematica delle diverse unioni che convivono all'interno dell'ordine legale e istituzionale europeo, Fabbrini ne svela le contraddizioni a ogni plesso decisionale.

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## IL VOLUME



**Sergio Fabbrini,**  
*Which European Union?*  
*Europe After the Euro Crisis,*  
Cambridge University Press,  
384 pagine

Il volume, scritto dal direttore della School of Government della Università Luiss, scandisce il processo storico europeo fino a rivelarlo in modo inedito e descrive la crisi come coesistenza problematica delle diverse unioni che convivono all'interno dell'ordine legale e istituzionale europeo.

# Un leader e un patto politico per un'Europa «all'americana»

## L'euro-crisi ha fatto danni come una guerra Ripariamoli con una nuova Costituzione

**Scenari** Un percorso per rifondare le istituzioni di Bruxelles nell'analisi di Sergio Fabbrini, che ha in mente di sganciare la comunità economica dall'alveo dell'unione federale e di disegnare, per la seconda, un sistema di poteri più simile a quello degli Stati Uniti

**Conflitti paralizzanti** L'ostacolo maggiore sono le divergenze fra gruppi di Stati circa la destinazione finale del cammino intrapreso dall'Unione

di MAURIZIO FERRERA

In un articolo apparso sul «New York Times» nell'aprile 2014, l'ex consigliere economico del presidente della Commissione europea Barroso, Paul Legrain, sostenne una tesi forte: in Europa vige ormai un regime di «colonialismo fiscale». I Paesi più forti (e la Germania in particolare) hanno messo sotto tutela finanziaria i Paesi più deboli. In effetti, i vincoli fiscali, le regole di sorveglianza e le minacce di sanzione introdotte durante la crisi hanno dato vita a una inedita forma di «democrazia vigilata», che non ha quasi paragoni sotto il profilo storico o comparato.

La clausola del *no bail-out* (divieto di salvataggio) in caso di insolvenza esiste in tutti i sistemi federali. Gli Stati americani sono individualmente responsabili per eventuali default e quasi tutti hanno nella propria Costituzione l'obbligo del pareggio di bilancio. In apparenza, la situazione è simile a quella dell'Eurozona. Ma la realtà è molto diversa. Negli Usa infatti esiste un bilancio federale che finanzia investimenti pubblici ed eroga trasferimenti agli Stati, in modo da stabilizzare le loro economie e promuovere la crescita. È questo secondo elemento che manca oggi, drammaticamente, in Europa. Bruxelles non dispone di risorse proprie per far fronte a shock asimmetrici. Quando questi si verificano (l'euro-crisi) l'unica possibilità è che i Paesi più ricchi prestino soldi a quelli in difficoltà. Non per aiutarli a crescere, ma per consentire loro di ripagare i debiti; non per solidarietà, ma per interesse. Dove questo sistema ci ha condotti è ormai sotto gli occhi di tutti: stagnazione economica, risentimento sociale e radicalizzazione politica.

L'ultimo libro di Sergio Fabbrini, *Which European Union?* (da poco uscito per

la Cambridge University Press), ci aiuta a capire le ragioni profonde della crisi Ue e a individuare possibili vie di uscita. Fabbrini è un noto e autorevole comparatista, grande conoscitore dei sistemi politici europei e di quello statunitense. La Ue — questa la sua tesi centrale — non potrà mai diventare un super-stato, dotato di un governo centrale monocratico. Può solo evolvere verso un «unione federale» caratterizzata da una molteplicità di centri decisionali che si controbilanciano. Questo tipo di regime politico può sicuramente funzionare in modo efficace. Ma solo a patto di possedere alcuni requisiti che la Ue ancora non ha.

A differenza degli Stati federali (che si formano per disaggregazione dal centro: ad esempio Belgio o Spagna, per certi aspetti ormai anche l'Italia), le unioni federali nascono dal basso, attraverso l'aggregazione di comunità politiche preesistenti. Gli esempi paradigmatici sono gli Stati Uniti e la Svizzera. I popoli (al plurale) americani divennero membri di una unione con la Dichiarazione d'indipendenza del 1776, cui seguì la Costituzione federale approvata a Filadelfia nel 1789. A loro volta, i cantoni svizzeri — per secoli collegati in una lasca confederazione — costituirono una vera e propria unione solo nel 1848, dotandosi di un testo costituzionale condiviso.

Le unioni federali sono sistemi composti (*compound*). Il termine fu coniato da James Madison durante la Convenzione di Filadelfia per sottolineare un'esigenza fondamentale: garantire ciascuna entità dell'Unione contro la possibile tirannia della maggioranza. Perciò la Costituzione americana (come del resto quella svizzera) disegnò un assetto istituzionale radicalmente anti-centralista. A livello orizzontale, i poteri del governo di Washington sono divisi fra istituzioni diverse (Presidenza, Congresso, Corte Su-

prema); a livello verticale, il potere è accuratamente diviso fra centro federale e Stati. Certo, il carattere composito di questo assetto può dar luogo a incoerenze e stalli decisionali. Ma l'esperienza americana dimostra che è possibile mantenere equilibri efficaci fra poteri e competenze: nell'esempio da cui siamo partiti, *no bail-out* degli Stati, ma responsabilità federale per la crescita.

Il processo di integrazione europea può essere visto come cammino graduale verso un'unione federale. Ma è stato un cammino più tortuoso e meno «pulito» di quelli svizzero e statunitense, soprattutto a causa delle divergenze fra gruppi di Stati circa la destinazione finale.

Per un primo gruppo, guidato dal Regno Unito, con i Paesi nordici e, in buona misura, quelli centro-europei, la Ue deve limitarsi a essere una comunità economica, un grande spazio per gli scambi di mercato. Londra non vuole sentir parlare di federalismo. Durante i negoziati per il Trattato costituzionale europeo, nei primi anni Duemila, gli inglesi si rifiutavano persino di pronunciare quella parola e usavano un'abbreviazione dispregiativa: *the f-word*. Per i Paesi continentali, la Ue deve invece trasformarsi in una vera unione federale. Ma all'interno di questo gruppo si oscilla fra due possibili modelli: quello dell'unione parlamentare, ossia, *mutatis mutandis*, una democrazia rappresentativa modellata sull'esperienza degli Stati nazionali; e quello dell'unione intergovernativa, cioè una forma di cooperazione stabile fra governi nazionali su alcune politiche strategiche. Tradizionalmente, Germania e Italia erano schierate a favore del primo modello, la Francia del secondo.

Fabbrini osserva giustamente che i tre tipi di unione coesistono oggi l'uno accanto all'altro in maniera confusa e incoerente. Il Trattato di Lisbona (2009) ha

cercato di fare un po' d'ordine, ma senza riuscirci fino in fondo. Quel che è peggio, durante la crisi i Paesi dell'Eurozona hanno rafforzato la cooperazione intergovernativa (vedi il *fiscal compact*, un trattato separato da Lisbona per il governo macro-economico dell'Eurozona), rendendo il sistema ancora più complesso.

Che fare? Fabbrini propone una tripla ricetta: separare, ricomporre, connettere. Innanzitutto, prendere atto delle divergenti finalità fra i due gruppi di Paesi ed estrarre la comunità economica dall'alveo dell'unione federale, delineando per la prima un sistema di gestione semplice e leggero. Poi si deve ridisegnare l'architettura dell'Unione, ricomponendo le tensioni fra modello parlamentare e intergovernativo. Qui Fabbrini ha in mente un ordinamento «all'americana», imperniato su un euro-esecutivo duale (Presidenza del Consiglio europeo e Commissione), due euro-assemblee rappresentative (Parlamento e Consiglio dei ministri) e la Corte di Giustizia. Infine, occorre connettere la comunità economica allargata all'unione federale più ristretta, per il tramite di un qualche accordo flessibile.

Il cuore della proposta di Fabbrini sta naturalmente nel «ricomporre». Giustamente l'autore sostiene che l'unione federale deve nascere attraverso un solenne patto politico (*political compact*) fra gli Stati contraenti e l'adozione di una nuova Costituzione. Una grossa sfida, che richiede «leadership politica della più alta qualità», capace di gettare il cuore oltre l'ostacolo. Il volume è interessantissimo nel suo complesso, originale e persuasivo nella diagnosi, ricco di spunti (anche se da approfondire) nella prescrizione. Ma lascia il lettore con il fiato sospeso. Da dove verrà mai la leadership indispensabile per uscire dall'attuale disordine?

Diciamolo chiaro, nei due unici esempi storici di cui disponiamo, la leadership emerse a seguito di guerre: quella di indipendenza in America e quella del *Sonderbund* (fra cantoni cattolici e protestanti) in Svizzera. La crisi dell'euro ha avuto effetti simili a quelli di un evento bellico su vasta scala, ma la leadership di qualità non è (ancora?) emersa. L'instabilità politica e militare sui fronti Est e Sud dell'Europa generano crescenti problemi di sicurezza, ma certo nessuno si augura una guerra. Leader cercansi disperatamente: questo è il messaggio di quasi tutti gli studi che si pubblicano oggi sull'Europa. Guardando i giri di valzer ormai quotidiani fra Merkel, Hollande, Juncker e gli invitati di turno, a noi cittadini tocca, finché riusciamo, restare in apnea.

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**Il tema**

Si parla del futuro dell'Ue in molti libri recenti: Giuliano Amato, Ernesto Galli della Loggia, *Europa perduta?* (il Mulino, 2014); Luigi Zingales, *Europa o no* (Rizzoli, 2014); Barbara Spinelli, *La sovranità assente* (Einaudi, 2014); Giacomo Vacago, *Un'anima per l'Europa* (il Mulino, 2015)







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# Rebalancing the governance of the euro area

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## Abstract

Alongside the setting-up of a crisis management regime and the creation of a banking union, the strengthening of economic governance has been a major pillar of the European Union's response to the eurozone crisis. Between 2010 and 2014, the Economic and Monetary Union (EMU) was the subject of a series of reforms, more than ever before in such a short time span. Yet, two years after this major legislative effort, few policy-makers would dare to claim 'mission accomplished'. This paper outlines and discusses alternative possible directions for the reform of euro area's economic governance. To this end, the reforms introduced in recent years, as well as the main shortcomings of the resulting policy system, are briefly reviewed. The paper then proceeds with a presentation and analysis of alternative templates for governance reform and concludes with proposals for a practical agenda.

Keywords: crisis management, economic governance, European Union, Economic and Monetary Union, reform



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## Résumé

Depuis 2010, la gouvernance de la zone euro a fait l'objet de plusieurs réformes : institution de la Troïka FMI-Commission-BCE, création du Mécanisme européen de stabilité (MES), adoption des paquets législatifs dits Six-Pack et Two-Pack, nouveau Traité sur la stabilité, la coordination et la gouvernance (TSCG), mise en place enfin d'une union bancaire. Jamais, dans l'histoire de l'UE, autant de réformes n'avaient été introduites en si peu de temps. Peu de responsables jugent pourtant qu'il suffit désormais de cueillir les fruits de cet effort. En octobre 2014, les chefs d'État et de gouvernement de la zone euro sont convenus de la nécessité de développer des « mécanismes concrets » pour renforcer « la coordination des politiques économiques, la convergence et la solidarité ». Un rapport des quatre présidents (Commission, Conseil, BCE et Eurogroupe) doit présenter des propositions. L'objet de cet article est de recenser ce qui a été accompli, d'évaluer les déficiences qui subsistent dans le système de gouvernance économique, de discuter les modèles alternatifs d'organisation de la politique économique en zone euro, et enfin de formuler des propositions concrètes pour l'avenir.

La réforme de la gouvernance de la zone euro s'est déployée sur trois fronts : le renforcement de la surveillance préventive dans les domaines budgétaire, économique et macro-financier ; la création d'un régime de gestion des crises souveraines ; et l'intégration de la supervision des banques et de la résolution de leurs crises. Si l'Union a été audacieuse sur les deux derniers points, elle l'a été sensiblement moins en matière de prévention des crises : la réforme de la surveillance a essentiellement consisté en un renforcement du Pacte de stabilité et de croissance (PSC), complétée par la création de mécanismes de surveillance macro-économique.

Le système résultant de ces initiatives souffre de plusieurs défauts :

- une complexité excessive, qui contribue à faire obstacle à son appropriation par les décideurs nationaux. Le volume de la législation secondaire relative à la gouvernance économique de la zone euro a triplé entre 2008 et 2014 ;
- le maintien d'un biais pro-cyclique dans l'orientation de la politique budgétaire. Ce biais, ancien, n'a été contredit qu'en 2009. Dès 2010, l'orientation budgétaire d'ensemble de la zone euro est redevenue pro-cyclique. Pour l'avenir, on peut craindre que la mémoire des crises souveraines conduise à une insuffisance de stabilisation en période de ralentissement ;
- un écart d'effectivité entre la surveillance budgétaire et la surveillance macro-économique, que la création de la procédure pour déséquilibres macro-économiques excessifs n'a pas réussi à combler. Cette procédure souffre de son asymétrie (les excédents extérieurs sont jugés plus graves que les déficits) et du caractère indirect de la relation entre instruments et objectifs de politique économique ;

- la persistance du syndrome OHIO (*Own House In Order*) au gré duquel l'intérêt collectif de la zone euro est servi au mieux quand chaque État mène, pour ce qui le concerne, une politique orientée vers la stabilité. L'intérêt collectif de la zone euro demeure mal pris en compte et ceci a des inconvénients notables en matière de gestion de la demande (absence de capacité budgétaire commune), de coordination des réformes et de relations avec le reste du monde ;
- des institutions faibles. Seule la BCE est sortie renforcée de la crise, tandis que la Commission a été affaiblie, notamment par la création du MES, et que l'Eurogroupe souffre de n'avoir pas bien rempli son rôle de prévention et de s'être fait déposséder d'une partie de ses responsabilités par les chefs d'État et de gouvernement.

Les discussions sur l'avenir de la zone euro tendent à se centrer sur le point de savoir s'il convient de réviser les traités. La question sera importante pour l'avenir, mais dans l'immédiat l'attention devrait davantage porter sur la direction dans laquelle la zone euro doit évoluer. Trois modèles de son avenir coexistent en effet :

- un modèle décentralisé correspondant à une union monétaire minimale, sans solidarité budgétaire ou financière et sans dispositifs élaborés de surveillance des politiques nationales, mais dotée de mécanismes de résolution des crises souveraines et de limitation de leurs conséquences sur le système financier. Peu réaliste tant politiquement que financièrement (parce qu'il suppose un beaucoup plus faible endettement des États), ce modèle présente néanmoins l'intérêt d'être logiquement cohérent et offre à ce titre un point de repère utile ;
- un modèle fédéral au gré duquel la zone euro se doterait graduellement d'un budget spécifique et d'un système de gouvernance organisé autour de la Commission, avec pour pendant un contrôle par le parlement européen. Plutôt que sur des mécanismes de coordination, la zone euro évoluerait vers une délégation de certaines fonctions économiques au niveau central, en matière de stabilisation notamment. Ce modèle souffre d'avoir perdu de sa crédibilité dans le contexte politique actuel de montée de l'euroscpticisme, mais aussi de ne pas offrir de réponse au problème que la qualité du fonctionnement d'une zone monétaire dépend moins du degré de centralisation des décisions que de la cohérence entre politiques nationales et objectifs communs. En d'autres termes, la fédéralisation n'éliminerait pas le besoin de coordination ;
- un modèle hybride, qui prenne appui sur l'existant pour combiner plus de centralisation dans certains domaines et, dans d'autres, à la fois plus de décentralisation et plus de prises en compte dans les décisions nationales des contraintes qu'implique la participation à une monnaie commune. C'est ce modèle qu'il s'agit de construire.

En matière de finances publiques, il est souhaitable de simplifier le système de surveillance en favorisant la décentralisation de la responsabilité budgétaire. Cette direction a déjà été prise avec la création, requise par le TSCG, de comités budgétaires indépendants (en France, le Haut Conseil des finances publiques). L'évolution doit être poursuivie : ces conseils devraient voir leur responsabilité élargie aux prévisions de recette, à l'évaluation du

coût des mesures législatives et à l'analyse de la soutenabilité des finances publiques ; ils devraient s'organiser en réseau, autour d'un conseil similaire pour l'ensemble de la zone euro ; et l'Union devrait inciter les États à accroître leur rôle en donnant, dans le cadre du Pacte de stabilité, plus de marges de manœuvre aux pays dotés d'institutions crédibles et effectives.

Des conseils de compétitivité devraient être mis en place sur le même modèle pour évaluer, dans chaque pays, l'évolution de la compétitivité relative et les déséquilibres extérieurs. Ces conseils, qui devraient également fonctionner en réseau, pourraient utilement formuler des recommandations à l'échelle nationale sur la formation des salaires et des prix, ainsi que sur la compétitivité hors-coût.

En matière de solidarité, il est souhaitable de compléter le dispositif actuel qui est marqué par une très forte discontinuité entre l'état d'autonomie et l'état de sujétion des pays sous programme Troïka. Il faudrait aller vers un système plus graduel qui permette à un pays de bénéficier plus précocement du soutien de ses partenaires, soit sous la forme de prêts à conditionnalité allégée, soit sous la forme d'un accès à une tranche d'emprunt bénéficiant d'une garantie mutuelle. Naturellement, une telle facilité devrait avoir de strictes contreparties en matière de discipline budgétaire, notamment un droit de veto des partenaires sur les budgets des pays qui y auraient recours.

Une capacité budgétaire commune doit surtout être envisagée comme un instrument de réponse à des situations d'urgence macro-économique ou financière, et non comme un instrument de stabilisation. Il importe notamment de ne pas faire reposer la réponse à des risques économiques sur la seule politique monétaire. On peut concevoir que cette capacité budgétaire repose soit sur la coordination (avec, dans ce cas, un mécanisme de décision), soit sur une capacité commune d'emprunt.

Enfin la réforme de la zone euro devra également concerner les institutions. Le système actuel, qui voit coexister une Commission disposant de moyens humains et un Eurogroupe qui en est dépourvu, n'est pas un état stable. Soit on évolue vers une présidence fixe de l'Eurogroupe, qui appellera inévitablement le développement d'une structure administrative de soutien et donc une gouvernance à deux têtes ; soit on adopte le modèle en vigueur pour les affaires étrangères et l'on confie au Commissaire ECFIN la présidence de l'Eurogroupe, ce qui impose évidemment qu'il ne soit plus chargé de l'instruction des dossiers de surveillance des États. Selon le modèle qui sera choisi, différentes procédures de contrôle démocratique devront être mises en place.





# Rebalancing the governance of the euro area

Jean Pisani-Ferry<sup>1</sup>

## Introduction

Alongside the setting-up of a crisis management regime and the creation of a banking union, the strengthening of economic governance has been a major pillar of the European crisis response. Between 2010 and 2014, the Economic and Monetary Union (EMU) went through a series of reforms: the introduction of cooperation between the International Monetary Fund (IMF), the European Commission, and the European Central Bank (ECB) in the monitoring of financial assistance (the Troika); the creation of the European Stability Mechanism (ESM), the euro area's financial assistance arm but also a genuinely new institution; the adoption of the Six-Pack and Two-Pack legislative packages that aim at strengthening and broadening the surveillance apparatus; the further agreement of a new Treaty on Stability, Coordination and Governance (TSCG), whose main provisions strengthen the participating countries' commitment to fiscal discipline; and last but not least, the initiation of a banking union among euro area countries. Never before in the history of the European Union (EU) had so many reforms been introduced within such a short time span.

Two years after this major legislative effort was completed, however, few policymakers would dare to claim 'mission accomplished'. In his first speech to the European Parliament Jean-Claude Juncker, then still candidate to the presidency of the Commission, pledged to 'continue with the reform' of the EMU, taking inspiration from the 2012 report of the four presidents (van Rompuy et al. 2012), and from the Commission's 2012 'Blueprint for a deep and genuine EMU' report (European Commission 2012). Mario Draghi, the president of the ECB, has also emphasised the incompleteness of the EMU. In a speech in July 2014, he underlined the case for 'some form of common governance over structural reforms... because the outcome of structural reforms is not merely in a country's own interest [but] in the interest of the Union as a whole' (Draghi 2014a). And in his Jackson Hole speech of 22 August 2014 (Draghi 2014b), he called for 'a discussion on the overall fiscal stance of the euro area', thereby breaking with the tradition of considering fiscal matters on a country-by-country basis only.

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(1) France Stratégie, Paris, and Hertie School of Governance, Berlin. I am grateful to Paul Berenberg-Gossler for effective research assistance as well as to Vincent Aussilloux and Arthur Sode for comments on an earlier version. This paper was prepared for the Hertie School Governance Report (forthcoming Oxford University Press, 2015).

Academics and observers have also contributed to the discussion, as various groups and individuals put forward a series of blueprints for a genuine EMU (see Enderlein et al. 2012; Allard et al. 2013; Glienicker Gruppe 2013; Eiffel Group 2014; Piketty and Rosanvallon 2014; Vallée 2014; Pickford, Steinberg, and Otero-Iglesias 2014; Enderlein and Fritz-Vannahme 2014) that combine in various proportions ingredients for further integration and discuss their institutional implications. Different protagonists have different perspectives on what should be added to the existing framework. Fiscal union, a common budget, a common fiscal backstop to bank crisis resolution, a sovereign debt resolution procedure, the coordination of structural reforms, and labour mobility are among the most frequently mentioned additions to the existing set-up. As the assignment of new and extensive powers to the euro area level is hardly imaginable without strengthened accountability procedures, the authors of these proposals also discuss the reforms of the euro area governance system that would need to accompany it.

At the other end of the spectrum, other observers contend instead that Europe has already gone too far and that adding further competences to those already transferred to the euro area level would be an illusory solution (Mody 2013). They rather recommend dismantling the existing web of surveillance procedures and simplifying the existing architecture radically, putting emphasis on decentralisation and the individual responsibility of the member states—up until an eventual sovereign bankruptcy.

There are several reasons for this revival of discussions on the future of the EMU. First, both the substandard aggregate performance of the euro area since the Great Recession and the persistence of major imbalances among participating countries are a cause for dissatisfaction and concern, in Europe and beyond; although economic governance alone cannot be considered responsible for this state of affairs, it cannot escape scrutiny either. Second, the question remains whether the serious deficiencies apparent in the run-up to and during the 2010-2012 euro crisis have been fully addressed: It is not clear, whether the reformed euro area would have enough resilience to withstand another major economic or financial shock. Third, the complexity of the new surveillance system contributes to a lack of ownership by national governments and parliaments; this raises doubts about its effectiveness, especially in the context of mounting euroscepticism in many euro area countries.

On 24 October 2014, the Euro Summit agreed that 'closer coordination of economic policies is essential' and called for work to continue 'to develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity' (European Council 2014). In response, the 'analytical note' prepared in anticipation of the Four Presidents' report that should be issued in 2015 lists a series of questions about the future economic governance of the euro area (Juncker et al. 2015). Pragmatic contributions to this endeavour have already started to be released (Wolff and Sapir 2015; Bénassy-Quéré and Ragot 2015). Unlike the more ambitious blueprints, they put emphasis on measures that do not require a treaty overhaul but would help improve the functioning of the EMU.

In this paper, I outline and discuss alternative possible directions for the reform of euro area economic governance. To this end, I first briefly review the reforms introduced in recent

years. I then review the main shortcomings of the resulting policy system. Next, I present and analyse alternative templates for governance reform and then conclude with proposals for a practical agenda.

## 1. Economic governance: What has been done

In response to the global financial crisis and the euro area crisis, European policy reforms were developed on three fronts (Table 1):

- a) The strengthening of preventive surveillance, both on the economic front with the already-mentioned legislation and treaty-level provisions and on the financial front with the introduction of a macroprudential oversight scheme, the responsibility for which was assigned to the European Systemic Risk Board (ESRB);
- b) The building of a crisis-management regime based, on the one hand, on principles for conditional financial assistance and the provision of corresponding financing by the ESM, and, on the other hand, on the new tools put in place by the European Central Bank, especially the Outright Monetary Transactions (OMT) scheme;
- c) Further systemic integration. The major initiative on this front has been banking union, which involved the assignment of supervisory responsibility to the ECB and the creation of a common resolution mechanism for banks.

Whereas the creation of the ESM and banking union were bold initiatives, the reform of surveillance has been much less radical. Reforms mainly aimed at correcting deficiencies in the enforcement of the Stability and Growth Pact (SGP) and at complementing it with non-fiscal procedures, but they fell short of an overhaul or the introduction of new and ambitious schemes.

**Table 1: Main EMU reforms introduced in 2011-2013**

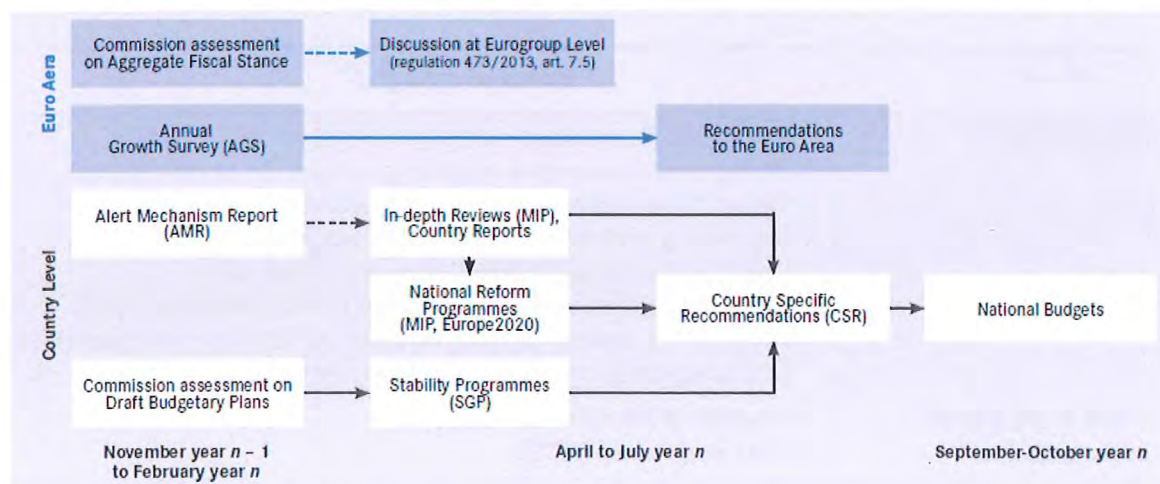
Field	Enacted reforms
<b>Surveillance</b>	<ul style="list-style-type: none"> <li>• Reinforced treaty-based commitment to fiscal discipline [TSCG]</li> <li>• Strengthened preventive monitoring of fiscal developments [6-P, 2-P]</li> <li>• Closer surveillance of countries in financial difficulty [2-P]</li> <li>• New voting rules for excessive deficit procedure [TSCG]</li> <li>• Debt criterion for correction of excessive deficit [6-P]</li> <li>• Prevention and correction of macroeconomic imbalances [6-P]</li> <li>• Integration of sectoral procedures within the European semester [6-P]</li> <li>• Macroprudential oversight [specific legislation]</li> </ul>
<b>Crisis management and resolution</b>	<ul style="list-style-type: none"> <li>• Creation of ESM [specific treaty]</li> <li>• OMT programme [ECB]</li> </ul>
<b>Systemic integration</b>	<ul style="list-style-type: none"> <li>• Banking union [specific legislation]</li> </ul>

Note: 6-P stands for Six-Pack and 2-P for Two-Pack.

This limitation was not because of a shortage of ideas. Academic proposals for a sovereign crisis resolution regime that would complement crisis management and define under what conditions or through what procedures the debt of an insolvent state could be restructured were put forward at an early stage (Gianviti et al. 2010; Buchheit et al. 2013), but fell onto deaf ears. Similarly, schemes for Eurobonds (Delpla and Weizsäcker 2010) or the Debt Redemption Pact of the German Council of Economic Experts (Sachverständigenrat für Wirtschaft 2011) provoked a lively discussion but were ultimately rejected. The idea to create a euro area fiscal capacity was floated in the 2012 Four Presidents' report (van Rompuy et al. 2012), and it was further detailed in a French Treasury working paper (Caudal et al. 2013), but it did not reach the stage of serious discussions. Initiatives to incentivise structural policies and integrate labour markets were considered, especially after Germany floated the idea of 'reform contracts' and France contemplated a euro area unemployment insurance scheme (Lellouch and Sode 2014), but interest in such ideas quickly faltered. Suggestions for firming up the governance institutions were made, most notably by Jean-Claude Trichet, the former president of the ECB, who called for 'federal governance by exception' (Trichet 2012), but beyond commitments to more frequent Euro Summits, no significant decision as taken in the institutional field. As to more radical proposals for federalisation (Gliénicker Gruppe 2013; Eiffel Group 2014) or, to the contrary, radical decentralisation (Mody 2013), they were simply ignored.

The policy system resulting from the reforms enacted in 2011-2013 continues to be based on the same Treaty provisions but has been developed beyond the straightforward implementation of the Stability and Growth Pact in force until 2011. The system consists of a series of interlinked procedures involving fiscal and structural policies and covering both the euro area level and national levels (Figure 1).

**Figure 1: A schematic representation of economic governance in the euro area**



Source: Bénassy-Quéré and Ragot (2015).

It is important to note that the policy reforms introduced in 2011-2013 combine a strengthening of fiscal discipline and a broadening of the scope for surveillance and coordination. The former was introduced in response to the widespread claim that the crisis resulted from a lack of adequate enforcement of the rules of the Stability and Growth Pact. The latter echoed the view that apart from the case of Greece, it is not the lack of fiscal discipline that explained crises in the euro area, but the neglect of relative price divergence, credit developments, and current account imbalances. The case for a broadening of surveillance had actually been put forward at an early stage in an insightful but largely forgotten Commission report (European Commission 2008). It was later taken on board by the van Rompuy Task Force, whose report (van Rompuy 2010) provided the launch pad for the Six-Pack and Two-Pack legislative initiatives.

## 2. Shortcomings of the reformed policy system

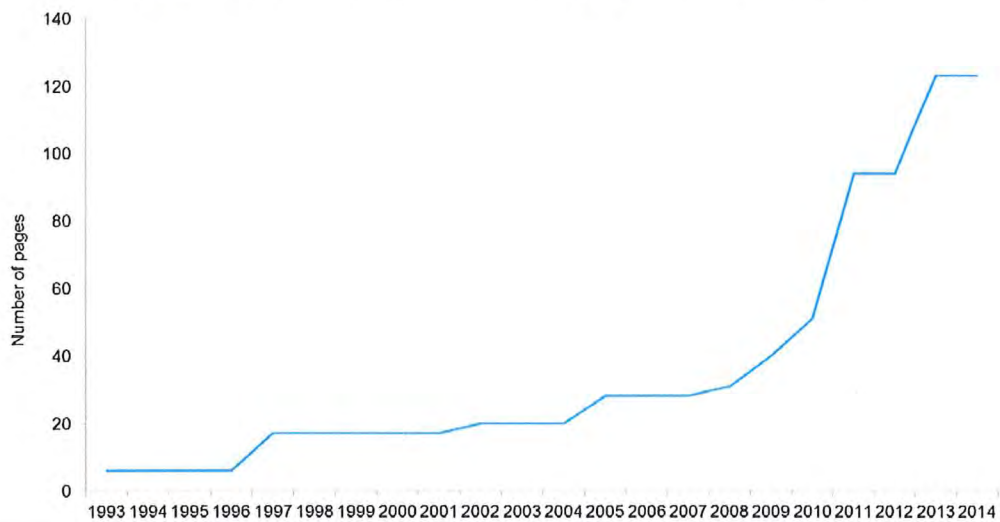
In spite of the crisis reform efforts (and in part, also, because of them), the current EMU policy system suffers from five significant shortcomings, each examined in greater detail below:

1. It has become excessively complex, which contributes to hampering its ownership by national policymakers and to reducing its effectiveness;
2. It does not favour an appropriate fiscal policy stance over the cycle. There is a risk of procyclicality and under-provision of fiscal stabilisation;
3. In spite of the Macroeconomic Imbalance Procedure (MIP), a significant discrepancy remains between the fiscal and non-fiscal dimensions of surveillance. The fiscal bias has not been corrected;
4. The Own House In Order (OHIO) syndrome still dominates policy choices and the common euro area interest tends to be underrepresented in the decisions;
5. Procedures have been strengthened, but institutions remain relatively weak.

### *Complexity and lack of ownership*

Figure 2 depicts the increase over time in the volume of EMU secondary legislation. It unambiguously indicates that in comparison to the situation that prevailed after the introduction of the Stability and Growth Pact in 1997 and its reform in 2005, recent additions have dramatically increased the corpus of EMU-specific legislation. Provisions concerning the procedures in force now span over more than 120 pages.

**Figure 2: Volume of EMU secondary legislation, 1993–2014**



Source: Own computations based on EU legislation. The graph depicts the volume of legislation in force at each point in time. Secondary legislation includes the TSCG but not the EU Treaty. It does not include interpretative statements such as the Commission communication on flexibility within the Pact of January 2015 (European Commission 2015).

Beyond volume indicators, practitioners and outside observers concur that the EMU policy system has become excessively complex, and for this reason can only be mastered by a few technocrats and experts. Complexity results from the intricacy of the procedures, from the technical character of some of their provisions (as regards, for example, the measurement of structural deficits), and from their mutual entanglement. The result is that national policymakers and members of national parliaments have at best a very approximate notion of what this system exactly implies. They often perceive the EU framework as excessively procedure-driven. To use a comparison first made in the Sapir report (2003), the EU is widely seen as a policeman rather than as a facilitator.

This situation contributes to a serious lack of ownership of the reformed EU framework in the national capitals. It contributes in some countries to the perception of EU discipline as an abstruse external straightjacket.

### ***Procyclicality and under-provision of stabilisation***

The initial Stability and Growth Pact was widely criticised for being procyclical because it was based on nominal variables only (Sapir et al. 2003). To correct this deficiency, the 2005 reforms introduced cyclically-adjusted variables, and the 2011-2013 reforms went further: The overall monitoring of fiscal positions is now based on such variables.

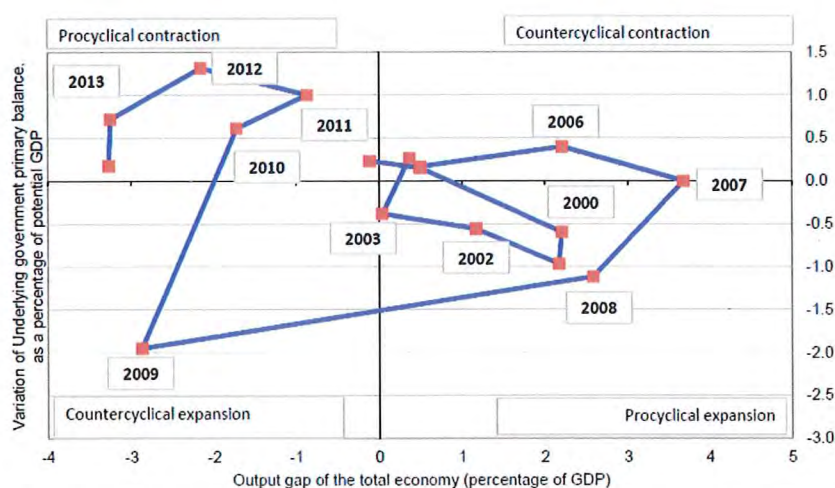
However, incentives to procyclical fiscal behaviour remain for two reasons: first, the 3 per cent of GDP deficit threshold for initiating an Excessive Deficit Procedure (EDP) remains defined in nominal terms by Art. 126 of the Treaty on the Functioning of the EU (TFEU). As a

consequence, in a recession, member states in a still-weak fiscal position may be forced to consolidate and even those in an initially strong position may be incentivised to premature tightening for fear of passing the threshold; furthermore, cyclical corrections are themselves procyclical. Potential GDP growth for current as well as for past and future years has been regularly revised down in the aftermath of the Great Recession. This has translated into larger structural deficits and led to early corrective action, even when the economy was still in a recession or near-stagnation.

These factors come on top of a pre-existing inclination towards an under-provision of fiscal stabilisation in the EMU. This is first due to political economy reasons: Governments by themselves tend to behave procyclically, for example, by lowering taxes in an upswing. Furthermore, it is to be feared that when facing a downturn, they will be behaving even more procyclically in the years ahead: In the period 2010–2012, governments have learned from experience that market access could be lost precipitously and that even countries whose fiscal position was relatively sound could easily experience a rise in bond rates. This lesson is unlikely to be forgotten, especially as debt levels are now much higher than in 2007. For a long time governments will be mindful of reducing their deficits when recessions occur, even at the cost of causing unnecessary cyclical hardship.

Empirical evidence suggests that fiscal policy in the euro area has been almost systematically either neutral or procyclical (Figure 3): It was too lax during the boom years and too tight during the downturn years. The only notable exception was 2009, because of Europe’s participation in the global stimulus.

**Figure 3: Fiscal stance and the output gap, euro area 15, 1993–2013**



Source: Own computations based on OECD Economic Outlook data.

## **Fiscal dominance**

The architects of the Maastricht Treaty correctly anticipated the risk for monetary instability arising from irresponsible fiscal behaviour, but they minimised the risk posed by lasting price–wage divergence resulting in real exchange-rate misalignments. They also overlooked the possibility of balance-of-payment crises within the monetary union. The initial EMU policy regime largely mirrored this neglect and limited macroeconomic surveillance to the non-binding and essentially ineffective monitoring of non-fiscal variables within the framework of the Broad Economic Policy Guidelines.

The introduction of the MIP as part of the Six-Pack was meant to correct this neglect, but it has failed to trigger a rebalancing between fiscal and non-fiscal surveillance. The MIP involves an early warning system that may lead to in-depth reviews for countries found in significant imbalance. Its results are then included in annual Country-Specific Recommendations (CSR) and may lead to a stepping-up of the procedure, ultimately leading to pecuniary sanctions.

The MIP has however been weakened by its asymmetric character (surpluses are considered more benign than deficits), by the indirect character of the linkage between policy variables and the resulting price and current account developments (unlike a fiscal deficit, which can be corrected by an increase in taxation or a cut in public spending, governments do not have at their disposal a lever to correct current account deficits and surpluses), and by the non-automaticity of decisions (at the time of writing, the corrective arm of the procedure, called the Excessive Imbalance Procedure, has never been activated). The CSR are largely ignored in national capitals. By contrast, the enhanced SGP remains more predictable and more binding, and it involves stronger enforcement mechanisms. Its effectiveness may not be as strong as its promoters wished, but it undoubtedly influences national decision-making.

Another channel for taking structural dimensions into account is to make use of built-in flexibilities within the SGP. In its communication of January 2015 (European Commission 2015), the Commission proposed allowing deviations from the path towards a country's medium-term objective if they result from priority investments. The same would apply to major structural reforms, and such reforms would also be taken into account in setting deadlines for the correction of excessive deficits. Yet the EU policy framework remains centred on fiscal discipline. Fiscal dominance remains nearly as strong as it was before the Six-Pack.

## **OHIO syndrome**

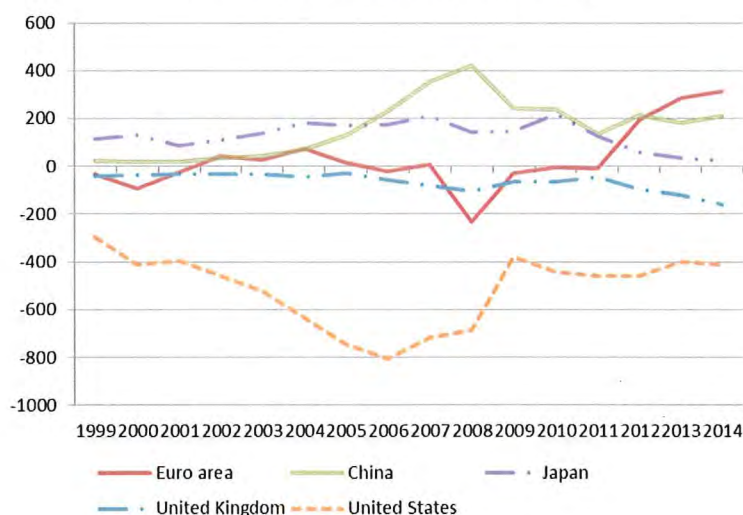
The European Semester framework is intended to integrate euro area-wide surveillance and country-level surveillance, so that aggregate developments and priorities are taken into account when preparing national decisions. Nevertheless, as observed by Bénassy-Quéré and Ragot (2015), a large disconnect remains between the two levels. Discussion on the aggregate situation and priorities does not result in observable action and its conclusions are



not even taken into account in country-specific recommendations<sup>1</sup>. In practice, there is no such thing as a euro area policy stance, and the OHIO syndrome continues to dominate.

The lack of a euro-wide policy stance became very visible in the aftermath of the Great Recession when the area-wide current account started exhibiting a significant surplus (Figure 4). In 2014, the current account surplus of the euro area exceeded those of China and Japan and almost equalled in size the deficit of the United States. Whatever the concerns expressed by other countries, however, the euro area does not have any instrument at its disposal to monitor its current account and, if needed, to redress an imbalance.

**Figure 4: Current account balances of the euro area, China, Japan, the UK, and the US, 1999–2014 (Billions of US dollars)**



Source: IMF World Economic Outlook Database.

The case for taking cross-country dimensions into account is however strong:

- On the fiscal front, the absence of a common capacity or effective procedures for coordination makes the euro area excessively reliant on the monetary instrument (Draghi 2014b). Should monetary policy become ineffective, it would lack the ability to substitute fiscal action for monetary action. This incompleteness may not be a cause for alarm in normal times, but it could become a serious handicap in situations of acute macroeconomic stress.

(1) Bénassy-Quéré and Ragot (2015) observe that the 2014 euro area-level conclusion that current account surpluses needed to be reduced was not taken on board in the recommendations made to surplus countries. See also Hallerberg, Marzinotto, and Wolff (2012).

- On the structural front, significant interdependence makes coordination desirable, if only because structural reforms are often intended to devalue the real exchange rate (Cœuré 2014). The design of economic and social reforms is however intrinsically national and in spite of the EU procedures, governments are reluctant to coordinate their actions in politically sensitive fields.
- The euro area is a large global player but in the absence of macroeconomic mechanisms, it lacks the ability to deliver on global commitments.

### **Weak institutions**

Apart from the ECB, whose power and legitimacy have been strengthened by the crisis, the economic governance institutions of the euro area have suffered from significant weakening. The Commission's authority has been dented by its own failings in the prevention and the management of the crisis, but also by the member states' decision not to rely on it for the provision of financial assistance to the countries in crisis.

The creation of the ESM can be regarded as a no-confidence vote for the Commission. Financially, the ESM is akin to a mutual lending cooperative that pools resources from the member states and puts them at the disposal of the Eurogroup for use in conditional assistance. From an institutional standpoint, it is based on new principles and procedures that make it the embryo of an alternative governance system.

At the same time the Eurogroup, whose remit was to coordinate national policies in the common interest, has paid a price for not having been able to prevent major economic and financial imbalances. Furthermore, during the height of the crisis, the Eurogroup was deprived of virtually all its powers by the direct handling of all important crisis management decisions by the Euro Summit. It is only in the post-crisis implementation of the SGP that it has regained a role.

The euro area has therefore emerged from the crisis with a series of feeble economic and financial institutions: a weakened Commission; an ESM whose remit is limited to the mere provision of funding; and a Eurogroup whose authority is disputed and that lacks the machinery that could help turn it into an effective policy body. Furthermore, the involvement of the IMF and the ECB in the Troika and the implications it has for countries under financial assistance and for the overall policy priorities of the euro area further complicate the situation.

This state of affairs is an impediment to the proper democratic legitimacy of the euro area institutions. First, the multiplicity of institutions and their overlapping responsibilities do not make it possible to hold any of them accountable for policy outcomes: It would be hard to determine, for example, who should be held responsible for a possible failure in Greece. A 'Who Lost Greece?' question would undoubtedly give rise to extensive soul-searching in the EU that would, for example, highlight that the Commission as a college never took responsibility for the Troika-monitored programme and that, although the ECB is part of

the Troika, it is not part of the MOUs<sup>1</sup> that result from the programme negotiations. Second, there is no single body to which euro area policy players are accountable: The European Parliament is the relevant body for some decisions, for example, the implementation of the SGP, but for other decisions, such as the provision of conditional financial assistance, the responsibility rests mainly with the national parliaments that voted on the corresponding resource commitments. This represents a serious obstacle to proper democratic control.

### 3. The way forward: Choices

Whereas the need for further reforms of the euro area is widely acknowledged, discussions in the EU tend to focus on whether they imply treaty amendments. Accordingly, the yardstick of ambition (or, conversely, of realism) tends to be assessed on this basis.

A focus on changing treaties is beside the point. Whether treaty amendments are needed will be an important issue once euro area members have agreed on a roadmap for the future, and it is certainly not a minor issue in the context of British calls for renegotiation and popular dissatisfaction with the way the EU is run. But to make it the centre of the agenda is to put the cart before the horse. What Europe needs is first and foremost a shared vision of the direction in which the euro area should evolve and the type of institutions it requires. At what speed the resulting programme should be implemented, and whether or when treaty revisions will be needed are important questions, but they can only be addressed in a second stage.

This is even truer in the current context, because rival interpretations of the root causes of the euro crisis of 2010-2012 and the corresponding remedies prevail. Throughout Europe, conflicting crisis narratives put forward by public intellectuals have captured the minds of citizens and influence policymakers. Like after the failed Franco-British Suez intervention of 1956, from which France concluded that it could not afford to rely on US support in its foreign policy initiatives, and Britain that it could not afford not to rely on it, the same traumatic experience gives rise to sometimes opposite conclusions. This is what makes a shared vision of the future so important, and so difficult to define.

There are basically three competing models of the euro area of the future (Table 2). The first is a fully decentralised model, the second a federal model, and the third a hybrid one.

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(1) Memoranda of understanding.

**Table 2: Alternative models for the future of the euro area**

	<b>Discipline</b>	<b>Solidarity</b>	<b>Governance</b>	<b>Legitimacy</b>
<b>Fully decentralised model</b>	Strict no-bail out, maximum exposure ceilings for banks	No euro area-specific solidarity	Insolvency procedures for sovereigns	No specific accountability
<b>Federal model</b>	Rules and procedures for fiscal and macroeconomic surveillance	Countercyclical transfers and conditional assistance financed by common budget	Federal institution (presumably Commission) as euro area executive	Accountability to European parliament
<b>Hybrid model</b>	National rules consistent with common principles, network of national institutions	Graduated mutual support mechanism	Euro-area coordination executive	Parliamentary body built out of national parliaments and the EP

Source: partially adapted from France Stratégie (2014).

The first model corresponds to a minimal monetary union where governments are free to behave as they wish as long as they bear the consequences. In this model, which has been proposed by, for example, Mody (2013), irresponsible fiscal behaviour ultimately results in a sovereign bankruptcy, for which there should be a procedure. Banks are protected from such irresponsibility, through banking union and the setting of ceilings to bank exposure to the default of any particular borrower. Nations and governments are treated as adults: They are expected to be aware of the risks, to know the rules, and to understand that they will not be rescued by their neighbours.

Because it keeps common requirements at minimum level, this fully decentralised model provides a useful intellectual benchmark for thinking about the structure of monetary union. Its proponents claim that it is in fact very close to that of the modern-day US: Whereas states in trouble after the Independence War were supported by the federal government, a strict no bail-out principle emerged in the mid-19<sup>th</sup> century (Henning and Kessler 2012).

The problem, however, is that the political and financial viability of this model are both open to question. Politically, an implicit quid pro quo to the renunciation to monetary sovereignty has been that member states could count on support and solidarity from their neighbours in case of severe adverse shocks. Exclusion of such support would amount to a rewriting of this contract. Financially, the model is furthermore hardly accessible to the EU, because it would require much lower levels of public debt in the member states. The public debt of Italy amounts to nearly 20 per cent of the aggregate GDP of the euro area, whereas that of California represents less than 3 per cent of the US GDP. An Italian bankruptcy would be a financial disaster for the EU, whereas for the US a Californian bankruptcy would be a more absorbable one. A strict no-bailout clause, interpreted as excluding any form of cross-country support, is therefore not credible.

The second, federal model does not require much presentation. It implies a common budget for the euro area, the strengthening of executive role of the Commission, and accountability to the European Parliament (EP). In short, the Commission would become the embryo of a federal government equipped with a budget and accountable to a parliament. Evidently, this would remain a very decentralised federation in comparison to existing federal states. But the logic would be similar: For the euro area to function properly, Europe should get closer to the true federation its early architects had in mind.<sup>1</sup>

The difficulty with this approach is however threefold. First, it has lost credibility. To start with, there is currently very little appetite politically for transferring more powers to Brussels. The notion that a better functioning monetary union necessarily implies more Europe is alien to many of the coalitions in power in the continent's capitals. Furthermore, the Monnet logic, according to which each crisis in the EU should serve as an opportunity for further integration<sup>2</sup>, has reached its limits. Citizens cannot be told after each crisis that the reason why the EMU is dysfunctional is that too little power has been transferred to the EU. As documented by Guiso, Sapienza, and Zingales (2015), European citizens still believe in the European currency, but have no appetite for delegating more powers to the federal level.

This does not imply that any form of integration must be ruled out, if its necessity is demonstrated: In 2012–2013, agreement on creating a banking union was remarkably swift, including within the UK, because it was convincingly argued that the initiative was indispensable to safeguarding the integrity of the euro area. But crises cannot be used anymore as a mere pretext for promoting an integration agenda.

Second, federalisation would not solve the basic issue which is that a country's fate within a currency zone largely depends on its own economic choices. Allocating further responsibilities to the federal level would not make this fate less dependent on domestic behaviour. Labour market and R&D policies would still be key for competitiveness, the behaviour of the budget balance over the cycle would still be key for stabilisation, and public spending choices would still be key for the sustainability of public finance. In other words monetary union cannot be regarded as the mere transfer to the European level of specific sectoral competences. The analogy between, on the one hand, market integration through the removal of obstacles to microeconomic integration and the establishment of common regulations and, on the other hand, policy integration in the context of a common currency zone, is a flawed one.

Third, unlike market integration, policy centralisation, which is complete for monetary policy and deep in related fields such as banking supervision, may call for more national autonomy

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(1) I do not discuss here whether such a federation should be built around the euro area, the EU as a whole, or a coalition of the willing within the EU. This is an important question but not the focus of this paper.

(2) Monnet (1976) writes in his memoirs, 'J'ai toujours pensé que l'Europe se ferait dans les crises, et qu'elle serait la somme des solutions qu'on apporterait à ces crises' ['I always thought that Europe will be forged in crises, and will be the sum of the solutions adopted for those crises'].

in other fields. This is because the unavailability of an individual monetary response to shocks calls for keeping other instruments such as fiscal or tax policy at the disposal of member states. As long as national economies remain heterogeneous, centralisation in one field may actually call for decentralisation in another one.

What is lacking in some fields is therefore less a centralisation of decision-making than an internalisation by national policymakers of the constraints that arise from participating in a currency union. For example, what was missing in the first decade of the euro was first and foremost consciousness of the long-term implications of the currency regime for, say, wages and prices, taxation, and the sustainability of public finances. It is not primarily because governments did not behave uniformly that countries got into trouble; it is because they did not behave in accordance with the discipline their countries had explicitly or implicitly subscribed to. Lack of coherence mattered more than lack of similarity.

The same applies to the fiscal field: More coherence in the use of national policy instruments does not imply centralisation. The management of a common currency might be facilitated by a common budget, but—whatever the likely size of the EU or euro area budget in the years to come—it will remain very small in comparison with national budgets. What is required is that public finances be managed in a way that is coherent with the sharing of the currency. In the same way, centralised wage-setting is not desirable; rather, what is needed is an adaptation of national or subnational wage-setting institutions to the interdependence created by the sharing of the currency.

Against this background, the euro area should combine more integration or centralisation in some fields with more margins for manoeuvre in other fields. It should also combine these traits with incentives to coherence with common requirements and discipline.

## 4. A practical agenda

These observations provide guidance to think about the third, hybrid model—a model that draws on recent evolutions and combines centralised and decentralised features.

### *Fiscal institutions*

In order to remedy the deficiencies discussed above, a first requirement is to streamline the fiscal surveillance system, which has become much too complex. As indicated, the way forward is to decentralise the corresponding discipline, while keeping the requirement that national policies be consistent with the principles of monetary union.

The euro area's crisis response has actually opened the way to such an evolution. The TSCG provision that mandates the adoption of fiscal rules at national level and the creation of a fiscal council in each member state represents a significant shift towards decentralisation. It is an attempt to foster domestically-rooted fiscal responsibility rather than a discipline imposed top-down by EU procedures. Fiscal councils are part of the national policy system, they speak the same language as national policymakers, and they are able to intervene in

real time in the preparation of the stability programme and the budget. At the same time their mandates are consistent with the overall principles governing fiscal responsibility in the EU and the euro area. For this reason they are well-placed to contribute to the required policy coherence. It is certainly very early to assess the effectiveness of these new institutions, but anecdotal evidence suggests that they may already have had an impact on policy choices.

This evolution should be pushed one step further. First, the remit of the fiscal councils should be broadened to encompass the forecast of tax receipts, the costing of tax and spending measures, and debt sustainability analysis. Some of them have already been assigned such responsibilities, but not all.

Second, a similar council should be built at the euro area level, which would—following the template offered by DG Competition and the national Competition Authorities—provide a hub to the network of national fiscal councils. This euro area council, which would be located within the Commission but should enjoy the same degree of independence as its national counterparts, would help foster exchange on best practices and develop common methodologies and instruments. Unlike the Commission's DG ECFIN it would however not be in charge of enforcing discipline.<sup>1</sup>

Third, governments should also be encouraged to rely more on the independent expertise of these committees, and this could be done by granting countries equipped with better and more credible domestic institutions more margins of manoeuvre within the framework of the SGP. For example, temporary deviations from the medium-term objective should be more easily allowed for countries with better institutions. This would give governments a major incentive to invest in domestically-rooted fiscal discipline and set in motion a move towards decentralisation.

### *Economic institutions*

Competitiveness councils could also be formed on the same model. Their role would be to monitor developments in real exchange rates, current accounts, and non-price competitiveness and to provide recommendations to national governments and social partners for wage-price evolution, taxation, and non-price competitiveness enhancement measures.<sup>2</sup>

Again, such institutions would be much better placed than the EU to formulate recommendations. Because they would be part of the domestic discussion and in contact with all players, their assessments and recommendations could be much more timely and fine-tuned or granular.

The network dimension would be especially important here, as competitiveness is largely a relative property. To avoid systematic biases towards deflation or, conversely, inflation, it

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(1) The initial idea for a network of fiscal councils was laid out in Sapir et al. (2003).

(2) Similar ideas have been put forward by Wolff and Sapir (2015) and Bénassy-Quéré and Ragot (2015).

would be crucial to ensure that methodologies used to evaluate real exchange rate misalignments in participating countries are mutually consistent.<sup>1</sup>

## **Solidarity**

Solidarity is a natural counterpart to discipline (which is why the fully decentralised model involves neither), but it may take different forms. In a model built around cooperation between participating countries, it would logically not take place through transfers financed by a common budget, at least not primarily. Rather, it would take the form of graduated mutual financial support. This is already the case with conditional lending by the ESM and the ECB's OMT programme, but there is discontinuity between the normal situation (in which a state gets no support whatsoever) and the programme situation (in which it has to subscribe to harsh conditions). As indicated already, a 'fear of the Troika' syndrome has developed that may result in a very procyclical behaviour of indebted governments facing an economic downturn.

Instruments should be created for a more gradual approach to mutual support. This could imply low-conditionality lending as with the recent IMF facilities, whose aim is to discourage excessive reserve accumulation by countries fearing capital flows reversals. An alternative would be a scheme such as that suggested by Enderlein et al. (2012): States would in a first stage be granted unconditional access to a buffer of mutually guaranteed borrowing and gradually move to more conditional types of financing, until a point where they would be compelled to subscribe to a conditional assistance programme—the last step before a formal bankruptcy and the ensuing restructuring of public debt, for which a procedure should also be put in place. A system of this sort would offer more gradation and continuity. By providing predictability to the individual member states, it would also help counter the risk of an under-provision of stabilisation. Instead of substituting national stabilisation with euro area-wide stabilisation, the system would aim to support the national level and thereby make it effective.

Naturally, such a policy regime would require a strengthening of fiscal discipline. Access to a mutually guaranteed borrowing buffer could not be granted without significant guarantees, including a potential EU veto on the national budgetary decision of the states that draw on this buffer.

## **Fiscal capacity**

Whereas the need for stabilisation should be addressed by making participating states more able to cushion shocks through their own fiscal means, this response would not eliminate the need for an aggregate fiscal capacity. There are two reasons why it would still be needed—one macroeconomic and one financial.

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(1) A similar approach also applies to credit policies, which are outside the remit of this paper.



With the creation of the ESM, the euro area as a whole has been given the means to finance exceptional assistance to countries in trouble. As indicated already, similar common requirements may arise from the need to provide the fiscal support of last resort in situations of acute stress. Again, there could be two ways to organise it: either through coordination—which would require creating a formal mechanism that would make it possible in exceptional circumstances to take, by qualified majority, the decision to mobilise national fiscal means—or by giving the euro area the possibility to borrow in predefined special circumstances. Either would be a significant innovation.

A common fiscal capacity would also be needed in the hopefully rare case when bail-in mechanisms and the recourse to the insurance scheme financed by the banking industry would not be sufficient to address the financial consequences of a bank failure. A contingent mechanism to remedy such situations would not imply any permanent tax resource but it should make it possible to mobilise it, should the need arise.

The important point about the fiscal capacity is that it should not be understood as an instrument for cyclical stabilisation. Cyclical stabilisation needs and exceptional crisis-management needs are of a different nature, and they may be responded to in different ways. Whereas the former can (and in my view should) be addressed through restoring the individual states' stabilisation capacity, the latter involves significant collective action dimensions and requires a specific common mechanism.

### ***Governance institutions***

Institutional reform should also be put on the agenda, for two main reasons. First, such reform is necessary to ensure a better representation of the common euro area interest. Governments essentially speak in the name of the national interest, and the voice of the common interest is too muted. Second, the current governance system is weak and wobbly: The president of the Eurogroup is in charge of coordinating national policies, but s/he is not supported by a bureaucracy and does not have coordination instruments at his/her disposal; the Commissioner for economic and monetary affairs does have a bureaucracy to rely on, but is bound by the existing procedures and can only issue recommendations. This dual system is well-suited to the preparation of legislative proposals but not to the exercise of executive powers. Its weaknesses have been displayed throughout the euro crisis.

There are basically two alternative solutions to strengthen the governance machinery of the euro area. One is to equip the Eurogroup with a full-time president and professional services, presumably building on the ESM. This is what is intended by the proponents of a 'European Treasury'. Such an arrangement would have the advantage of addressing the executive deficit but at the cost of creating a two-headed governance system with two potentially rival bureaucracies—the Commission and the European Treasury. The alternative would be to adopt the template in use for the High Representative for Foreign Affairs and Security Policy: to let the Eurogroup be chaired by the ECFIN commissioner. This 'double hat' solution would

necessarily require giving to a separate person and a separate body the fiscal and economic watchdog role currently assigned to the ECFIN commissioner, because the same commissioner cannot simultaneously play the procurator and the judge. It would be consistent with the creation of a fiscal council at European level. National capitals might be reluctant to grant additional powers to the Commission, but a divided executive is not a very attractive prospect either.

### **Legitimacy**

Because they would clarify what belongs to the EU and what belongs to the national level, reforms of the type discussed in this paper would help strengthen democratic legitimacy. The appropriate way to organise it would however depend on the structure of economic governance. As long as resources mobilised in assistance or coordination processes come from the EU budget or a potential euro area budget, accountability should be to the European Parliament. However, if resources do not come from a federal budget but from the national parliaments, they should be involved in the accountability procedures. This would require establishing a parliamentary body that would draw on national parliaments as well as the EP.

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# Strengthening and deepening the Economic and Monetary Union within the current Treaties: possibilities and limits

## 25 proposals

### SUMMARY

This policy brief analyses the possibilities that the Treaty of Lisbon offers in order to deepen and strengthen the Economic and Monetary Union and improve its democratic legitimacy and effectiveness. The democratic legitimacy of the EMU could be strengthened by a significant involvement of the European Parliament in the economic policy-making process, by a better division between the executive and legislative powers, and by the creation of an EMU Committee or Super-Committee within the European Parliament. The basis of a future economic and fiscal government of the euro area could be created by concentrating key prerogatives and capabilities on these matters and by merging the positions of President of the Eurogroup and Vice-President of the Commission into a de facto "EMU Finance Minister" responsible for the development and implementation of EMU economic and fiscal policy and democratically controlled and sanctioned by the European Parliament. An own budget for the Eurozone would allow the implementation of macroeconomic convergence and investment policies aimed at improving growth in the Euro area and to increase its resilience.

If the measures proposed here were implemented (and particularly if they were implemented as a package, or within a single roadmap), they could constitute a considerable improvement in the functioning of the EMU. While potentialities exist à traité constant, rallying the necessary political consensus among Member States (especially for the many measures that can only be implemented by unanimity of the Member States) represents a major challenge.

On the other hand, the limitations provided by the Treaties are also very clear. The potential degree of financial autonomy of the Union or the EMU is restricted by their lack of powers for tax collection or for issuance of sovereign debt and their limited spending powers. The inexistence of European political accountability when it comes to policies decided through the intergovernmental method is the major obstacle to democracy, effectiveness and enforceability. Sooner rather than later the Treaties would need to be revised to reach a definitive settlement in these areas and secure a sustainable future for the EMU. ■

By **DAVID MARTINEZ GARCIA**  
AND **PAOLO VACCA**

### RECOMMENDATIONS

- Create a fiscal capacity / budget for the EMU integrated in the EU institutional framework
- Fully involve the European Parliament in key stages of EMU governance and create an EMU Committee or Super-Committee in the EP
- Merge the positions of President of the Eurogroup and Vice-President of the Commission creating a de facto "EMU Finance Minister"
- Revise the system of own resources of the EU or create an own resource system for the EMU
- Establish instruments for a Single Economic and Fiscal Policy for the EMU

## INTRODUCTION

This policy brief constitutes the first part of the contribution to the debate on the report on "Improving the functioning of the European Union building on the potential of the Lisbon Treaty" being prepared by the Committee on Constitutional Affairs of the European Parliament with co-rapporteurs Elmar Brok and Mercedes Bresso. This first policy brief addresses the possibilities of and limits to substantially improving the Economic and Monetary Union (EMU) within the framework of the current Treaties and puts forward 25 specific proposals in this respect.

The financial and debt crises that have affected the European Union, and particularly the euro area, for the last seven years have led to substantial improvements in the way the Economic and Monetary Union works, through the creation of new institutions (such as the European Stability Mechanism for providing financial support to euro countries facing particular financial difficulties), the establishment of new European supervisory authorities (particularly the Single Supervisory Mechanism for the banking sector) and a new framework for the coordination of national fiscal and economic policies of the euro countries through the so-called European semester.

*"THE EURO AREA LACKS THE TOOLS, POWERS AND RESOURCES FOR IMPLEMENTING EFFECTIVE ECONOMIC POLICIES AT THE EUROPEAN LEVEL."*

However, the urgency with which decisions were made and the lack of sufficient political will for a more ambitious project prevented three structural issues at the basis of the weakness of the Economic and Monetary Union from being addressed: (1) while monetary policy is European, fiscal and economic policies remain national. Today's governance framework reflects a "rule-based approach" and tries to coordinate national economic policies through a combination of surveillance, monitoring, recommendations and incentive instruments put under the umbrella of the European Semester, but it lacks the ultimate power of enforcing policies aiming at the convergence of national fiscal and economic policies; (2) the euro area lacks the tools, powers and resources for implementing effective economic policies at the European level (particularly to complement the necessary national structural reforms ongoing in many euro countries with anti-cyclical European policies); (3) the increased powers of the European level have not been accompanied by an increased democratic legitimacy of the decision-making processes, leading to increasing tensions between the European rules and the national democratic processes and a widespread perception of a lack of legitimacy of the system put in place in recent years.

Ultimately, all three issues need to be addressed to ensure a sustainable Economic and Monetary Union. A satisfactory solution to these issues will ultimately require a change to the European Union Treaties (or one or more additional treaties on the model of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the so-called Fiscal Compact). However, with the required political will and consensus among Member States, substantial improvements could be made even without changes to the current Treaties. This paper provides 25 proposals in this respect. Each of the following proposals could be implemented on a stand-alone basis. Nevertheless, the interrelations between many of the proposals is such that their implementation would be much more effective (and able to achieve the goal of a substantially improved Economic and Monetary Union) if they were adopted as a package, or within a single roadmap to be implemented within a short-period of time in the near future.

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Each section of this policy brief deals with a specific dimension of the EMU governance framework: its government structure, its financial capability, its financing and, finally, the nature and scope of its policies.

Annex 1 clarifies which proposals could be implemented through the Ordinary Legislative Procedure (i.e. co-decision and qualified majority voting in the Council) and which ones through the Special Legislative Procedure (i.e. requiring unanimity of Member States) or through the adoption of other legal instruments. As will be shown, the most critical measures put forward here do require unanimity of Member States and therefore can be expected to face significant challenges to their adoption and implementation. Annex 1 also indicates when changes to the Treaties (or an additional treaty for the euro countries) would be required for a final settlement or full deployment of the euro area's potential in the subject of the proposal. ■

## 1. STRENGTHENING THE EMU GOVERNANCE FRAMEWORK

### 1.1 INCREASING DEMOCRATIC LEGITIMACY IN THE EMU GOVERNANCE FRAMEWORK

The strengthening of the EMU governance framework that has occurred since 2010 has entailed considerable institutional and democratic consequences for the Union and the euro countries. First, national parliaments (and in fact national governments) have lost a substantial portion of their budgetary powers as they need to act within the framework of European rules and the limitations that may be imposed by the Union when they define their economic priorities and adopt their positions on national budgets. Yet, apart from the theoretical leverage they enjoy in the framework of the subsidiarity control, they lack means of control and influence on the EMU decision-making processes.

The misalignment between a supranational monetary union and a still intergovernmental system of coordination of national economic policies prevents national parliaments from exercising their control powers on their governments and from having an impact on the final result of negotiation processes between Member States, which are based on the inequality of the bargaining power of each government. The decrease in national parliaments' powers has not been compensated for at European level, which undermines the so-called input legitimacy of the new EMU governance framework.

*"THE INTERGOVERNMENTAL METHOD HAS PROVEN INEFFECTIVE FOR THE ADOPTION OF BINDING DECISIONS IN ALL THE POLICY FIELDS WHERE IT HAS BEEN USED, AND THE EMU IS PROVING TO BE NO EXCEPTION."*

At the European level, the concentration of political decision powers regarding the EMU in the European Council (then formalised by national ministers in the Council) with no or very limited involvement of the European Parliament has led to the emergence of the European Council as a quasi-executive body. Given that the European Council is not designed to make decisions on binding acts, the Treaties do not provide any system of

control of its activity by the European Parliament. The intergovernmental method has proven ineffective for the adoption of binding decisions in all the policy fields where it has been used, and the EMU is proving to be no exception. In addition, the lack of parliamentary backing leaves the EU short of means to diffuse increasing tensions with national democratic processes and constituencies.

Last but not least, the abnormal role given to the European Council allows the Member States to decide on the final implementation of decisions made in the framework of the European Semester. Over the last years, the widespread lack of application of the Country-Specific Recommendations (CSR) and the increased flexibility granted to some Member States in the application of the budgetary rules has proven the inefficiency of this method. This will eventually undermine the same basis of the system by removing all the credibility from the commitments acquired under the Stability and Growth Pact (SGP) and the Treaty on Stability, Cooperation and Governance (TSCG).

The current EMU governance framework is characterised by other fundamental contradictions that undermine the effectiveness of the system. As mentioned above, executive power is shared between the Commission, the Council (ECOFIN Council and the Eurogroup) and the European Council. Yet the Council preserves its role as legislator. This system splits the political responsibility between the Commission and the Member States. Whereas Member States are theoretically responsible in front of their respective constituencies, in practice, none of them has the means to change the direction of European economic policy individually. At the same time, the European Parliament has not been conferred any power of control over the actions undertaken in this field. As a result, political responsibility is completely blurred, and, in practice, decisions are impossible to enforce and a power of sanction cannot be exercised.

Such a great extension of powers created at the European level (which prospectively are not unlikely to be increased) requires a matching extension of democratic checks and balances, clearer lines between the executive power and the representative institutions of the Union, and specific democratic legitimacy of decisions affecting only the euro area.

*"SOLUTIONS COULD BE SOUGHT IN ORDER TO ALLOW MORE FLEXIBILITY IN THE CONFIGURATION AND WAY OF WORKING OF THE EUROPEAN PARLIAMENT WHEN IT COMES TO THE EMU."*

The balance between the executive and the legislative powers also raises the question of whether parliamentary control can be exercised by the European Parliament as a whole – considering the involvement of non-euro country Members of the European Parliament (MEPs) in EMU matters. As many propose, one solution to this could be the creation of a new parliament for the euro area, in spite of the effects it could have on the EU institutions<sup>1</sup>. Alternatively, solutions could be sought in order to allow more flexibility in the configuration and way of working of the European Parliament when

it comes to the EMU. The treaty provisions regarding the functioning of the Council in EMU matters could be the basis for this reflection.

Without changes to the Treaties, the legal nature of the instruments used in order to set up the European Semester (7 regulations and 1 directive adopted according to the ordinary legislative procedure) would allow some of its functions to be reallocated among the EU Institutions with a view to increasing democratic legitimacy.

<sup>1</sup> See, for instance, statement by Mr Wolfgang Schäuble, German Finance Minister reported by Reuters (retrieved on 01/10/2014 <http://uk.reuters.com/article/2014/01/27/uk-germany-eurozone-parliament-idUKBREAO01NP20140127>) or the positions expressed in the Groupe Eiffel's manifesto (retrieved on 10/01/2015 <http://www.groupe-eiffel.eu/pour-une-communaute-politique-de-leuro/>)



### PROPOSAL 1.

**Involving the European Parliament in the key stages of the European Semester, in particular in the adoption of Country-Specific Recommendations (CSRs), Economic Partnership Programmes (EPPs), Corrective Action Plans (CAPs) and sanctions.**

Given that the role of the European Parliament in such framework would constitute a function of control of the executive power, and not a real legislative function, the European Parliament should be given the possibility to express its disagreement through a motion adopted by simple majority. Such a motion would stop the process and require that the Commission present a modified draft of the concerned document. Eventually this motion should be adopted between mid-May and mid-June, i.e. before the adoption of the CSRs and the EPPs by the Council.

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#### IMPLEMENTATION:

*This would require the revision of, inter alia, the following provisions:*

- Art. 3 Regulation (EU) No 1467/97 (Adoption of CSRs)
- Art. 10 Regulation (EU) 1176/2011 (Adoption of EPPs and CAPs)
- Art. 9 Regulation (EU) 473/2011 (Adoption of EPPs and CAPs)
- Art. 3 Regulation (EU) 1174/2011 (Adoption of sanctions)

*The same effects could be reached through an interinstitutional agreement between the European Parliament, the Commission and the Council*

### PROPOSAL 2.

**Providing the European Parliament with the possibility of adopting Alert Mechanism Reports (AMR) through the European Semester.**

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**IMPLEMENTATION:** *This would require the revision of, inter alia:*

- Art. 6 Regulation (EU) 1176/2011

### PROPOSAL 3.

**Conferring to the European Parliament the right to require a hearing of the Head of the Government or one of the ministers of the Member State concerned by CSRs, EPPs, CAPs, sanctions or AMRs before vote.**

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**IMPLEMENTATION:** *Although the mechanism of the Exchanges of Views with national governments already exists, all the "economic dialogue" clauses of the Six-pack and the Two-pack could be revised in order to use a more prescriptive wording.*

In order to upgrade the involvement of the European Parliament in the European Semester, it could assume a pivotal role in the negotiations between the Member States and the European level. Exchanges of Views are already done, without much impact. However, if the European Parliament was given a say in the process on a substantially equal footing with the Council and was entitled to ask for modifications in the Commission's drafts, those hearings could become the centre piece of the budgetary debate at European level. This right could be mutual, i.e. the Government of a Member State concerned by CSR, EPP or AMR could be entitled to ask to be heard by the European Parliament to defend its positions before any decision on CSR, EPP or AMR is made.

*"IN ORDER TO UPGRADE THE INVOLVEMENT OF THE EUROPEAN PARLIAMENT IN THE EUROPEAN SEMESTER, IT COULD ASSUME A PIVOTAL ROLE IN THE NEGOTIATIONS BETWEEN THE MEMBER STATES AND THE EUROPEAN LEVEL."*

**PROPOSAL 4.****Creation of a new Committee of the European Parliament on EMU Affairs.**

This Committee would be composed only by MEPs elected in euro countries. It would carry out all the preparatory, deliberative and monitoring work currently undertaken by the ECON Committee, but limited to the area of the EMU.

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**IMPLEMENTATION:** *Parliament's vote on a proposal from the Conference of Presidents (according to Rule 196 of the Rules of Procedure (RoP) of the European Parliament)*

This Committee on EMU Affairs could work exactly in the same manner as the other committees of the European Parliament. In this case, it would prepare and vote on its reports before passing them for final adoption to the plenary, which also includes all MEPs from non-euro countries. The current Treaties would not allow the European Parliament to legislate in a restricted configuration where only MEPs elected in euro countries would have the right to vote in EMU matters. However, a procedural mechanism could be found to mitigate this problem and obtain similar effects, although it would certainly complicate the work of the Parliament. A definitive and more direct solution would require the revision of the Treaties.

**PROPOSAL 5.**

**Creation of a super-Committee for the euro area regrouping all the MEPs elected in the EMU.** This super-Committee would formally be a standing Committee of the European Parliament but entitled to discuss and decide on the transferal to the plenary of reports prepared by the Committee on EMU Affairs (see Proposal 4 above), thus acting *de facto* as a kind of "Plenary" of the MEPs of the euro countries.

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**IMPLEMENTATION:** *Parliament's vote on a proposal from the Conference of Presidents (according to Rule 196 of the Rules of Procedure (RoP) of the European Parliament) establishing a standing Committee of the EMU composed of all EMU MEPs. In this configuration, the Committee on EMU Affairs presented in Proposal 4 above should become a standing Subcommittee of the euro area Committee. The division of competences between the Committee and the Subcommittee should be clearly defined in the proposals prepared by the Conference of Presidents, with the Subcommittee having a preparatory and advisory role and the Super-Committee a deliberative role prior to the full plenary of the Parliament.*

This solution would imply splitting the competences of the Committee on EMU Affairs in two. The Committee would prepare and deliberate on the reports that it intends to forward to the plenary, but it would not vote on them. The transferral to the plenary would be decided instead by the euro area super-Committee comprising all the MEPs elected in euro countries. This would give the necessary legitimacy - with reference to the euro countries - to the texts then adopted by a plenary where non-euro countries are represented, and it could deter non-euro countries' MEPs from blocking EMU legislation on the grounds of national interest.

## PROPOSAL 6.

**Concentrating executive tasks in the Commission by suppressing the role of the Council in the assessment of DBPs and in the monitoring of the implementation of CSRs, EPPs and CAPs.**

### IMPLEMENTATION:

- Modification of Art. 9(6) of Regulation (EU) 473/2013 (monitoring purposes)
- Modification of Art. 7(5) of Regulation (EU) 473/2013 (assessment of DBPs)

Concentrating all technical tasks required in the context of the European Semester in the hands of the European Commission would minimise political interference by Member States in the documents (assessment of DBPs) and actions (monitoring of the implementation of CSRs, EPPs and CAPs) which are later used as a basis for political decisions.

## 1.2 INCREASING POLITICAL ACCOUNTABILITY IN EMU DECISION-MAKING PROCESSES

Experience from the last years has shown that, within the current framework, the more intrusive economic and budgetary decisions made at European level are, the higher the costs are in terms of democratic legitimacy<sup>2</sup>. As has been noted above, because of the largely intergovernmental nature of the European Semester, the political responsibility for EMU policies is widely spread between the Commission, the President of the European Council, the President of the Eurogroup and the Member States.

More concretely, the more intrusive the EU action is (EPPs, sanctions, Excessive Deficit Procedure-EDP), the more likely the European Council is to be called to make *ad hoc* decisions to conciliate the interests and requests of the different stakeholders and in particular Member States. This role of last-resort decider that the European Council has assumed over the last 6 years contributes to a further blurring of political responsibility. The European Council and its President are unaccountable. Its President is only obliged to present a report to the European Parliament after each European Council (Art. 15(6) TEU) after each Euro Summit (point 5.2.(e) of the Rules of Procedure of Euro Summit meetings<sup>3</sup>), but the European Parliament has no sanction powers that could allow it to control the activity of the European Council. By the same token, it would not be possible to make the President of the European Council responsible for decisions made by Member States, as big as his agenda-setting and policy-shaping powers may be.

Therefore, in order to increase democratic accountability, it is urgent to clearly define responsibilities for decisions on and the conduct of EMU policies. Assigning political responsibility first requires a concentration of decision-making powers and capabilities in the hands of a limited number of positions to prevent the capability-expectation gap from growing further.

<sup>2</sup> Cinzia ALCIDI, Alessandro GIOVANNINI, Sonia PIEDRAFITA (CEPS), Enhancing the legitimacy of EMU Governance, ed. Directorate General for Internal Policies - European Parliament, December 2014, p. 29 (retrieved on 20/12/2014 [http://www.europarl.europa.eu/RegData/etudes/STUD/2014/536312/IPOL\\_STU%282014%29536312\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2014/536312/IPOL_STU%282014%29536312_EN.pdf))

<sup>3</sup> Guiding principles for the conduct of proceedings of Euro Summit meetings adopted on 14 March 2013

Specifically, the EMU's governance system would benefit from concentrating the following prerogatives and capabilities into a single body or position:

- Initiative powers
- Agenda-setting powers at the Council
- Powers of assessment, monitoring and surveillance of the implementation of the European Semester and other EMU policies by Member States
- Direct horizontal coordination (between the Council/Eurogroup, the Commission, the ECB and the Parliament)
- Direct vertical coordination (between the EU and Member States, and between Member States)
- Use of financial instruments (ESM, European Fund for Strategic Investments)
- Use of administrative capabilities (DG ECFIN of the Commission, DG G of the Council Secretariat-General)
- Right to bring actions for annulment to the ECJ in case of misuse of powers by the European Council or other institutions
- Capability to effectively report to the European Parliament
- External representation of the euro in international financial institutions

**"THE EMU'S GOVERNANCE SYSTEM WOULD BENEFIT FROM CONCENTRATING THE FOLLOWING PREROGATIVES AND CAPABILITIES INTO A SINGLE BODY OR POSITION."**

In the current institutional framework, these powers are split between the Commission, the Council (ECOFIN Council and *in fine* the Eurogroup) and the President of the Eurogroup as Chair of the Board of Governors of the ESM. Two positions stand out as possible candidates to assume the political responsibility of EMU policies: the President of the Eurogroup and the Vice-President of the Commission (*in charge of Economic and Financial Affairs*).

The current description of the position of President of the Eurogroup given by Protocol 14 is at the very best succinct. However, art. 137 and 139 TFEU and the actual practice give the President of the Eurogroup the prerogatives belonging to the chair of the Council when it decides on EMU affairs, since, even if the decisions are formally adopted in the ECOFIN configuration (chaired by the rotating presidency), they are made beforehand in the Eurogroup configuration. Therefore, the President of the Eurogroup enjoys great influence in terms of vertical coordination, agenda setting and policy shaping. However, no mechanism of accountability before the European Parliament is provided. Over time, this position has been strengthened informally with functions of information to the European Parliament and external representation of the EMU in its intergovernmental aspects at ministerial level. In addition, an informal agreement between the ESM Board of Governors and the Eurogroup provides that the President of the latter should also be appointed as chair of the ESM Board. The powers and the democratic accountability of the President of the Eurogroup could be strengthened through the following measures:

**PROPOSAL 7.**

**Appointment of a full-time President of the Eurogroup with no national mandate.**

Since the establishment of the Eurogroup the position of President has been occupied by a finance minister. However, this is not a requirement provided for by Protocol 14. In a framework where the President of the Eurogroup assumes increasing and time-demanding responsibilities, the role's effectiveness would obviously significantly increase if the position were permanent and not combined with a national mandate. Moreover, it would ensure a level of neutrality, insulated from the political dynamics of a national constituency. If, in addition, a direct link between the European Parliament and this position were created (for example, by granting the European Parliament the power of dismissal), the President of the Eurogroup would be more likely to make additional efforts to ensure horizontal coordination between the Council and the European Parliament. This would rebalance the powers of the Council in favour of the European Parliament, with a consequent increase in the democratic legitimacy of the decisions made by the Eurogroup.

**PROPOSAL 8.**

**Interinstitutional agreement between the Council (ECOFIN/Eurogroup configuration) and the European Parliament committing the Eurogroup to dismiss its President should the European Parliament adopt a motion to this purpose.**

Within the current Treaties, the European Parliament has no powers of supervision or sanction over the activity of the President of the Eurogroup. The power to dismiss the President of the Eurogroup would constitute a way to link the residual intergovernmental dimensions of the decisions made in the framework of the EMU to the European citizens' constituency.

**PROPOSAL 9.**

**Permanent invitation of the President of the Eurogroup to Euro Summit meetings.**

This would follow the other fields of policy combining intergovernmental and community instruments. For example, in the field of external action, the High Representative benefits from a permanent invitation to European Council meetings when matters under her scope of competence are discussed. This reinforces her capacity to ensure the inter-institutional and the vertical coherence of such policies (i.e. between the European Council on the one hand and the Council and the Commission on the other, and between the EU and its Member States).

Regarding the position of the Vice-President of the Commission in charge of Economic and Monetary Affairs, the position's powers are much wider and more defined than those of the President of the Eurogroup. Collegially with the rest of the Commission, the Vice-President is responsible for most of the executive tasks within the EMU (assessment, surveillance, monitoring, emission of recommendations, etc.) and has the right of initiative. In addition, the Commission's DG ECFIN implements several financial instruments

and benefits from means of coordination with the financial institutions of the Union (ECB, EIB, EBRD, IFIs) and the European Parliament. However the position does not bear the ultimate responsibility for the most important political decisions, which are reserved for the Eurogroup.

#### **PROPOSAL 10.**

**Merger of the positions of President of the Eurogroup and Vice-President of the Commission (Commissioner for Economic and Fiscal Affairs) based on the HR/VP model, creating a de facto “EMU Finance Minister”.**

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**IMPLEMENTATION:** *A long-lasting settlement would require treaty revision. However, for the duration of one Commission term, this could be implemented through a political arrangement in the form of an interinstitutional agreement between the Council, the Commission and the European Parliament.*

Although in legal terms the responsibility for EMU policies could be divided between the President of the Eurogroup and the Vice-President of the Commission in their respective fields of competence, the reality is that the community and the intergovernmental dimensions of EMU governance are so interconnected that no sanction powers could be exercised in such a set up. The merger of these two positions into one single person would overcome this democratic deadlock.

This set up would also allow the European Parliament (and EU citizens at large) to identify the main political responsibility in EMU economic and fiscal policies and to sanction or reward its holder politically. However, the political responsibility of this position could only be effectively engaged if the following proposal were implemented:

#### **PROPOSAL 10 BIS.**

**Proposal 10 bis. Commitment by the President of the Commission to ask for the resignation of the VP for Economic and Fiscal Affairs if the European Parliament votes a motion to dismiss him/her from the position of President of the Eurogroup** (as part of the interinstitutional agreement and complementing Proposal 8).

#### **PROPOSAL 11.**

**Merger of the administrative structures under the authority of the VP (DG ECFIN) and the respective services of the Council (DG G).**

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Two options exist for the **IMPLEMENTATION:**

##### **PROPOSAL 11. OPTION A.**

Migration of Directorate General G of the Council (or of a considerable part of it) to the Commission under the structure of DG ECFIN.

##### **PROPOSAL 11. OPTION B.**

Creation of a body regrouping DG ECFIN and DG G (EEAS model).

*Both options could be implemented through a Council Decision establishing the EMU Fiscal and Treasury Administration (Based on Art. 352 TFEU).*

Consistency between the intergovernmental and the Community duties of the EMU Finance Minister could be ensured by the merger of the current administrative structures in the Council and the Commission. It is to be noted that the Secretariat for the Eurogroup (the so-called Eurogroup Working Group) is already hosted by the Commission under the administrative authority of the Director-General of DG ECFIN. ■

## 2. AN ADDITIONAL BUDGET FOR THE EURO AREA

The euro area represents an imperfect monetary union, with a supranational monetary policy managed by an independent and non-political institution (the European Central Bank) but without a proper European government with the competences, instruments and resources of policy-making at European level. As a result, the euro area currently lacks any policy instrument to address asymmetric shock or give impulse to economic growth, since only monetary policy has been transferred and is exclusively reserved to pursuing price stability.

### PROPOSAL 12.

#### **Creation of an EMU additional own fiscal capacity (in essence: a euro area budget).**

**IMPLEMENTATION:** See options in sections 2.1. and 2.2 below.

The EMU would need a variety of policy instruments to directly support the economy of the euro area and make it more resistant, particularly in case of asymmetric shocks. The idea that the EMU would need its own budget is not new, but it has gained relevance during the last years. An own budget would allow it, first, to deploy instruments designed to reduce the probability of asymmetric shocks by conducting long-term strategies increasing economic convergence, addressing structural flaws and favouring the mobility of the work factor. Even if the coordination of economic policies would primarily be implemented through the adoption of secondary legislation, from a political point of view, the adoption of convergence measures would be much easier if the costs of their implementation were compensated through financial incentives, which could be funded by the EMU's fiscal capacity. Second, an own budget would enable the EMU to make investments in infrastructure and initiatives aimed at making its economy more integrated, dynamic and attractive by exploiting the synergies of the Single Market. Third, given that the risk of asymmetric shocks cannot be brought to zero, it should also rely on financial instruments to react in a timely fashion to tackle the regional effects of economic shocks before they produce negative externalities.

*"THE EMU WOULD NEED A VARIETY OF POLICY INSTRUMENTS TO DIRECTLY SUPPORT THE ECONOMY OF THE EURO AREA AND MAKE IT MORE RESISTANT, PARTICULARLY IN CASE OF ASYMMETRIC SHOCKS."*

The creation of a budget for the EMU would certainly have considerable democratic implications. In the previous section, it was argued that a more powerful EMU needs a stronger political structure to legitimise its action. The reverse is also true. Indeed, any political structure deprived of the financial means necessary to implement its decisions and required to live up to its political commitments would be an empty shell:

*"AS LONG AS THE EMU CONTINUES TO RELY ON THE MEMBER STATES' WILL TO FINANCE ITS POLICIES, THE EFFORTS MADE TO INCREASE DEMOCRATIC LEGITIMACY AND POLITICAL ACCOUNTABILITY WOULD REMAIN A DEAD LETTER."*

as long as the EMU continues to rely on the Member States' will to finance its policies, the efforts made to increase democratic legitimacy and political accountability would remain a dead letter.

In order to identify the possibilities that exist within the Treaties to establish an EMU own fiscal capacity, it is necessary to study its three dimensions separately. The first dimension consists of the fiscal capacity itself, i.e. the legal and financial structure that would constitute the recipient of the financial resources. This will be the topic of the present section. The next two sections will deal, respectively with its financing, i.e. the fiscal resources used to fill the recipient, and finally with its expenditure, i.e. the policies that could be financed, according to the Treaties, with such a budget.

Regarding the structure of the EMU fiscal capacity, the possibilities that exist within the current treaty framework can be grouped in two categories. The first comprises the ways to create an EMU budget within the EU general budget. The second includes options that would allow the establishment of an EMU budget outside of the EU budget. Both sets of options will be described below.

## 2.1 EMU FISCAL CAPACITY WITHIN THE EXISTING FINANCIAL FRAMEWORK

The financial framework of the EU must respect the principle of universality of EU expenditure. The space for the creation of a separate budget within the EU financial framework is quite limited, but the Treaties and the financial regulations in force provide for two cases where certain expenditures can or must be financed separately.

### PROPOSAL 12. OPTION A.

**Establishment of an EMU additional fiscal capacity / budget through the creation of a new line in the EU general budget financed with specific earmarked resources.**

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**IMPLEMENTATION:** *Modification of the MFF Council Regulation.*

The first option would consist of creating a **new line in the EU general budget** funded with new resources which would be earmarked to finance specific policies. The new resources can take several forms (FTT, a second GNI-based system of national contributions, etc.) but, in any case, they must be additional and cannot replace national contributions to the EU general budget.

### PROPOSAL 12. OPTION B.

Establishment of an EMU additional fiscal capacity / budget through the creation of an enhanced cooperation scheme.

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**IMPLEMENTATION:** *Adoption of a Council Decision authorising enhanced cooperation between euro countries for the financing of their mutual obligations.*



The second exception to the principle of universality of the EU budget is the expenditure resulting from the implementation of **enhanced cooperation**<sup>4</sup>. In practice, this method would not be very different from the first, although the expenditure of this new fiscal capacity must comply with the quite restrictive provisions about enhanced cooperation laid down in Title III of Part Six of the TFEU.

These options seem to be preferred both by the Commission and the European Parliament, since they must comply with the principle of unity of the institutions and the budget of the EU. Thus, the EMU budget could be implemented by the European Commission and managed and supervised by the European Parliament<sup>5</sup>.

However, although these options could constitute a (cosmetic) exception to the principle of unity of the EU budget, this option would face the limits imposed by the adoption mechanism of the Multiannual Financial Framework (MFF). Indeed, it could be seen to violate the principle of 'no tax without representation'<sup>6</sup>, since non euro countries would have a veto power on the budgetary line.

In addition, the option based on enhanced cooperation presents serious legal and conceptual limitations. First, the method of differentiated integration provided for by enhanced cooperation and by the specific provisions concerning the EMU in the Treaties could turn out to be incompatible<sup>7</sup>. The main reason for this is that the particular nature of the economic and fiscal policies that the EMU would need to finance through this fund could have a considerable impact on the rights and obligations of non-euro Member States according to Single Market law. This would preclude enhanced cooperation, or limit considerably the scope of the policies that could be carried out within its framework.

## 2.2 EMU FISCAL CAPACITY OUTSIDE OF THE EU FINANCIAL FRAMEWORK

As has been explained above, the exceptions provided by the Treaties regarding the principle of universality of the EU budget are in general questionable and have a reduced scope. However, it has been reaffirmed by the precedent of the European Development Fund (EDF) and the European Court of Justice's (ECJ) jurisprudence on that matter (particularly in the case C-316/1994<sup>8</sup>, hereafter the EDF Judgement) that Member States enjoy a great degree of flexibility when it comes to financing their commitments taken in fields belonging to the shared competences of the Union.

4 Art. 332 TFEU says: "Expenditure resulting from implementation of enhanced cooperation, other than administrative costs entailed for the institutions, shall be borne by the participating Member States, unless all members of the Council, acting unanimously after consulting the European Parliament, decide otherwise".

5 Directorate General for Internal Policies (EP), Note Legal options for an EMU fiscal capacity, 2013 (retrieved on 2/12/2014 [http://www.europarl.europa.eu/RegData/etudes/notes/join/2013/474397/IPOL-AFCO\\_NT\[2013\]474397\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/notes/join/2013/474397/IPOL-AFCO_NT[2013]474397_EN.pdf))

6 Domenico Moro, "All'eurozona serve una "capacità di bilancio aggiuntiva": il "meccanismo di solidarietà" è il primo passo", *The Federalist*, Year LVI, number 1-2, page 173 (retrieved on 1/12/2014 [http://www.thefederalist.eu/site/index.php?option=com\\_content&view=article&id=1425:alleurozona-serve-una-capacita-di-bilancio-aggiuntiva-il-meccanismo-europeo-di-solidarita-e-il-primo-passo&catid=5:discussioni&lang=it](http://www.thefederalist.eu/site/index.php?option=com_content&view=article&id=1425:alleurozona-serve-una-capacita-di-bilancio-aggiuntiva-il-meccanismo-europeo-di-solidarita-e-il-primo-passo&catid=5:discussioni&lang=it))

7 Giulia Rossalio, "Autonomia finanziaria e integrazione differenziata", *The Federalist*, Year LVI, 2014, number 1-2, page 9 (retrieved on 1/12/2014 [http://www.thefederalist.eu/site/index.php?option=com\\_content&view=article&id=1415:autonomia-finanziaria-e-integrazione-differenziata&catid=2:saggi&lang=it](http://www.thefederalist.eu/site/index.php?option=com_content&view=article&id=1415:autonomia-finanziaria-e-integrazione-differenziata&catid=2:saggi&lang=it))

8 The ECJ ruled that given that the EDF was constituted of direct contributions from Member States and that the implementation of the obligations of the Lomé IV Convention belonged to a shared competence, Member States had the freedom to choose the means to fulfill these commitments. (European Court of Justice (ECJ), Judgement in case C-316/1994, *European Parliament vs. Council of the European Union*, 2 March 1994 (retrieved on 3/12/2014 <http://curia.europa.eu/juris/showPdf.jsf?text=&docid=96278&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=121348>)

In the case of the EDF, the ECJ recognised that Member States could establish separate funds and use the Union's institutional structure for their implementation, management and supervision provided that two conditions are respected. First, the fiscal capacity must not be constituted of EU resources (para. 37-38 of the EDF judgement). Second, the policies financed through the separate fiscal capacity must not fall into the scope of the exclusive competences of the EU (para. 35).

### PROPOSAL 12. OPTION C.

#### Establishment of an EMU additional fiscal capacity through an internal agreement

**IMPLEMENTATION:** *Conclusion of an internal agreement in the framework of the Eurogroup (non-legislative text under EU law)*

The EDF was established by an Internal Agreement<sup>9</sup> concluded by the Member States and its functioning is defined by a Council Regulation<sup>10</sup> (Council Decision before 2008) which is renewed every 5 years. On the one hand, the Internal Agreement was adopted by the Member States using the Council as a multilateral forum and not an EU Institution. Therefore, the Internal Agreement is an international legal instrument, not an EU legislative act. However, given that Member States did not commit to any additional obligation than those provided for by the EU Treaties and the Yaoundé and Lomé Conventions signed with ACP countries (already ratified), this internal agreement did not require ratification. The functioning of the EDF, on the other hand, is laid down in a European legislative act adopted through a special legislative procedure (requiring unanimity in the Council and no participation of the European Parliament), making its provisions enforceable under Union law. This regulation provides, for example, that the Commission should be in charge of its implementation.

### PROPOSAL 12. OPTION D.

#### Establishment of an EMU additional fiscal capacity / budget through an intergovernmental treaty

**IMPLEMENTATION:** *Conclusion of an international treaty in the framework of the Euro Summit*

The internal agreement is not the only intergovernmental procedure that can be used in order to create a separate budget to finance European policies. The European Stability Mechanism (ESM) was created by an international treaty, and the judgement of the

<sup>9</sup> Internal agreement in force: Internal Agreement of 24-26 June 2013 between the Representatives of the Governments of the Member States of the European Union, meeting within the Council, on the financing of European Union aid under the multiannual financial framework for the period 2014 to 2020, in accordance with the ACP-EU Partnership Agreement, and on the allocation of financial assistance for the Overseas Countries and Territories to which Part Four of the Treaty on the Functioning of the European Union applies ([http://ec.europa.eu/europeaid/sites/devco/files/internal-agreement-11edf-2013-2020\\_en.pdf](http://ec.europa.eu/europeaid/sites/devco/files/internal-agreement-11edf-2013-2020_en.pdf))

<sup>10</sup> Council Financial Regulation currently in force: COUNCIL REGULATION (EU) No 567/2014 of 26 May 2014 amending Regulation (EC) No 215/2008 on the Financial Regulation applicable to the 10th European Development Fund as regards the application of the transition period between the 10th European Development Fund and the 11th European Development Fund until the entry into force of the 11th European Development Fund Internal Agreement ([https://ec.europa.eu/europeaid/sites/devco/files/edf-bridging-facility-financial-regulation-567-2014\\_en.pdf](https://ec.europa.eu/europeaid/sites/devco/files/edf-bridging-facility-financial-regulation-567-2014_en.pdf))

ECJ about its compatibility with the Treaties (Judgement in case C-370/12)<sup>11</sup> helps further clarify the possibilities that Member States have to create separate funds and to involve the EU institutions in their functioning. This judgement confirms the ECJ's view regarding the Member States' freedom to choose the means to finance commitments belonging to shared competences. Regarding the new tasks conferred on the EU Institutions by the ESM Treaty, the Court stated:

"[I]t is apparent from the caselaw of the Court that the Member States are entitled, in areas which do not fall under the exclusive competence of the Union, to entrust tasks to the institutions, outside the framework of the Union, such as the task of coordinating a collective action undertaken by the Member States or managing financial assistance [...], provided that those tasks do not alter the essential character of the powers conferred on those institutions by the EU and FEU Treaties."<sup>12</sup>

That is to say, an intergovernmental treaty can create new duties for the EU Institutions provided they do not entail any power to make decisions of their own and that the activities pursued by the institutions within the intergovernmental treaty only generates commitments for the fund that it creates.

Regarding the jurisdiction of the ECJ itself, the Court refers to article 273 TFEU, which provides that "the Court of Justice shall have jurisdiction in any dispute between Member States which relates to subject matter of the Treaties if the dispute is submitted to it under a special agreement between the parties". It considers that nothing prevents the Member States from concluding such a special agreement in advance with reference to a class of pre-defined disputes, as was done in the ESM Treaty.

The conclusions drawn from this judgement have important consequences for the assignment of political responsibility in the policies funded through the EMU fiscal capacity. In case of creation of an EMU budget through an intergovernmental fund, the Commission could be conferred the responsibility for the decisions pertaining to economic coordination (shared competence and therefore within the scope of competence of the Commission) and could be vested with the powers of implementation of the EMU budget. However, when contractual arrangements are necessary to provide conditionality in the context of reform programmes to be implemented by Member States under assistance, the Commission could not be held responsible for the adoption of decisions regarding the political conditions imposed on beneficiary countries, given that this is not a competence conferred to the Union by the Treaties. In this specific case, the responsibility would still belong with the Eurogroup as an intergovernmental body and, if so decided, with its President. This again shows that the intergovernmental and community dimensions of the EMU governance are virtually impossible to disentangle without treaty change.

<sup>11</sup> European Court of Justice (ECJ), Judgement in case C-370/12, Reference for a Preliminary Ruling from the Supreme Court (Ireland) in case Thomas Pringle vs. Government of Ireland, 27 November 2012 (retrieved on 15/01/2015 <http://bit.ly/1CJLvRL>)

<sup>12</sup> ECJ, Op. CII., 2012, paragraph 158

The method just outlined would have two major advantages compared to the establishment of an EMU budget within the existing financial framework. On the one hand, as explained above, it would allow Member States to make an innovative use of the EU Institutions<sup>13</sup>. This could consist, for example, of providing the ECJ and the European Parliament with the same powers they enjoy under the EU general budget, while making the budgetary debate much easier than under the current financial procedures. On the other hand, it would allow euro countries to make important decisions for the integration of the EMU (increase in EMU budget, EMU own resources, establishment of macroeconomic convergence policies and automatic stabilisers, etc.) without the interference of non-euro Member States. ■

### 3. THE OWN RESOURCES OF THE EU OR THE EMU

In the last few years the European debate has been inflamed by discussions about the own resources of the EU, particularly due to the difficulties that the *juste retour* controversy provoked in the adoption of the current MFF in 2012. At that time, a High Level Group on Own Resources (HLGOR) was created in order to start a reflection on how to improve the composition of the revenue of the EU<sup>14</sup>. The current system of own resources of the EU has been criticised for its lack of simplicity, of transparency, of fairness and of democratic accountability. In addition, the cumbersome decision-making procedure of the Own Resources Decision, requiring unanimity in the Council and the ratification of all national parliaments, has also been identified as a great barrier to a more efficient system. Finally, its composition, consisting mostly of GNI-based contributions from Member States (including the VAT-based own resource), focuses the debate on *juste retour* claims, instead of real budgetary realms.

*"INCOME FINANCED MOSTLY BY MEMBER STATE CONTRIBUTIONS WOULD HINDER THE REDISTRIBUTIVE CAPACITY OF THE EMU ECONOMIC AND FISCAL POLICIES "*

In the framework of the EMU, the issue of the funding of its own fiscal capacity must be addressed at its very conception, given that the origin and nature of its income would have a direct impact on the policies that would be financed through it and that they will have considerable democratic implications. *On the one hand*, income financed mostly by Member State contributions would hinder the redistributive capacity of the EMU economic and fiscal policies because of the likelihood of toxic debates between net contributors and net beneficiaries. On the other hand, a mismatch between the level at which European redistributive policies are decided and the one at which taxation policies are defined would blur political responsibility. In such configuration Member States would have the last word with regard to the funding of the policies decided at the EMU level. In addition, that would break the democratic link existing between expenditure at EMU level and the taxation and financial control powers of national parliaments over the expenditures of their State.

<sup>13</sup> This innovative use could even include the extension of the Ordinary Legislative Procedure to the adoption of EMU financial regulations, the EMU multiannual financial framework and of the EMU annual budget, as well as to the conduct of the EMU Economic and Fiscal Policies. With regards to this, in the EDF judgement, the ECJ stated: "[n]o provision of the Treaty prevents Member States from using, outside its framework, procedural steps drawing on the rules applicable to Community expenditure" (para. 41)

<sup>14</sup> High Level Group on Own Resources (HLGOR), First Assessment Report, Brussels, 17 December 2014 (retrieved on 20/12/2014 [http://ec.europa.eu/budget/library/biblio/documents/multiannual\\_framework/HLGOR\\_1stassessment2014final\\_en.pdf](http://ec.europa.eu/budget/library/biblio/documents/multiannual_framework/HLGOR_1stassessment2014final_en.pdf))

In the last decade, the European Parliament<sup>15</sup>, the Commission<sup>16</sup> and the HLGOR have issued several publications addressing a series of goals that the reform of the own resources should attain. These objectives would consist of: (1) reducing the share of GNI-based contributions from Member States; (2) avoiding antagonist debates between net contributors and net beneficiaries; (3) simplifying the decision-making procedures; and (4) creating a more direct financial relationship between the EU and the European citizens.

In order to identify the potentialities existing within the Treaty of Lisbon in order to achieve these goals, it is necessary to split the task into two technical objectives. The first step of the reflection will consist of defining the mechanisms that would allow the EU/EMU revenue to be disconnected from GNI-based national contributions. The second will aim at identifying the possible new own resources that could be assigned to the EU's or the EMU's budgets.

### 3.1 DISCONNECTING OWN RESOURCES FROM GNI-BASED NATIONAL CONTRIBUTIONS

As will be explained in Section 3.2., the type of own resources that could be assigned to the EU or the EMU is considerable. Therefore, the greatest challenge when it comes to reforming the system of own resources, or creating one for the EMU, does not consist of identifying new sources of revenue but of finding consensus among Member States on the type and amount of resources and, more fundamentally, on disconnecting such resources from national contributions. As long as these appear in the Member States' balance sheets as expenses to the profit of the European budgets, the budgetary debate in national parliaments will inevitably remain focussed on the notion of *juste retour*.

#### PROPOSAL 13.

**Reforming the system of own resources of the Union in order to disconnect own resources from Member States' contributions.**

**IMPLEMENTATION:** *See options below.*

#### PROPOSAL 13. OPTION A.

**Taking contributions to the EU budget out of the Member States' national balance sheets, at least for the effects of the European Semester.**

**IMPLEMENTATION:** *Revision of Council Regulation (EC) No 2223/96 on the European system of national and regional accounts in the Community*

<sup>15</sup> European Parliament, European Parliament initiative report on the future of the European union's own resources, A6-0066/2007 final, Alain Lamassoure (MEP), 13 March 2007

<sup>16</sup> European Commission, Amended proposal for a Council Decision on the system of own resources of the European Union, COM(2011)739 Brussels, 9 November 2011 (retrieved on 20 January 2015 [http://ec.europa.eu/budget/library/biblio/documents/fin\\_fwk1420/COM\\_2011\\_0739\\_EN.pdf](http://ec.europa.eu/budget/library/biblio/documents/fin_fwk1420/COM_2011_0739_EN.pdf)) and European Commission, Amended proposal for a Council Regulation laying down implementing measures for the system of own resources of the European Union, COM(2011)740, 9 November 2012 (retrieved on 20 January 2015 [http://ec.europa.eu/budget/library/biblio/documents/fin\\_fwk1420/COM\\_2011\\_0740\\_EN.pdf](http://ec.europa.eu/budget/library/biblio/documents/fin_fwk1420/COM_2011_0740_EN.pdf))

Within the current Treaties, this issue could be addressed in two different ways. The first would consist simply of taking Member States' contributions to the EU budget out of their national balance sheets. This measure would be based on the assumption that Member States are acting as agents of the EU when they levy the taxes that constitute the traditional or new own resources of the Union. This would be a cosmetic solution, but it would be likely to soothe debates in national parliaments. However, it could be used by the opponents of European integration, who could interpret it as a new source of opacity in the functioning of the EU.

#### **PROPOSAL 13. OPTION B.**

**Creation of a Generalised Correction Mechanism financed with traditional and new own resources and used to refund the part of each Member State's contributions exceeding 0.2% of the average contribution-GNI ratio.**

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**IMPLEMENTATION:** *Revision of Council Decision 2014/335/EU (ORD)*

The Commission has proposed a simplification of the permanent and temporary national rebates which are used to avoid excessive imbalances between net contributors and net beneficiaries of the EU budget. It proposed to replace it with a generalised Correction Mechanism<sup>17</sup>. However, this proposal was complex to implement, and it left some important unanswered questions like the way corrections would be financed. In addition, it raised concern among some Member States that it would crystallise the *juste retour principle as the rule with regards to EU revenue debates*<sup>18</sup>.

It could be positive nevertheless to smooth the differences between the contributions of some Member States when they are excessive compared to their prosperity. A Generalised Correction System could be considered, financed with one part of the traditional and new own resources of the Union. It would refund the part of the contributions of a Member State that exceed a proportion of the average contributions of the 28 Member States compared to their GNI. For instance, it could be decided to refund the contributions exceeding the average contribution-GNI ratio by 0.2%. This correction system would still allow the EU budget to play a redistributive role by permitting a significant difference between each Member State's contributions. In addition, if the corrections were financed with own resources, the position of net beneficiaries would not be eroded as has occurred with the 2004-2007 new Member States compared to the United Kingdom.

However, none of the proposals mentioned above would put a definitive end to the division between net contributors and net beneficiaries. Only the application of the subsidiarity principle to the way taxation powers are distributed in the EU could solve this problem. So far, one of the main principles that have guided the financing of the EU is the respect of the financial sovereignty of national parliaments. This comes from the traditional constitutional doctrine, which considers that the taxation power is an unlimited

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<sup>17</sup> European Commission, 2011, Op. Cit. (see footnote no. 16)

<sup>18</sup> Senate of the French Republic, *Rapport d'information fait au nom de la commission des affaires européennes sur les ressources propres du budget de l'Union européenne*, prepared by Senator Mr. Pierre Bernard-Reymond (Commission des affaires européennes), Paris, 21 February 2012 (retrieved on 10 January 2015 [<http://www.senat.fr/tap/r11-385/r11-3851.pdf>])

power of the sovereign and that it is disconnected from any obligation of expenditure<sup>19</sup>. However, this definition of taxation power falls short of conceptual tools in a political system where some areas of sovereignty have been pooled and are exercised jointly.

In a political construction like the EU, the principle of 'no tax without representation' cannot be interpreted only in the light of the traditional concept of national sovereignty. On the contrary, the provision by the EU of a series of public goods entails the existence of a single European taxation space, over which the European Parliament should be recognised to have exclusive powers of representation (in respect of the principles of subsidiarity and proportionality).

In consequence, only the establishment of a European taxing jurisdiction would demolish the barriers that hinder the redistributive capacity of the European budgets. For this, the EU (as EU or as EMU) would have to be conferred the power of tax collection, which would require the revision of Art. 311 of the TFEU.

*"THE PROVISION BY THE EU OF A SERIES OF PUBLIC GOODS ENTAILS THE EXISTENCE OF A SINGLE EUROPEAN TAXATION SPACE, OVER WHICH THE EUROPEAN PARLIAMENT SHOULD BE RECOGNISED TO HAVE EXCLUSIVE POWERS OF REPRESENTATION "*

### 3.2 DEVELOPING THE OWN FINANCIAL RESOURCES OF THE EU (AND POTENTIALLY THE EMU)

The share of the so-called Traditional Own Resources in the EU budget, consisting mainly of the revenue from the common customs duties and excises on sugar products, has been dramatically reduced over the last decades. Today it accounts for approximately 12% of the EU budget. The greatest part is currently financed by the VAT-based and the GNI-based contributions, both considered in practice as contributions by Member States.

Several proposals have been made by different EU and national institutions in order to find new own resources for the EU budget. It has to be noted that if a separate budget was created by the EMU, the following considerations would also apply to its own resources.

#### **PROPOSAL 14.**

**Reform of the VAT-based own resource, with the establishment of an EU or EMU rate of 2% maximum applied to the national VAT revenue from all goods and services currently subject to the standard rate.**

**IMPLEMENTATION:** *Revision of the Council Own Resources Decision (ORD)*<sup>20</sup>

<sup>19</sup> James M. Buchanan and Geoffrey Brennan, *Power to Tax: Analytical Foundations of a Fiscal Constitution*, ed. Cambridge University Press, 1980

<sup>20</sup> Council Decision of 26 May 2014 on the system of own resources of the European Union (2014/335/EU, Euratom)

In 2011 the Commission proposed a deep **reform of the VAT-based own resource and the creation of a Financial Transaction Tax (FTT)**. Currently the VAT-resource tax base is defined according to complex statistic calculations that disconnect it from the real VAT revenue in each Member State and pegs it instead to their GNI. The Commission proposed to replace this source by a proportion of the national revenue from VAT on a tax basis composed of all the goods and services currently subject to the standard rate. This European bracket would be fixed at European level and limited to 2%.

#### PROPOSAL 15.

##### Establishment of a European Financial Transaction Tax

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###### IMPLEMENTATION:

- *Adoption of the Commission Proposal for a Directive implementing enhanced cooperation in the area of financial transaction tax<sup>21</sup>, if so decided, as modified in order to assign its revenue to the EMU budget.*
- *Revision of the ORD*

Regarding the second new own resources, the FTT started making its way forward in 2011 with this proposal from the Commission, and appears to have advanced among 11 Member States in the framework of enhanced cooperation in spite of some opposition. However, discussions about its scope (application to operations made by financial institutions based in the participating countries or operating in them) seems to have left it in stalemate.

In addition to the two proposals from the Commission mentioned above, a series of new own resources can be considered and have already been assessed in several instances<sup>22</sup>.

#### PROPOSAL 16.

##### Assignment of one part of the revenue from the European Emission Trading System to the EU or the EMU

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###### IMPLEMENTATION:

- *Revision of the ORD*
- *Revision of the Directive 2003/87/CE*

A possible source of revenues could consist of the assignment of one part of the revenue from the **European Emission Trading System (ETS)** to the EU or the EMU. The transaction costs of the establishment of this new source of revenue would be relatively low since Member States have not benefited from it yet. At the same time, given that the ETS was established through a European Directive, it constitutes a legitimate claim for the EU to have its revenue assigned.

<sup>21</sup> European Commission, Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013)71 final, Brussels, 14 February 2013 (retrieved on 20 January 2015 [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/com\\_2013\\_71\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/com_2013_71_en.pdf))

<sup>22</sup> Senate of the French Republic, 2012, Op. Clf., (see footnote no. 18)



**PROPOSAL 17.**

**Establishment of a European excise on tobacco and alcohol products**

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**IMPLEMENTATION:**

- Revision of the ORD
- Revision of the Council Directive 2010/12/EU (for tobacco)
- Revision of the Council Directive 92/84/CEE (for alcohol products)

Another source of revenues could be generated by the establishment of a **European excise on tobacco and alcohol products**. This tax would have the advantage of benefiting from a high degree of harmonisation between all the EU Member States. It would find a double justification to have a European excise on such products, since it would contribute to the fight against smuggling and to reduce the consumption of these products across the Union.

The EU Corporate Income Tax has also emerged as a possibility in different studies mainly since 2008. It has not been put forward by any of the above mentioned reports because of the complexity of the definition of its base and by the lack of consensus among Member States on its possible implementation. Nevertheless the recent scandals regarding corporate tax evasion within the EU and the evident difficulty of addressing tax evasion by large corporations that benefit from divergent and competing tax regimes in different Member States should push towards a system of corporate taxation based on a common tax rate at EU (or euro area) level and remaining tax competition only on any additional tax bracket.

**PROPOSAL 18.**

**Definition of a European Common Corporate Tax Base**

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**IMPLEMENTATION:** Adoption of the Commission Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011)121 final or of a different proposal on this purpose

**PROPOSAL 19.**

**Creation of an EU Corporate Income Tax**, consisting of a minimum European corporate income tax applicable to the Common Corporate Income Tax Base and including a European bracket to fund the EU/EMU budget

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**IMPLEMENTATION:**

- Revision of the ORD
- [Eventually revision of the Directive on Common Corporate Income Tax Base]

The establishment of this tax would require a two-step approach. In a first stage, it would require the definition of a common corporate income tax base, which in itself would be likely to increase national revenue. This procedure was initiated by the Commission in 2011, but the adoption of its Proposal for Directive is currently blocked at the Council. The establishment of this base would constitute the necessary first step for the creation of a European Corporate Income Tax (known as EUCIT) at a later stage.

This tax system would consist of a minimum taxation rate decided at European level and applicable to the Corporate Income Tax Base in the EU or the EMU. Within this harmonised system, a European bracket could be created, i.e. an adjustable proportion of the common corporate tax rate would be decided at European level and the revenue corresponding to it could constitute a new own resource for the EU or the EMU. As explained above, within the framework of the current Treaties, this revenue could not be collected directly by the EU. Instead it should be transferred by the Member States to the EU or the EMU budget.

#### **PROPOSAL 20.**

**Transfer of a part of the profits generated by the ECB's financial operations to the European Investment Bank (EIB) in order to reimburse project-bonds and feed European investment funds.**

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**IMPLEMENTATION:** *Amendment of Art. 33.1(a) of the ECB Statute by means of regulation of the Council and the Parliament (ordinary legislative procedure).*

#### **PROPOSAL 21.**

**Conversion of a part of the net profits generated by the ECB's financial operations into a new own resource of the EU or the EMU.**

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**IMPLEMENTATION:** *Amendment of Art. 33.1(a) of the ECB Statute by means of regulation of the Council and the Parliament (ordinary legislative procedure). Modification of the EU's Own Resource Decision (unanimity and ratification required) or adoption of an EMU Own Resource Decision including this source of revenue.*

Finally, according to the Statute of the European System of Central Banks and of the European Central Bank (the Statute), the net profits made by the ECB from its financial operations are distributed among the ECB General Reserve Fund (up to 20%)<sup>23</sup> and national central banks proportionately to their paid-up shares<sup>24</sup>. This distribution of earnings contrasts with other currency unions within established federal states. For example, only 6% of the Federal Reserve's earnings are paid to stockholders as dividends, while the rest is transferred to the Secretary of the Treasury and used in order to supplement the gold reserve or to reduce the federal debt<sup>25</sup>. This is a system that could be replicated for the ECB and the EMU.

In the EMU, the profits of the ECB could thus be used in two different ways. The first would consist of transferring a part to the EIB in order to repay project-bonds or feed the European Fund for Strategic Investment (EFSI), and thus support the EU's debt. This would require the modification of Art. 33.1(a) of the Statute, which can be done by means of a regulation adopted according to the ordinary legislative procedure<sup>26</sup>.

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<sup>23</sup> Article 33.1(a) of the Statute

<sup>24</sup> Article 33.1(b) of the Statute

<sup>25</sup> Section 7 of the Federal Reserve Act

<sup>26</sup> Art. 40.1. of the Statute

One part of the ECB's profits could also be transferred to the EU or the EMU budgets as a new own resource. Apart from the modification of Art. 33.1 (a) of the Statute, this would need the ORD to be amended if this revenue was to become part of the EU's own resources. If it were decided to assign this revenue to the EMU instead of the EU, the new EMU Own Resource Decision should have to include it.

#### **PROPOSAL 22.**

##### **Reduction of collection costs of traditional own resources from 20% to 10 %**

**IMPLEMENTATION:** *Modification of Art. 2(3) of the ORD*

The current Own Resources Decision provides for collection costs of 20% of the amount of the traditional own resources. Across the successive MFFs, the proportion of the traditional own resources retained by Member States to cover the expenses generated by their collection has steadily increased from 5% to 25% for the 2007-2013 MFF. The simple reduction of these costs to 10% would increase the share of traditional own resources from 12% to 14% automatically. ■

## **4. SHIFTING EMU POLICIES FROM A RULE-BASED APPROACH TO POSITIVE ECONOMIC AND FISCAL POLICY MAKING**

The recent evolution of the non-monetary policies carried out in the framework of the EMU has remained limited to the realm of economic coordination and, when required, their financing has been ensured in the form of loans (ultimately from Member States), and not actual EU expenditure. In addition, excluding the first stones of the Banking Union, the European Semester is a crisis-driven mechanism (at best activated in the stages immediately preceding a crisis) aimed at the prevention of negative spill-overs between euro countries.

In the short to medium term, the rule-based system of the European Semester constitutes a zero-sum game by design, since it does not provide for any positive effect compared to the situation prior to the implementation of the excessive imbalance procedure. In practice, compared to the moment where the reform programmes are put in place, it could end up being a negative-sum game in the short to medium term. This has had a considerable negative impact not only on the effectiveness of the system but also on the way European citizens perceive the functioning of democracy at the European level<sup>27</sup>.

<sup>27</sup> The above mentioned report prepared by CEPS (see footnote no. 2) highlights increasing dissatisfaction in peripheral euro countries. In 2013, compared to 2010, satisfaction with the way democracy works in the EU has dramatically dropped in Cyprus (-42%), Greece (-46%), Italy (-38%), Portugal (-53%) and Spain (-43%).

The negative impact of the rule-based system could be reversed by a switch to positive policy making in the areas of economy and taxation in the EMU. The establishment of a genuine economic government of the EMU, embodied by the EMU Finance Minister (see Proposal 10 above) and adequately controlled by the European Parliament (Proposals 1 to 4), and the creation of an EMU fiscal capacity to finance its policies (Proposal 12) would lay down the necessary political basis to support a single economic and fiscal policy for the euro area. This new framework could be accompanied by insurance-type macroeconomic stabilisers, which could be used to share the risk and alleviate the effects of asymmetric economic shocks. However, the functions of the EMU budget would be highly dependent on its legal structure and the composition of its revenue.

The following proposals could be introduced gradually in order to move from the current rule-based economic governance system to a system based on political decision-making.

#### 4.1 PROMOTING MACROECONOMIC AND SOCIAL CONVERGENCE WITHIN THE EMU / TOWARDS A SINGLE ECONOMIC AND FISCAL POLICY FOR THE EMU

The existing European economic surveillance framework already provides a basis for economic policy coordination but it does not provide for ex ante coordination mechanisms nor for effective enforcing mechanisms for use on Member States. In many cases, the necessary reforms are not carried out because of the high short-term economic, social and political costs for national governments, even if the long-term benefits could be sizeable. The Single Economic and Fiscal Policy (SEFP) would allow the EMU to go beyond the current Macroeconomic Imbalance Procedure. It would constitute a framework for ex ante coordination of major national economic and structural reforms likely to have positive externalities for the euro area as well as for the identification and implementation of EMU-wide projects to be financed through direct European public investments. In order to be able to promote reforms outside the framework of the corrective arm of the SGP, the SEFP could provide financial assistance to Member States to alleviate short-term costs. The SEFP would thus fully exploit the potential of both articles 136 TFEU and 11 TSCG and the proposal made in the Commission's Blueprint of a Convergence and Competitiveness Instrument<sup>28</sup>.

##### PROPOSAL 23.

Creation of a Single Economic and Fiscal Policy (SEFP) for the EMU, with the following prerogatives:

- **Strategic framework for macroeconomic policy in the EMU** (general strategies, CSR and thematic roadmaps).
- **Implementation of strategic framework** through: 1) coordination of national labour, social and economic policies; 2) establishment of minimum standards in key public policies; 3) provision of incentives/imposition of sanctions; and 4) direct European public investments in projects representing an interest for the entire EMU.
- **Confidence building measures.**

<sup>28</sup> See section 3.1.5. of the document European Commission, A blueprint for a deep and genuine economic and monetary union – Launching a European debate, COM(2012) 777 final/2, Brussels, 30 November 2012 (retrieved on 15/12/2014 [http://ec.europa.eu/archives/commission\\_2010-2014/president/news/archives/2012/11/pdf/blueprint\\_en.pdf](http://ec.europa.eu/archives/commission_2010-2014/president/news/archives/2012/11/pdf/blueprint_en.pdf))

The SEFP could be articulated around two main operative task clusters: 1) a programmatic cluster, with the formulation of strategies for the creation and financing of European public goods and the promotion of macroeconomic convergence and positive externalities within the euro area; and 2) an implementation stage, with the adoption of secondary legislation translating the above mentioned strategies. It should be complemented by confidence building measures, which would increase transparency and trust between euro countries.

Regarding the first cluster, the EMU should build on the instruments of the European Semester in order to go further in the identification of and joint decision on reforms at national level and policies and projects at European level, particularly specific projects having potential positive spillovers for the euro area. The Strategy for Macroeconomic Convergence in the EMU would provide political guidance for the medium term and would constitute the basis for the SEFP. It would constitute the logical evolution of the 'broad guidelines' provided for by article 121(2) TFEU and should be proposed by the Commission and adopted by the European Parliament and the Council as co-legislators. At a second stage, these strategies should be translated into Country-Specific Recommendations when it comes to national reforms and Thematic Roadmaps defining EMU-wide policies and projects.

*"THE STRATEGY FOR MACROECONOMIC CONVERGENCE IN THE EMU WOULD PROVIDE POLITICAL GUIDANCE FOR THE MEDIUM TERM AND WOULD CONSTITUTE THE BASIS FOR THE SEFP"*

The implementation of these strategies would comprise the adoption of secondary EU legislation in order to coordinate national policies in the areas of labour market regulation, pensions and taxation and to set minimum standards on key public policies (R&D, transparency and meritocracy in public administration, the fight against tax evasion, etc.). Moreover, it would include direct European investments in order to finance projects benefiting the EMU financed by the European Fund for Strategic Investments (or another similar fund) managed by the EIB, which could be partially guaranteed by the EMU budget. It could also require financial incentives to introduce country-specific reforms inside and outside the corrective arm, and the imposition of sanctions when the Treaties provide for them.

As for the coordination of social and economic policies, the current treaty framework would still contain some room for manoeuvre, but in the medium term the preclusion of harmonisation in the field of social policy<sup>29</sup> could represent a great challenge to the functioning of the SEFP.

Financial support could not be provided outside the framework of a contractual arrangement concluded between the Commission and the Member State concerned<sup>30</sup>. These contractual arrangements would constitute the underbelly of the SEFP for two reasons. First, as has been highlighted by the European Parliament<sup>31</sup>, the contractual arrangements would share many features with the Memoranda of Understanding (MoU), which paradoxically constitute non-contractual instruments given that they cannot entail sanctions in case of non-compliance. Secondly, the final implementation of the SEFP would eventually depend on the will of national governments, since they are free not to conclude contractual arrangements with the Commission if they do not wish to

<sup>29</sup> Art. 153(2) TFEU (however, this article falls under the scope of application of the Simplified Revision Procedure)

<sup>30</sup> Art. 124-125 TFEU, respectively imposing the necessity of "prudential considerations" when financial assistance is given by the Union to a Member State and allowing "mutual financial guarantees for the joint execution of a specific project".

<sup>31</sup> Directorate General for Internal Policies (EP), 2013, Op. Cit. (see footnote no.5)

benefit from financial assistance. Therefore, in the medium term treaty revision would be required in order either to include a new type of enforceable instrument –to be concluded between the Commission and individual Member States, and whose conclusion would be compulsory under certain circumstances–, or to give the EMU institutions direct powers over Member States' policy measures.

Finally, the SEFP could be used to put measures in place promoting mutual confidence between euro countries. Under the current Treaties, such measures would consist of the standardisation and harmonisation of data collection in all areas of public administration.

## 4.2 SHARING AND ALLEVIATING THE IMPACT OF ASYMMETRIC SHOCKS IN THE EMU / THE NEED FOR AUTOMATIC MACROECONOMIC STABILISERS

Any currency union is exposed to the risk of asymmetric shocks, which are not as such the result of deficient economic and fiscal policies by its constituent members' governments but from differences in the structures of each Member State's economy coupled with the loss of monetary sovereignty and the freedom of movement of capitals<sup>32</sup>. The soundness of national finances and the implementation of measures aiming at meeting the conditions of an optimal currency area (e.g. improving the mobility of the work factors) could alleviate the effects of asymmetric shocks by increasing the resilience of the currency union, but such measures will not prevent them from happening.

*"IN ORDER TO COPE WITH SUCH ASYMMETRIC SHOCKS, MATURE CURRENCY UNIONS WITHIN ESTABLISHED FEDERAL STATES HAVE PUT DIFFERENT TYPES OF STABILISERS IN PLACE, WHICH COULD BE TAKEN AS A MODEL BY THE EMU."*

In order to cope with such asymmetric shocks, mature currency unions within established federal states have put different types of stabilisers in place, which could be taken as a model by the EMU. Stabilisers can be classified in two categories<sup>33</sup>. The first are bailout agreements or other forms of *ex post* financial support that come into play after crises erupt. This is the type of stabiliser that the EMU has put in place after the outset of the sovereign-debt crisis, but it is based on a rather low level of risk sharing between euro countries. Therefore, the political, economic and social costs generated by the asymmetric shock are concentrated in the State concerned. In contrast, the

second type of stabilisers is based on relatively high risk sharing. Thus, the centralised provision of public goods and services (e.g. a common floor for unemployment insurance or common infrastructure investment insulated from potentially pro-cyclical fiscal policies at national level) and counter-cyclical transfer mechanisms require some extent of political union and *ex ante* fiscal arrangements.

*"INCOME FINANCED MOSTLY BY MEMBER STATE CONTRIBUTIONS WOULD HINDER THE REDISTRIBUTIVE CAPACITY OF THE EMU ECONOMIC AND FISCAL POLICIES."*

The establishment of an SEFP would pave the way for greater risk sharing in the EMU, given that *ex ante* coordination of economic policies would generate a framework of shared responsibility. In consequence EMU automatic stabilisers could be conceived as a solidarity mechanism aimed at mitigating the effects of asymmetric shocks that have occurred in spite of the implementation of and compliance with the SEFP.

32 See Ronald I. McKinnon, "Optimum Currency Areas and Key Currencies: Mundell I versus Mundell II", in *Journal of Common Market Studies*, 2004, Volume 42, Number 4, pp. 689-715 (retrieved on 20/01/2015 [https://notendur.hi.is/qjansson/kennsla\\_2012/MundellIversusMundell2.pdf](https://notendur.hi.is/qjansson/kennsla_2012/MundellIversusMundell2.pdf))

33 IMF, *Toward a fiscal union for the euro area: technical background notes*, Washington, September 2013 (retrieved on 20/01/2015 <http://www.imf.org/external/pubs/ft/sdn/2013/sdn1309fn.pdf>)

**PROPOSAL 24.**

**Creation of a semi-automatic macroeconomic stabiliser**, funded by contributions from Member States calculated as a function of their output gap during early- and mid-cycles, and used to finance specific counter-cyclical projects in countries affected by an asymmetric shock.

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**IMPLEMENTATION:** *This stabiliser could be funded by a specific line of the EMU fiscal capacity, or, in its absence, a separate line of the EU budget (see limitations of this option in section 2.1). Its financing mechanism should be laid down in the EU/EMU own resource decision and the respective financial regulation. Its payments would require the previous conclusion of a contractual arrangement between the EU and the Member State concerned.*

For the last few years several models of automatic stabilisers have been proposed. The Commission's Blueprint adopts a broad approach to stabilisation, proposing a system that "may encourage fiscal retrenchment during economic booms, while providing additional room for manoeuvre for a supportive fiscal stance in downturns"<sup>34</sup>. Ideally, such a mechanism should work on the basis of a system of automatic contributions/payments as a function of each Member State's output gap. That is to say, countries with high growth rates should pay a percent of their GDP to the fund, while those experiencing a downturn in their activity should receive a part of this money. This balancing system of contributions and payments should be triggered according to a series of thresholds, without need for political decisions to be made. However, the current Treaties would allow the automatic activation only with respect to contributions. For payments to be activated, a contractual arrangement should be previously concluded. Therefore, even if in this partially automatic setting its potential benefits would remain sizeable, its functioning could be hindered by political interference in the conclusion of the contractual arrangements (see section 4.1 above).

**PROPOSAL 25.**

**Creation of a European Incentive Scheme for Mobility**, based on bilateral contracts between the physical beneficiaries and the Commission and providing grants to promote workers' mobility between EMU countries

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**IMPLEMENTATION:** *EU Regulation based on article 46(d) TFEU.*

Another proposal present is the European Unemployment Insurance Scheme<sup>35</sup>, already known as the EUIS. All these proposals conclude that the establishment of a genuine EUIS would require treaty change, given that the transfers to national unemployment insurance schemes or directly to their countries' job seekers would generate a moral hazard contrary to the provisions of articles 125 and, more generally, 310 TFEU. Indeed, this moral hazard could be addressed only through means of harmonisation of the social policies of the euro countries, which is precluded by article 153(2) TFEU.

<sup>34</sup> European Commission, Blueprint, 2012, Op. CII. (see footnote no.28), p. 32

<sup>35</sup> See, e.g. European Commission, Blueprint, 2012 Op. CII. (see footnote no. 28); Herman van Rompuy, President of the European Council, Towards a Genuine Economic and Monetary Union (known as the Four Presidents' report), Brussels, 5 December 2012; Michaela del Monte and Thomas Zandsira [European Parliament Research Service], Common unemployment insurance scheme for the euro area, Cost of Non-Europe Report, Brussels, June 2014; IMF, 2013, Op. CII. (see footnote no. 33)

Nevertheless, two transitional solutions could be implemented. The first would consist of using the semi-automatic stabilisation mechanism described above in order to finance specific unemployment-related projects normally funded by the Member States so that the liberated funds can be redirected to unemployment subsidies. In addition, a European Incentive Scheme for Mobility could be proposed by the Commission in order to achieve the objective set out in article 46(d) TFEU<sup>36</sup>. This scheme could use the Erasmus model in order to provide job seekers from countries where unemployment exceeds a fixed rate with grants in order to allow them to move to another EU country where the chances of finding a job can be assessed by the Commission to be objectively higher. In this case, the moral hazard would be addressed through a direct contract between the Commission and each individual applicant setting out their specific rights and duties. ■

## CONCLUSIONS

In the previous sections the deficiencies of the EMU's functioning in terms of democratic legitimacy and political accountability have been analysed with a view to identifying the potentialities existing within the framework of the current Treaties that would allow the EMU to work in a more democratic and efficient way, as well as the limitations that the Treaties impose.

On the one hand, the democratic legitimacy of decisions made under the EMU umbrella could be strengthened thanks to a greater involvement of the European Parliament and a better division between the executive and representative powers of the European / euro area institutions. On this matter, the current Treaties would allow clearer political responsibility to be assigned in economic and fiscal matters of the euro area, which would be embodied by an EMU Finance Minister (combining the roles of a full-time President of the Eurogroup and Vice President of the European Commission) and democratically controlled and sanctioned thanks to the full exploitation of the European Parliament's powers. In addition, recommendations were made in order to avoid negative interferences by the Member States through the European Council and shifting decision-making powers to the European Commission.

A set of proposals were also presented regarding the capabilities and procedures at the disposal of an EMU executive to implement medium- and long-term macroeconomic policies aimed at improving the resilience of the euro area to asymmetric shocks. Such policies would set a strong framework of shared responsibility for the economic and fiscal policies of the euro countries, laying the foundations for the development of genuine European solidarity mechanisms. Yet, when it comes to this last issue, the Union falls short of instruments to address the moral hazard inherent in solidarity, given that harmonisation of social policies is precluded by the Treaties. Nevertheless, although treaty revision would be required to attain this objective, transitional solutions, such as semi-automatic macroeconomic stabilisers, could be used to circumvent this limitation, at least partially.

<sup>36</sup> Article 46 TFEU states: "The European Parliament and the Council shall [...] make regulations setting out the measures required to bring about freedom of movement for workers [...], in particular: [...] (d) by setting up appropriate machinery [...] to facilitate the achievement of a balance between supply and demand in the employment market in such a way as to avoid serious threats to the standard of living and level of employment in the various regions and industries".



On the other hand, as regards strong and effective assignment of political responsibility for EMU decisions, although the current provisions of the European Semester would allow most of the EMU executive powers to be concentrated in the hands of an identifiable government-like structure, the Treaties would leave ultimate decision-making powers in the hands of euro countries' governments. Apart from that, the financial provisions of the Treaties would not allow the EMU to become financially autonomous enough, which would still leave the final implementation of EMU policies in the realm of intergovernmental decision making.

Finally, the implementation of a Single Economic and Fiscal Policy for the EMU could be hindered by the lack of legal instruments supporting the implementation of macroeconomic convergence strategies or direct actions by the EMU's institutions. Indeed if a euro country is not in need of European financial assistance, the EMU would be unable to avoid the potential negative spillovers generated by national policies.

Therefore, the reform of the EMU and its further development into a governance structure for the implementation of a Single Economic and Fiscal Policy would require a two-step approach. First it could already be significantly improved through the adoption and modification of EU secondary legislation. The implementation of the proposals formulated in this paper would result in the strengthening of the EMU executive and its parliamentary counterparts. These configurations are more likely to be in line with the aspirations of European citizens and to increase their support for any reform of the Treaties.

In a second stage, treaty revision is required. Although this is beyond the scope of this paper, the limitations identified suggest that any revision of the constitutional framework of the EU as regards the EMU should consider the conferral of crucial powers and tools for the effective functioning of the currency union, such as the harmonisation of social policies, taxation powers, the capacity to contract debt within the limits of the SGP, enforceable instruments supporting the implementation of EMU macroeconomic convergence strategies, direct powers of intervention for the implementation of euro-wide policy strategies as well as corresponding reforms of the institutions towards a fully-fledged federal parliamentary democracy. ■

## Annex I: Summary of proposals and implementation methods

	Possible within the current Treaties			Treaty revision required for definitive settlement	
	Ordinary Legislative Procedure (QMV)	Special Legislative Procedure (unanimity)	Non-legislative act	Simplified Revision Procedure	Ordinary Revision Procedure
<b>Strengthening the EMU Governance Framework</b>					
<b>Proposal 1.</b> Involving the EP in the key stages of the European Semester, in particular in the adoption of Country-Specific Recommendations (CSRs), Economic Partnership Programmes (EPPs), Corrective Action Plans (CAPs) and sanctions.	Revision of specific Six-Pack and Two-Pack provisions				
<b>Proposal 2.</b> Providing the EP with the possibility of pushing Alert Mechanism Reports (AMR) through the European Semester.	Revision of specific Six-Pack and Two-Pack provisions				
<b>Proposal 3.</b> Conferring the right to the EP to require a hearing of the Head of the Government or one of the ministers of the Member State concerned by CSRs, EPPs, CAPs, sanctions or AMRs before vote.	No act required (After implementation of proposals 1 & 2)				
<b>Proposal 4.</b> Creation of a new Committee of the European Parliament on EMU Affairs. This Committee would be composed only by MEPs elected in euro countries and. It would carry out all the preparatory, deliberative and monitoring work currently undertaken by the ECON Committee, but limited to the area of the EMU.			Parliament's vote on a proposal from the Conference of Presidents		
<b>Proposal 5.</b> Creation of a super-Committee for the euro area regrouping all the MEPs elected in the EMU. This super-Committee would formally be a standing Committee of the European Parliament but entitled to discuss and decide on the transfer to the plenary of reports prepared by the Committee on EMU Affairs (see Proposal 4 above).			Modification of the EP RoP + Parliament's vote on a proposal from the Conference of Presidents		
<b>Proposal 6.</b> Concentrating executive tasks in the Commission by suppressing the role of the Council in the assessment of DBPs and in the monitoring of the implementation of CSRs, EPPs and CAPs.	Revision of specific Six-Pack and Two-Pack provisions				
<b>Proposal 7.</b> Appointment of a full-time President of the Eurogroup with no national mandate.			Decision by the Eurogroup (Simple majority)		

	Possible within the current Treaties				Treaty revision required for definitive settlement	
	Ordinary Legislative Procedure (OMV)	Special Legislative Procedure (unanimity)	Non-legislative act	Simplified Revision Procedure	Ordinary Revision Procedure	
<b>Proposal 8.</b> Intergovernmental agreement between the Council (ECOFIN/Eurogroup configuration) and the European Parliament committing the Eurogroup to dismiss its President should the European Parliament adopt a motion to this purpose.			Intergovernmental agreement between the European Council, the Council, the Commission and the European Parliament		Inclusion of the modified provisions of Protocol 14 into the TEU under Title III Provisions on the Institutions	
<b>Proposal 9.</b> Permanent invitation of the President of the Eurogroup to Euro Summit meetings.			idem		idem	
<b>Proposal 10.</b> Merger of the positions of President of the Eurogroup and Vice-President of the Commission (Commissioner for Economic and Fiscal Affairs) based on the HR/VP model, creating a de facto "EMU Finance Minister".			idem		idem	
<b>Proposal 10 bis.</b> Commitment by the President of the Commission to ask for the resignation of the VP for Economic and Fiscal Affairs should the European Parliament vote a motion to dismiss him/her from the position of President of the Eurogroup.			idem		idem	
<b>Proposal 11.</b> Merger of the administrative structures under the authority of the VP (DG ECFIN) and the respective services of the Council (DG G).						
<b>Proposal 11. Option A.</b> Migration of Directorate General G of the Council (or of a considerable part of it) to the Commission under the structure of DG ECFIN.		Council Decision based on article 352 TFEU				
<b>Proposal 11. Option B.</b> Creation of a body regrouping DG ECFIN and DG G (EEAS model).		Council Decision based on article 352 TFEU				To be specified in the TEU provisions formalising the position of Eurogroup President/VP

	Possible within the current Treaties				Treaty revision required for definitive settlement
	Ordinary Legislative Procedure (QMV)	Special Legislative Procedure (unanimity)	Non-legislative act	Simplified Revision Procedure	
<b>Providing the Euro area with an additional budget</b>					
<b>Proposal 12.</b> Creation of an EMU additional own fiscal capacity (in essence: a euro area budget).					
<b>Proposal 12. Option A.</b> Establishment of an EMU additional fiscal capacity through the creation of a new line in the EU general budget financed with specific earmarked resources.		On the occasion of the adoption of each MFF			
<b>Proposal 12. Option B.</b> Establishment of an EMU additional fiscal capacity through the creation of an enhanced cooperation scheme.		Council authorisation (on Commission proposal + Consent from EP)			
<b>Proposal 12. Option C.</b> Establishment of an EMU additional fiscal capacity through an internal agreement.			Internal agreement (unanimity of euro countries required)		Creation of a separate EMU fiscal capacity under Title II of Part Six TFEU
<b>Proposal 12. Option D.</b> Establishment of an EMU additional fiscal capacity through an Intergovernmental treaty.			International treaty (ratification in every euro country required)		
<b>Improving the own resources system of the EU or the EMU</b>					
<b>Proposal 13.</b> Reforming the system of own resources of the Union in order to disconnect own resources from Member States' contributions.					
<b>Proposal 13. Option A.</b> Taking contributions to the EU budget out of the Member States' national balance sheets, at least for the effects of the European Semester.	Revision of Council Regulation (EC) No 2223/96				
<b>Proposal 13. Option B.</b> Creation of a Generalised Correction Mechanism financed with traditional and new own resources and used to refund the part of each Member State's contributions exceeding 0.2% of the average contribution-GNI ratio.		Revision of the Council ORD			
<b>Proposal 14.</b> Reform of the VAT-based own resource, with the establishment of an EU or EMU rate of 2% maximum applied to the national VAT revenue from all goods and services currently subject to the standard rate.		Revision of the Council Own Resources Decision (ratification by all EU Member States)			

	Possible within the current Treaties			Treaty revision required for definitive settlement	
	Ordinary Legislative Procedure (OMV)	Special Legislative Procedure (unanimity)	Non-legislative act	Simplified Revision Procedure	Ordinary Revision Procedure
<b>Proposal 15.</b> Establishment of a European Financial Transaction Tax.		Council directive (existing Commission proposal) Revision of the Council ORD			
<b>Proposal 16.</b> Assignment of one part of the revenue from the European Emission Trading System to the EU or the EMU	Revision of Directive 2003/87/CE	Revision of the Council ORD			
<b>Proposal 17.</b> Establishment of a European excise on tobacco and alcohol products.		Revision of Council Directive 2010/12/EU (for tobacco) Revision of Council Directive 92/84/CEE (for alcohol products) Revision of the Council ORD			
<b>Proposal 18.</b> Definition of a European Common Corporate Tax Base.		Council Directive			
<b>Proposal 19.</b> Creation of an EU Corporate Income Tax consisting of a minimum European corporate income tax applicable to the Common Corporate Income Tax Base and including a European bracket to fund the EU/EMU budget.		Council Directive Revision of the Council ORD			
<b>Proposal 20.</b> Transfer of a part of the profits generated by the ECB's financial operations to the EIB in order to reimburse project-bonds and feed European investment funds.	Council and EP regulation amending article 33.1(a) of the Statute of the ECB				
<b>Proposal 21.</b> Conversion of a part of the profits generated by the ECB's financial operations into a new own resource of the EU or the EMU.	Council and EP regulation amending article 33.1(a) of the Statute of the ECB	Revision of the Council ORD			
<b>Proposal 22.</b> Reduction of collection costs of traditional own resources from 20% to 10%.		Revision of the Council ORD			

	Possible within the current Treaties			Treaty revision required for definitive settlement	
	Ordinary Legislative Procedure (QMV)	Special Legislative Procedure (unanimity)	Non-legislative act	Simplified Revision Procedure	Ordinary Revision Procedure
<p><b>Shifting EMU policies from a rule-based approach to positive economic and fiscal policy making</b></p> <p><b>Proposal 23.</b> Creation of a Single Economic and Fiscal Policy (SEFP) for the EMU, with the following prerogatives:                      - Strategic framework for macroeconomic policy in the EMU (general strategies, CSR and thematic roadmaps).                      - Implementation of strategic framework through: 1) coordination of national labour, social and economic policies; 2) establishment of minimum standards in key public policies; 3) provision of incentives/imposition of sanctions; and 4) direct European public investments in projects representing an interest for the entire EMU.                      - Confidence building measures.</p> <p><b>Proposal 24.</b> Creation of a semi-automatic macroeconomic stabiliser, funded by contributions from Member States calculated as a function of their output gap during early- and mid-cycles, and used to finance specific counter-cyclical projects in countries affected by an asymmetric shock.</p> <p><b>Proposal 25.</b> Creation of a European Incentive Scheme for Mobility, based on bilateral contracts between the physical beneficiaries and the Commission and providing grants to promote workers' mobility between EMU countries.</p>	<p>No act required initially (the SEFP umbrella would remain an informal structure regrouping procedures and policy instruments from different chapters of the TFEU)</p>	<p>Revision of Part III of the TFEU (merging Titles VII and VIII, switching from broad economic guidelines to enforceable strategies, lifting the prohibition of harmonisation of social policies, etc.)</p>	<p>Revision of the ESM Treaty</p> <p>Revision of the TFEU to include possibility of sanctions when no compliance with EMU</p> <p>Macroeconomic Convergence Strategies (to address moral hazard)</p> <p>Deletion of Art. 135(2) TFEU</p>		
	<p>According to the procedure used to create the EMU fiscal capacity (if at all):                      - Within EU budget; MFF and revision of the ORD                      - Outside the EU budget: provision in the act creating the EMU budget and the EMU Own Resource system</p>				
	<p>EU Regulation based on article 46(d) TFEU</p>				

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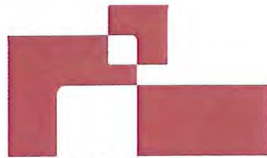
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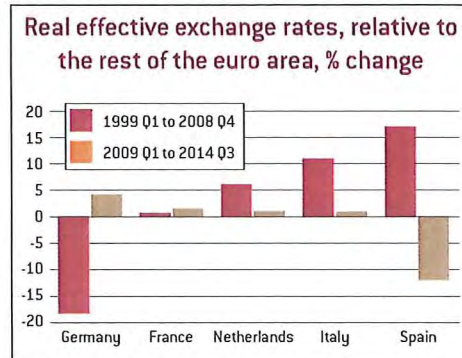
## EURO-AREA GOVERNANCE: WHAT TO REFORM AND HOW TO DO IT

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**THE ISSUE** Reform of the governance of the euro area is being held back by disagreement on what is at the root of the euro area's woes. Pre-crisis, the euro area suffered from the built-up of financial imbalances, price and wage divergence and an insufficient focus on debt sustainability. During the crisis, the main problems were slow resolution of banking problems, an inadequate fiscal policy stance in 2011-13 for the area as a whole, insufficient domestic demand in surplus countries and slow progress with structural reforms to overcome past divergences.

### POLICY CHALLENGE

Euro-area governance needs to move beyond the improvements brought about by banking union and should establish institutions to prevent divergences of wages from productivity. We propose the creation of a European Competitiveness Council composed of national competitiveness councils, and the creation of a Eurosystem of Fiscal Policy (EFP) with two goals: fiscal debt sustainability and an adequate area-wide fiscal position. The EFP should have the right in exceptional circumstances to declare national deficits unlawful and to be able to force parliaments to borrow more so that



Source: Bruegel. Selected euro-area countries.

the euro-area fiscal stance is appropriate. A euro-area chamber of the European Parliament would have to approve such decisions. No additional risk-sharing would be introduced. In the short term, domestic demand needs to be increased in surplus countries, while in deficit countries, structural reform needs to reduce past divergences.



JUST AS IT WAS CELEBRATING its tenth anniversary, the euro area was hit by a financial crisis that started in the United States but rapidly spread to Europe. Economic and Monetary Union (EMU) was ill prepared to deal with the immediate crisis and the large fiscal, financial and structural imbalances that had accumulated over the years. The financial crisis turned first, in 2010, into a Greek sovereign crisis and then, in 2011-12, into a full-blown bank-sovereign debt crisis that at one point threatened the very existence of the monetary union. The debt crisis has now abated but an economic crisis, with feeble growth and near-zero inflation, has replaced it. A lost decade beckons for the euro area, but its governments have been slow to respond<sup>1</sup>.

The euro area has two features that have been particularly responsible for the crisis and for the difficulty of resolving it: major economic (and also political and social) differences between countries<sup>2</sup> resulting in some cases in failed policies, and the euro area's inadequate economic governance. Reform of this governance is needed in three major areas.

First, although fairly integrated, especially within the euro area, Europe's banking and finance system was left to operate without corresponding supervisory and resolution structures. Banking Union and various macro-prudential measures constitute a proper institutional response, though they will need to be improved in due course – a subject that is beyond the scope of this Policy Brief<sup>3</sup>. Second, in the

absence of a nominal exchange rate and without a fully integrated labour market, the euro area needs a system to prevent large divergences between the unit labour cost (ULC) developments in its member countries. Third, the euro area needs a fiscal governance system to (1) ensure the fiscal sustainability of individual members, (2) to generate an appropriate area-wide fiscal stance, and (3) to quickly provide fiscal resources for prompt resolution in the event of banking and sovereign crises. We propose medium-term governance reforms to address the second and third of these issues, before concluding with the most pressing short-term challenges.

#### THE RUN UP TO THE CRISIS: EMU'S SHORTCOMINGS

From the outset, the euro area comprised two groups of countries with substantially different socio-economic models and consequently different macro-economic policies and outcomes: the core countries that belonged to (or shadowed) the Exchange Rate Mechanism (ERM) for more than a decade prior to the launch of the euro, and the peripheral countries that stayed mostly outside the ERM.

Different initial conditions in the core and the periphery, mainly in terms of interest rates, led to the credit boom in the periphery financed by capital flows from the core. This led to increasing competitiveness problems within the

euro area, which were insufficiently monitored and difficult to counter in the absence of the exchange rate instrument. As a result, current-account balances and net foreign asset positions diverged to an unprecedented degree between the core (in surplus) and the periphery (in deficit). When the financial crisis hit in 2008-09, private capital flows from the core to the periphery suddenly stopped (Merler and Pisani-Ferry, 2012), leaving behind a mountain of external (private and public) debt in the periphery owed to creditors in the core countries. Italian and French price competitiveness diverged relative to Germany, but neither country ran significant current account deficits.

*'The single currency resulted in imbalances and was ill-prepared to deal with them.'*

Instead of producing sustainable real convergence between the core and the periphery, the single currency had resulted in imbalances and was ill-prepared to deal with them. Insufficient attention was paid to the build-up of financial imbalances. This failure was not specific to the euro area, but the European monetary union was unique in that it lacked common supervision and resolution mechanisms to properly address financial crises within the integrated financial system.

This shortcoming, along with deeply entrenched opposition to bank resolution in a system characterised by major interdependencies between political systems and banks (Monnet *et al*, 2014), was a major hindrance in

1. See, for example, Camey (2015). Recent ECB measures are welcome but may prove insufficient to prevent a lost decade.

2. See Sapir (2005). General policy complacency and the great moderation were further factors leading to the build-up of imbalances.

3. In particular, the bank resolution framework, the deposit insurance system and capital markets union are important elements for further work.



getting to grips with a European financial-cum-sovereign-debt crisis of considerable magnitude, which evolved in 2011-12 from the global financial crisis.

Another weakness of the euro area's economic governance architecture was that it lacked a mechanism to monitor and correct macroeconomic imbalances, except in budgetary policy. Enforcement of the deficit rules was inadequate, public debt sustainability received relatively little attention and private debt no attention at all. Similarly, external debt (and current account imbalances) was all but ignored. Moreover, no attention was paid to long-term and persistent ULC divergences.

The lack of focus on public debt sustainability led to two types of situations: (1) Fiscal rules were insufficiently applied, partly because there was inadequate understanding of the debt sustainability risks. Stricter application of the rules would have reduced future debt problems in Italy (and other countries) and in Greece, where enough was known to justify more forceful demands for corrective action. (2) Countries like Ireland and Spain that, although they abided by the fiscal rules, proved not to be immune to debt problems once the financial crisis erupted, revealing the huge build-up of private debt that led to problems for their public finances.

Governance mechanisms to address macroeconomic imbalances such as wage divergences do not exist in true federations such as the United States. The

euro area needs mechanisms to address both competitiveness divergence and coordination of fiscal policy, because labour mobility is limited and fiscal policy decentralised.

#### CRISIS MANAGEMENT: WHAT WORKED AND WHAT DID NOT?

When the global crisis triggered the European crisis, the European policy system was largely unprepared. Crisis management during 2008-14 consisted of:

- A timely coordinated macroeconomic response in 2009 consisting of monetary-policy easing, the European Central Bank playing the role of unlimited lender of last resort to banks and a substantial increase in fiscal deficits.
- Hesitant and delayed crisis management, with countries losing market access combined with the gradual establishment and reinforcement of institutions that can provide financial assistance and impose conditions for providing that assistance.
- A gradual process starting with the 'Van Rompuy task force' (European Council, 2010) to strengthen EU surveillance mechanisms, resulting in new rules and mechanisms<sup>4</sup>.
- When the sovereign debt crisis became more widespread and yields increased substantially in Italy and Spain, quicker fiscal consolidation and ECB support was implemented through the Securities Markets Programme (SMP) and Outright Monetary Transactions (OMT) programme.
- As banking and sovereign

stresses reinforced each other and bank resolution was delayed, the European Council decided to establish a banking union to de-link banks from their sovereigns and increasing financial stability. The banking union project is now officially finished.

The crisis response has not delivered economic results for the euro area. GDP has not grown since 2008, and unemployment has increased<sup>5</sup>. Inflation has fallen substantially and in December 2014, area-wide deflation (of -0.2 percent) was recorded for the first time since 2009. Internal adjustment has proceeded, with current-account deficits shrinking substantially<sup>6</sup>. However, current account surpluses have, if anything, increased in Germany and the Netherlands, reaching 7 percent of GDP or more in 2014. There was some wage and price adjustment in the crisis countries, but relative prices between the three biggest euro-area countries – Germany, France and Italy – have adjusted only marginally. The very low area-wide inflation rate has not helped: the lower it falls, the more difficult it becomes to achieve the necessary adjustment.

The euro area has not delivered. What went wrong in the last seven years, contributing to such a bad economic performance? Besides the severe macroeconomic imbalances at the beginning of the crisis, the following problems can be identified:

- From 2011 to 2013, fiscal policy in the euro area was pro-cyclical. In 2014, fiscal

4. The so-called six-pack, two-pack, Euro+ pact and the Fiscal Compact. See [http://ec.europa.eu/economy\\_finance/articles/governance/2012-03-14\\_six\\_pack\\_en.htm](http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm).

5. From 7.5 percent in 2007 to 12 percent in 2013 (11.6 percent in 2014).

6. Stressed countries including Cyprus, Greece, Ireland, Portugal and Spain reduced their current-account deficits on average by around 10 percentage points between 2007 and 2014.



policy was flat and did not counteract the continuing deterioration of the economy. Public investment and R&D expenditure have been cut during the crisis.

- Europe has taken a gradual approach to bank resolution; unresolved banking issues continue to plague credit provisioning in the euro area (European Systemic Risk Board, 2012). Banking problems were not addressed because of national political constraints and because of possible fiscal consequences.
- The ECB has been slow to respond to the deteriorating economic situation and has tried to avoid taking risk on board. It also misjudged the situation twice, resulting in erroneous rate increases.
- No serious and significant measures to address price divergence between Germany, France and Italy have been undertaken. Structural reforms progressed in all three countries largely in line with national political constraints, but were not commensurate with the need for adjustment in a monetary union where, by definition, adjustment cannot take place through exchange rate changes. Moreover, no euro-area wide demand management was undertaken to facilitate relative adjustment.

This analysis highlights the two central problems for euro-area governance:

- a) Fiscal policy: no institution is responsible for the area-wide fiscal stance and for the distribution of fiscal policy across

countries, and no fiscal resource (except the European Stability Mechanism) is available for risk sharing, including in banking.

- b) Only a very weak mechanism (the Macroeconomic Imbalances Procedure) exists to ensure that wage developments are in line with productivity, which means that serious competitiveness problems can and do occur within the euro area. Wage setting remains mainly a national process with little or no regard for euro-area developments. Other national structural policies are implemented without consideration of potentially substantial cross-border effects.

Beyond these two governance problems, some euro-area countries suffer from very significant debt burdens and differences in social and employment performances and in the structural features of their economies. These legacy problems make governance reform significantly more complicated.

#### ON WHAT GOVERNANCE REFORMS SHOULD THE EU FOCUS?

The issue of sovereignty, or political legitimacy over policies, lies behind both governance problems we have highlighted.

##### *Wages and competitiveness*

In many countries, persistent ULC increases were driven by unus-

tainable asset price booms resulting in overheating labour markets. The answer to such problems lies in better macro- and micro-prudential policies and better regulation of the financial system, which are beyond the scope of this Policy Brief.

Yet trying to prevent asset booms is not sufficient to address all competitiveness problems in the

*'Preventing asset booms will not address all competitiveness problems in the euro area.'*

euro area, where countries often have labour markets and social systems that are incompatible with their membership of a monetary union. Other reforms that increase economic dynamism – for example the creation of a single and competitive market or the reduction of harmful regulation – are also essential.

The functioning of national labour markets must not lead to excessive competitiveness divergence. National wage formation and bargaining systems vary widely. As a result, the alignment of nominal wage growth with labour productivity growth at national level also tends to differ considerably in different countries. Such differences lead to inter-country changes in competitiveness, which are difficult to correct within the euro area because of the absence of the exchange rate instrument.

There are two basic solutions to this problem. The first would be to create a system comparable to a true federation with a single labour market. In the United States, citizens accept the model, in which they move regularly in



their lifetime from one state to another. The cost of such moves is limited because of the unified market and the absence of language barriers and barriers in the welfare system.

The alternative model starts from the assumption that it is neither desirable nor feasible to create a unified European labour market in which a unified welfare system would enable citizens to change their country of residence several times in their lifetimes. Some increased mobility is probably desirable and feasible, but we also strongly believe that the euro area will not for the foreseeable future create such a unified labour market in which regional shocks can be essentially fixed by large migration flows.

The euro area, therefore, needs mechanisms to prevent and correct substantial misalignments of competitiveness between its member countries. Since wage formation and bargaining systems are deeply rooted and difficult to change, deviations in competitiveness must be monitored and corrected before they become too significant and entrenched.

At EU-level, the Macroeconomic Imbalance Procedure (MIP) has the potential to be an important tool and should be applied symmetrically to correct excessive positive and negative imbalances. The MIP needs however to be complemented by national procedures to monitor and, if needed, correct competitiveness problems and to increase ownership at the national level. These procedures should be required by

EU legislation and their performance monitored by the European Commission.

All euro-area countries should put in place a competitiveness-monitoring framework involving regular assessments and the definition of instruments to prevent problems. An interesting example is the Belgian framework, introduced in 1996 to preserve the country's competitiveness in EMU by keeping the evolution of wages in line with wage developments in the main trading partners. A national body regularly reports on the evolution of Belgian competitiveness relative to its three main trading partners (Germany, France and the Netherlands). These reports are used by social partners to fix a wage norm for the next round of wage negotiations. Although the norm amounts only to a non-binding guideline, it has generally been respected by the private sector (to which the system applies). In case social partners fail to agree a wage norm compatible with the evolution of competitiveness, the government can step in and make the norm legally binding. The system has worked fairly well: it kept untouched the wage formation and bargaining system that existed prior to the euro, but made the behaviour of social partners compatible with membership of the euro area. The result has been that ULCs in Belgium have evolved more-or-less in line with those in its main trading partners, thus avoiding major competitiveness problems.

*'All euro-area countries should put in place a competitiveness-monitoring framework'*

The Belgian system could be improved, and anyway cannot be exactly copied by other euro-area countries since they typically have different wage formation and bargaining systems. What is important is that all euro-area countries put in place a mechanism to ensure that, although operating within their own system, the behaviour of social partners and the outcome of their wage negotiations is compatible with membership of the euro area in terms of competitiveness and employment. These national mechanisms would constitute national competitiveness councils.

We would recommend therefore the creation of a Eurosystem Competitiveness Council (ECC) consisting of both national competitiveness councils and the European Commission. The ECC's primary task would be to coordinate the actions of national competitiveness councils to ensure that no euro-area country fixes a wage norm that implies significant competitiveness problems for itself and/or others. In case this fails, the Commission should have the power to require the relevant competitiveness councils to take corrective action using the MIP and the European Semester instruments.

#### *Fiscal policy*

The euro area faces the choice of either significantly moving ahead with fiscal integration while accepting that national parliaments lose some power (eg Marzinotto *et al*, 2011), or imple-



7. Technocratic solutions such as indexing bonds to GDP are unlikely to be practical and would require a totally different regulatory framework. At the minimum, a European sovereign debt restructuring mechanism would be required; see Gianviti *et al* (2010).

8. See, for example Coeuré (2015) for a recent discussion of the argument originally made by Lamfalussy. In situations like the current one, monetary policy alone is insufficient to provide adequate stabilisation.

9. In Sapir and Wolff (2013), we argue for the introduction of exposure limits or risk weights on sovereign debt.

10. It establishes a number of criteria that try to take account of the business cycle situation as well as debt sustainability in a rules-based framework. However, the rules fail to achieve what they promise because of the technical impossibility of computing output gaps, as has been amply documented. The discretion that is applied as a result is awkward and based on

menting a fully decentralised solution in which fiscal decisions are taken completely at the national level (eg Mody, 2013). For the latter, it is essential to have a credible no-bail-out regime so that national decisions have primarily national consequences.

The fully decentralised solution – accepting defaults without mechanisms to safeguard financial stability – would be politically, socially and financially unstable<sup>7</sup>. More worryingly, a decentralised solution would not provide adequate euro-area wide stabilisation, thereby forcing monetary policy to do more than it can achieve<sup>8</sup>.

The euro area therefore needs to have a fiscal mechanism to reduce the pernicious effects of recessions, increase financial stability, reduce cross-border contagion and manage the fallout from debt restructuring should it become necessary, while government default should remain a last-resort option. There should be (a) the ability to steer a euro-area wide fiscal stance, (b) a fiscal capacity to manage sovereign debt and banking crises, and (c) a different regulatory framework for sovereign debt<sup>9</sup>. Since this amounts to a limited insurance system, mechanisms would have to be in place to manage the risk of moral hazard.

The current system of fiscal rules aims to establish smart, rules-based fiscal governance. However it fails in its aim because

of faulty rules and ill-defined national fiscal discretionary space<sup>10</sup>. There is a need to adjust the current EU fiscal governance framework through several interconnected steps:

- a) A reform of the fiscal framework addressing moral hazard. This could involve fiscal federalism by exception<sup>11</sup>, with the focus of fiscal surveillance on debt sustainability. The closer a country moves to unsustainability, the stronger the intervention would be, with ultimately the complete removal of the ability to borrow. This enhanced governance would come on top of the ultimate possibility of debt restructuring.
- b) The fiscal framework should not only be given debt sustainability goals. It should also ensure that the sum of deficits in the euro area achieves a reasonable area-wide fiscal stance<sup>12</sup>. The new framework would thus not only have the right to prohibit borrowing, overruling national parliaments, but it would also have the right to force member states to run higher deficits, overruling national parliament decisions in substantial euro-area recessions. In other words, the notion of ‘fiscal federalism by exception’ should be symmetric. It should apply to countries with both dangerously excessive deficits and insufficient borrowing from a euro-area perspective.
- c) The governance of fiscal surveillance could be organised

*‘The ECB would be overburdened if it had to manage alone the euro area business cycle.’*

- in a Eurosystem of Fiscal Policy (EFP), composed of a Governing Council (GC) that would be comparable to the Eurosystem of central banks. At its centre would be a euro-area finance minister<sup>13</sup>. This person would prepare the meetings of the GC together with five budget directors that have joint responsibility over the ESM. All euro-area finance ministers would also sit on the GC. The GC would take fiscal policy decisions based on qualified majority with the six central representatives having a substantial vote. These decisions would become binding at the national level in case of substantial danger to debt sustainability or a substantial euro-area recession. In normal times, the size of fiscal deficits would still be managed by the national level and the recommendations of the EFP would not be fully binding.
- d) The EFP would also have the power to activate fiscal resources of a fund, such as the ESM, for special purposes. This would include providing support to individual member states in the context of an ESM programme, and backing-up banks in cases of severe systemic stress<sup>14</sup>.
- e) Such a system would raise substantial questions about its legitimacy and the role of national parliaments and the European Parliament. The ESM currently requires unanimity among the finance ministers, and prior parliamentary approval in several countries. This has proven to be complex. At the same time, unanimity is justified because the



resources needed to back up the fund are national taxpayers' resources. This system is ultimately unsustainable because it regularly puts national parliaments and decision makers in a position of having to vote on matters that could benefit banks elsewhere or even other countries.

- f) We would therefore imagine a system, in which political legitimacy would be allocated to the European level together with European tax-raising power. The European or euro-area parliament would be allowed to raise a certain amount of taxes to fund the commitments of the common fund in case the fund needs to borrow for extraordinary circumstances. In other words, the European fund would draw on European resources requiring European legitimacy. A 'euro-area parliament' would thus provide legitimacy to decisions on the ESM fund and would also approve decisions by the EFP-GC when they are become binding on national parliaments<sup>15</sup>.

- g) This system would be a huge change from the current system, in which legitimacy of fiscal policy – despite a treaty-based framework of coordination – derives from national processes. In the Eurosystem of Fiscal Policy, the majority decision would be binding on national parliaments in the sense that in certain circumstances, their ability to borrow would be

removed or they would be forced to borrow. Such a system would only be credible if the European Treaty and certain national constitutions were to change. It is also possible to conceive such a system without change to the European Treaty and instead with the establishment of a new intergovernmental treaty<sup>16</sup>.

- h) To increase the new institution's objectivity, we also recommend the creation of an independent euro-area fiscal council that issues opinions on the decisions taken and in particular confirms whether there are exceptional circumstances.

It is important to note that we do not propose the creation of a 'federal budget'. As essentially all government spending would remain at the national level, the creation of a federal capacity would imply either shifting substantial fiscal expenditures to the federal level or increasing overall government spending by creating new federal spending categories. The former option is unfeasible at this stage while the latter is probably undesirable given the already large size of the government sector in many euro-area countries.

It is also important to note that our proposal does not foresee risk sharing beyond the current ESM capacities. Our system is essentially a stepped-up framework for fiscal policy coordination. A much more far-reaching step would be to establish a fiscal mechanism

for proper risk sharing between countries, such as a European unemployment insurance mechanism to complement national systems. This would introduce real risk-sharing. However, this would arguably only be possible if labour market conditions are harmonised significantly so that the mechanism only insures against truly exogenous events rather than policy-induced ones (Claeys *et al*, 2014). More risk sharing is desirable because debt levels are high in many countries and national-level borrowing might become constrained and financial markets might not be able to provide adequate funding for stabilisation. But these differences in starting positions will make it very difficult to move ahead with a risk sharing option.

An important question is whether the treaty changes that would be required to underpin these proposed fiscal mechanisms, and the additional sovereignty pooling that would go with them, would still be necessary for the euro area's functioning if competitiveness and debt-overhang problems had been tackled. Our view is that they would. A well-functioning monetary union requires fiscal mechanisms to ensure that shocks are met by the union as a whole. Problem solving in a monetary union cannot only be about putting one's house in order; it must also be about putting the common house in order. But this necessary change of philosophy compared to the current [Maastricht-based] approach will require a treaty change that can only be envisaged once trust between the

complicated political and technocratic compromises.

11. As proposed by Jean-Claude Trichet (2011).

12. To achieve this, there needs to be first and foremost an agreement that this is actually a desirable policy goal. We believe that our analysis and the declining inflation rates clearly demonstrate the weak fiscal dominance and the substantial macro-economic problem that the euro area has.

13. A European budget commissioner who can reject national budgets if they fail to respect the rules, as Wolfgang Schäuble put it in a speech in Bruges in March 2014 [Schäuble, 2014].

14. We thus envisage a further development of the ESM into a system in which decisions are taken based on majority voting in the EFP instead of unanimity of the ESM finance ministers, as is currently the case.

15. This was recently advocated by German finance minister Wolfgang Schäuble; see footnote 13.

16. The EU Court of Justice's 2012 Pringle



countries and citizens of the monetary union has been regained by implementing measures that require no treaty change but can go a long way towards solving the current situation.

#### TRANSITION TOWARDS THE NEW GOVERNANCE SYSTEM

There is a pressing need to address two central problems in the euro area immediately. First, it is imperative to increase inflation and demand. Second, it is imperative to address the substantial

divergences in ULC, in particular between France, Germany and Italy. This requires political consensus between governments because the ECB cannot continue to act alone to achieve these objectives. A reformed European Semester with better timing and a greater focus on euro-area recommendations could lead to a change in philosophy.

Correction of imbalances in both surplus and deficit countries is essential as is dealing with the stock of debt through a combination of more aggressive

macroeconomic policies and messy debt restructuring where necessary.

In the next few years, it will be challenging to manage acute problems such as high debt, high unemployment and weak growth. Leaders should keep in mind a sense of direction towards a new governance model that cannot be achieved overnight. Yet, without a process starting now that will eventually lead to the necessary treaty changes, the daily management of the various crises may become impossible.

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## Analyse du fonctionnement de la zone euro dans son ensemble

**Sergio Fabbrini (2013)** Intergovernmentalism and Its Limits: Assessing the European Union's Answer to the Euro Crisis, *Comparative Political Studies* 46(9) 1003–1029

Although the measures adopted in the period 2010-2012, consisting of legislative decisions and new intergovernmental treaties, are of an unprecedented magnitude, they were nevertheless unable to promote effective and legitimate solutions for dealing with the financial crisis. In the context of an existential challenge, the intergovernmental approach faced a structural difficulty in solving basic dilemmas of collective action.

**Daniela Schwarzer (2012)** The Euro Area Crises, Shifting Power Relations and Institutional Change in the European Union, *Global Policy* Volume 3 Supplement 1 December 2012 **with policy recommendations**

This article studies recent governance dynamics in the euro area under the pressure of the sovereign debt crisis from 2009 to the end of 2011 from an institutionalist perspective. It argues that key steps of crisis management have actually created path dependencies for further institutional change. It also argues that incoherent responses from multiple actors in the face of immediate crisis management needs, new policy challenges and coordination difficulties in the crisis have strengthened the case for more substantial institutional change.

**Philip Arestis & Malcolm Sawyer (2011)** The Ongoing Euro Crisis, *Challenge*, 54:6, 6-13

This short article attempts to explain the original shortcomings of the euro project that led to the euro crisis and the potential solution to them.

## Analyse des politiques et mécanismes mises en place par l'UE en réaction à la crise de la zone euro

**Frank Schimmelfennig (2015)** Liberal intergovernmentalism and the euro area crisis, *Journal of European Public Policy*, 22:2, 177-195, DOI:10.1080/13501763.2014.994020

Whereas negotiations produced a co-operative solution averting the breakdown of the euro area and strengthening the credibility of member state commitments, asymmetrical interdependence resulted in a burden-sharing and institutional design that reflected German preferences predominantly.

## Sur le Pacte de stabilité et de croissance en particulier

**Sebastian Köhler and Thomas König (2012)** Fiscal governance in the Eurozone: How effective is the Stability and Growth Pact limiting public debt?

In this article, we examine whether and how the Stability and Growth Pact influenced the development of public debt in the Eurozone countries. Our synthetic control-analysis reveals that the mechanism effectively reduced public debt in the donor countries of the EU, while many recipient countries—including Greece, Portugal and Italy—could increase their public debt by membership. This suggests that a more sophisticated fiscal mechanism is required for overcoming free-riding and moral hazard in particular recipient countries.

Sur le Fonds européen de stabilité financière et le Mécanisme européen de stabilité en particulier :

**Ledina Gocaj & Sophie Meunier (2013)** Time Will Tell: The EFSF, the ESM, and the Euro Crisis, *Journal of European Integration*, 35:3, 239-253, DOI:

EFSF and ESM created path dependency in the subsequent management of an unrelenting crisis, enshrined intergovernmentalism as the modus operandi, and led to suboptimal solutions.

**Arne Heise (2012)** Governance Without Government, *International Journal of Political Economy*, 41:2, 42-60

Although, in the wake of the euro crisis, some crisis control and emergency measures have been established, crisis resolution has failed, as the core of the inefficient governance system—the European Stability and Growth Pact (ESGP)—has not been reformed adequately.

Sur le Pacte budgétaire européen en particulier :

**Christian Schweiger (2014)** The EU-25 Fiscal Compact: Differentiated Spillover Effects under Crisis Conditions, *Perspectives on European Politics and Society*, 15:3, 293-304, DOI: 10.1080/15705854.2014.912398

This article analyses the intergovernmental Fiscal Compact, which represents the latest layer in the emerging new governance framework European Union (EU) governments have adopted in response to the sovereign debt crisis in the eurozone.

**Paul Craig (2012)** The Stability, Coordination and Governance Treaty: Principle, Politics and Pragmatism, (2012) 37 *European Law Review* 231

This article examines the political background to the TSCG, and its legal provisions. It also considers the broader issues of principle raised by the TSCG, and the extent to which Member States together with EU institutions can proceed outside the confines of the Lisbon Treaty to attain goals that cannot be achieved therein.

Sur l'Union bancaire en particulier :

**David Howarth and Lucia Quaglia (2013)** Banking Union as Holy Grail: Rebuilding the Single Market in Financial Services, Stabilizing Europe's Banks and 'Completing' Economic and Monetary Union, *JCMS 2013 Volume 51 Annual Review* pp. 103–123 DOI: 10.1111/jcms.12054

First, we consider the fragmentation of the single market in financial services and the need for banking union to address this fragmentation. We then outline the key elements of banking union. Following that we review the intergovernmental debate on banking union, focusing on the main eurozone Member States and their priorities. We go on to discuss the stance of the ECB in this policy debate as well as the mostly likely changes that the eurozone's central bank will have to undertake in the near future. Finally, we explore the democratic accountability of the new institutional set-up, mainly focusing on the position of the European Parliament (EP).

Sur le rôle endossé par la BCE en particulier :

**Paul de Grauwe and Yuemei Ji (2013)** From Panic-Driven Austerity to Symmetric Macroeconomic Policies in the Eurozone, *JCMS 2013 Volume 51 Annual Review* pp. 31–41 DOI: 10.1111/jcms.12042

Will the new role for the ECB be sufficient to save the eurozone? The question is analyzed in this article in two steps: first, we look at the risks that have been created by austerity; and second, we ask what kind of macroeconomic policies would be most appropriate.

## Approche sociologique

**Matthias Matthijs & Kathleen McNamara (2015)** The Euro Crisis' Theory Effect: Northern Saints, Southern Sinners, and the Demise of the Eurobond, *Journal of European Integration*, 37:2, 229-245, DOI: 10.1080/07036337.2014.990137

We argue that the response to the euro crisis was heavily informed by broader social logics that constructed the problem and the solution heavily toward ordoliberal and neoliberal ideas.

**Magnus Ryner (2015)** Europe's ordoliberal iron cage: critical political economy, the euro area crisis and its management, *Journal of European Public Policy*, 22:2, 275-294, DOI: 10.1080/13501763.2014.995119

In addressing the puzzle of why not only the Economic and Monetary Union persists despite morbid symptoms but why crisis management is extending and deepening a discredited financed capitalism, the contribution synthesizes theories of transnational class formation and inter-state relations, and proposes that Europe is caught in an ordoliberal iron cage.

## **La zone euro de demain**

**Matthias Morys (2014)** Gold Standard Lessons for the Eurozone, *JCMS 2014 Volume 52. Number 4*. pp. 728–741 DOI: 10.1111/jcms.12146

The intricate combination of similarities and differences with the present situation makes one of two outcomes likely: either some countries will eventually leave the eurozone to boost their growth prospects; or, the eurozone will remain intact as a result of stronger political co-operation today, but a poorly working internal adjustment mechanism could result in low growth rates for the foreseeable future, similar to the experience of the gold bloc countries in the 1930s.

**Paul de Grauwe (2013)** Design Failures in the Eurozone: Can they be fixed?, *LEQS Paper No. 57/2013*

I first analyse the nature of the design failures of the Eurozone (...) and then study the way these failures can be overcome. This leads me to stress the role of the ECB as a lender of last resort and the need to make macroeconomic policies more symmetric so as to avoid a deflationary bias in the Eurozone. I conclude with some thoughts on political unification.

**Policy paper by Maria Joao Rodrigues published by Friedrich-Ebert-Stiftung (2012)** Mapping Future Scenarios for the Eurozone

Four major scenarios are conceivable. (i) The Member States can continue trying to muddle-through by means of crisis management, which may lead to the break-up of the Monetary Union; (ii) another variation of this leads to further reversals with regard to political integration; (iii) a specific combination of factors might lead to a two-tier Europe with a small hard core of Member States; alternatively, (iv) (some of) the Member States may press on to complete monetary union by means of a fiscal and political union.

**Published by Iain Begg on the LSE Blog (2012)** Recent measures may have signalled the beginning of the end of the Eurozone crisis. But the transformation of EU economic governance is still far from complete, <http://blogs.lse.ac.uk/europpblog/2012/03/24/end-of-eurozone-crisis/>

Measures such as the new Fiscal Compact and the European Stability Mechanism may have averted the immediate threat to the Euro. But, according to Iain Begg, some further measures, such as the introduction of Eurobonds, are needed on top of what has been, up until now, the largely piecemeal evolution of European economic governance.

**Published by Renaud Thillaye on the LSE Blog (2012)** EU leaders need to confront the political dilemmas of the Eurozone crisis, <http://blogs.lse.ac.uk/europpblog/2012/07/25/eu-leaders-confront-eurozone-crisis/>

Alongside economic issues, there is also a political dimension to the Eurozone crisis. Renaud Thillaye emphasises the importance of this political debate and highlights the key questions which must be addressed by European policymakers as part of any solution. The potential for the crisis to deepen socio-economic divergences between member states, and the future relationship between Eurozone countries and the rest of the EU-27 must be addressed. The EU must also be reconciled with democratic politics and European citizens' often weak sense of identification, if it is to remain legitimate.

**Published by Michelle Everson on the LSE Blog (2012)** A European banking union will only exacerbate the Eurozone crisis by further reducing democratic accountability, <http://blogs.lse.ac.uk/europpblog/2012/07/26/european-banking-union-exacerbate-crisis/>

The creation of a European banking union has been put forward as part of the solution to the Eurozone crisis. Michelle Everson argues that a banking union is not a viable solution because it represents a further weakening of democratic structures and a reduction in political accountability. The real crisis, she concludes, is the trend toward increasingly technocratic forms of governance in Europe.

**Policy paper by Roger Liddle, Olaf Cramme, Renaud Thillaye published by WWWForEurope (2012)** Where next for Eurozone governance? The quest for reconciling economic logic and political dilemmas.

This paper gives an overview of the institutional changes embarked upon by the EU in the aftermath of the sovereign debt crisis and identifies the resulting political dilemmas. The third section weaves together these possible scenarios in the light of fundamental dilemmas facing the EU: the tension between convergence and socio-economic diversity, the various institutional routes available to EU policy-makers, and the democratic forces constraining any further institutional move.

**Policy paper by Karl Aiginger (WIFO), Olaf Cramme (Policy Network), Stefan Ederer (WIFO), Roger Liddle (Policy Network), Renaud Thillaye (Policy Network) published by WWWFor Europe (2012)**

Reconciling the short and the long run: governance reforms to solve the crisis and beyond

This policy brief is the first outcome of a four-year project which started in April 2012 and aims at providing the analytical basis for a new European growth path towards a socio-ecological transition. Particular attention is paid to the policy and political dilemmas that have emerged throughout the crisis: the clash between adjustment, social cohesion and long-term investment; the challenge of finding a modus vivendi between a more integrated Eurozone with a Community-based EU 27; the demands for more sovereignty and more democracy.

**Andrew Hughes Hallett & Svend E. Hougaard Jensen (2012)** Fiscal governance in the euro area: institutions vs. rules, *Journal of European Public Policy*, 19:5, 646-664, DOI: 10.1080/13501763.2011.646773

This contribution considers mechanisms for rule-based fiscal policy co-ordination to replace the failed Stability and Growth Pact in the euro area. It argues in favour of soft debt targets as a means of addressing problems caused by excessive debt. It is shown how such targets can be safely operated, supported by an effective excess debt protocol.

**Franklin Allen and Victor Ngai (2012)** In What Form Will the Eurozone Emerge from the Crisis? Electronic copy available at: <http://ssrn.com/abstract=2141415>

We argue that in the meantime in order to save the euro, allowing default and temporary exit from the Eurozone is desirable as these policies are capable of initiating significant growth in the short run. This will allow Greece and possibly other countries that adopt them to bring down their unemployment, particularly youth unemployment, in a reasonable time frame.



## **La question de la légitimité démocratique**

**Ben Crum (2013)** Saving the Euro at the Cost of Democracy? JCMS 2013 Volume 51. Number 4. pp. 614–630 DOI: 10.1111/jcms.12019

This article explores the implications of the financial crisis for the relationship between monetary integration and democratic government in the European Union (EU).

**Kenneth Dyson (2013)** Sworn to grim necessity? Imperfections of European Economic Governance, Normative Political Theory, and Supreme Emergency, European Integration, 2013 Vol. 35, No. 3, 207–222, <http://dx.doi.org/10.1080/07036337.2013.774777>

The credibility of its capacity to act in supreme emergency is of existential significance for the Euro Area. At the same time this capacity poses is bound up with basic legitimacy issues.

**Marie Cramez**

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