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## Federalising the Eurozone: Towards a True European Budget?

by Eulalia Rubio



### ABSTRACT

Discussions about a future fiscal capacity for the euro area are too often limited to a comparison of the technical advantages and disadvantages of different modalities of cross-country fiscal shock absorbers. This paper aims to broaden the debate, by connecting these discussions with debates on fiscal union and the exercise of political power in EMU. Through an analysis of past and current debates on EMU, the paper identifies five different rationales for deepening budgetary integration in a monetary union: ensuring fiscal discipline and stable sovereign debt markets, protecting euro area countries against the risk of asymmetric shocks, equipping the euro area with a capacity to stabilise the economy over the cycle, providing budgetary support for convergence and providing an appropriate fiscal backstop for the banking union. The paper discusses the relevance of these various rationales in today's EMU and their different implications as regards to mutualising budgetary resources and powers.

*European Union | Budget | EMU | Economic governance | Eurozone crisis | Federalism*

**keywords**

## Federalising the Eurozone: Towards a True European Budget?

by Eulalia Rubio\*

### Introduction

The idea that the euro area needs a common “fiscal capacity” has gained ground since the publication of the Van Rompuy report in 2012. Since then, a rich literature has emerged on possible designs for a fiscal capacity and their different implications in terms of stabilisation effects and technical and political feasibility. Too often, however, the debate is confined to a comparison of different proposals of cross-country fiscal shock absorbers, neglecting the existence of other possible rationales for pooling fiscal resources and powers in EMU. Besides, discussions tend to be focused on the technical aspects, paying little or no attention to broader implications of pooling fiscal capacities with regards to the exercise of democracy and representation in Europe.

This paper aims to connect current discussions on fiscal capacity to broader debates about fiscal integration and the exercise of political power in the euro area. After a short review of past debates on fiscal integration in EMU, section 2 identifies five current debates on “fiscal union,” analyses their implications as regards the transfer of budgetary powers, and outlines the various technical and political challenges of different proposals for pooling fiscal resources. Sections 3 and 4 then discuss the consistency between different logics for mutualisation, provide some general recommendations for the design of a future euro area fiscal capacity, and identify and compare different possible long-term scenarios of “fiscal union.” The last section concludes.

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### 1. The early 1990s debates on fiscal integration in the EMU

The Eurozone is unique in the world in that it combines a centralised monetary policy with a highly decentralised system of fiscal policy-making. In this respect, it is different from other monetary unions in the world, which typically correspond with nation states, have sizeable central budgets and exercise important functions at the central level. The largest part of central spending in classical monetary unions goes to social welfare, but, given their size and functioning, central budgets also play an important role in stabilising the economy alongside the single monetary policy, cushioning asymmetric shocks and securing a minimum level of income equalisation. To fulfil this role, the central level has a considerable degree of public finance autonomy (understood as the capacity to borrow and raise cash from its own revenue sources). This also contrasts with the situation in the EU, where the common budget – the EU budget – is mostly financed by contributions from member states.

In the 1970s, when the project of monetary integration was being contemplated, the consensus among European policymakers and experts was that if monetary union was to be pursued, the latter had to be accompanied by commensurate steps towards fiscal integration. Two important early contributions epitomise this thinking: the Werner report (1970) and the MacDougall report (1977). The first highlighted that a monetary union would require all essential features of national public budgets to be decided at the Community level (including “the overall volume, the size of balances and the modes of financing as well as their use”<sup>1</sup>). The second argued that the establishment of a monetary union would require a Community budget of around 5-7 percent of GDP in order to absorb economic shocks and provide a minimum degree of income convergence.<sup>2</sup>

Discussions about the appropriate fiscal arrangements for EMU resurged again in the early 1990s. A significant increase of the EU budget (such as that proposed by the MacDougall report) was considered politically unrealistic at that time. Besides, new concerns took prominence in debates, especially the question of how to guarantee fiscal discipline at the national level. With respect to this point, the consensus at that time – reflected in Maastricht – was that an appropriate combination of market discipline (notably an explicit prohibition of monetarisation of debt and a “non bail out” clause enshrined in the Treaty) and fiscal discipline rules (in particular, rules on upper deficits) would suffice to keep national budgetary policies on a sustainable path and avoid risks of debt defaults.

<sup>1</sup> Pierre Werner, *Report to the Council and the Commission on the Realisation by Stages of Economic and Monetary Union in the Community* (Werner Report), Supplement to Bulletin No. 11, 1970, p. 12, <http://aei.pitt.edu/1002>.

<sup>2</sup> Donald MacDougall, “Report of the Study Group on the Role of Public Finance in European Integration” (MacDougall Report), in *Economic and Financial Series*, No. A 13 (April 1977), <http://aei.pitt.edu/36433>.

Apart from the question of fiscal discipline, another issue debated in the 1990s was how to ensure an adequate fiscal policy stance for the whole euro area. As stated above, a significant increase of the EU budget was not contemplated, and thus the debate focused on the benefits and costs of handling the aggregate stance through the coordination of national budgetary policies. Some advocated for strong coordination and the creation of common political institutions with the capacity to take joint binding decisions (a sort of “economic government,” as the French used to say at that time). Others considered that the costs of tightening coordination would exceed its benefits and that, providing that EMU rules allow national automatic stabilisers to operate fully, tight coordination would be unnecessary. This approach prevailed in the end, and budgetary coordination was basically confined to the application of the excessive deficit procedure.

A third issue at debate was whether the Community should be endowed with some capacity for interregional stabilisation. While there were discrepancies with regards to the likelihood of asymmetric shocks, most experts at the time agreed on the need to assist member states in the case of severe specific shocks. Various proposals were made in this respect; some proposed the creation of a quasi-automatic “rainy-day” fund to insure countries against the risk of asymmetric shocks,<sup>3</sup> others (i.e. the Delors report) recommended instead allowing for a flexible use of the EU budget to help countries in exceptional circumstances.<sup>4</sup> This latter idea was discussed and finally inserted into Maastricht, but it was significantly watered down over the negotiation, rendering the legal clause almost useless.<sup>5</sup>

Finally, during Maastricht negotiations, there were intense political discussions on how to promote a process of convergence in the transition to EMU. The compromise reached at that time was the establishment of a calendar and some strict convergence criteria (the so-called “Maastricht criteria”) that all countries should fulfil in order to qualify for EMU. This, however, was complemented by the setting-up a specific fund (the Cohesion Fund) designed to support poorer countries in their efforts to qualify for EMU.<sup>6</sup>

<sup>3</sup> See for instance Alexander Italianer and Jean Pisani-Ferry, “Systèmes budgétaires et amortissement des chocs régionaux: implications pour l’union économique et monétaire”, in *Économie prospective internationale*, No. 51 (1992), p. 49-69, [http://www.cepii.fr/IE/PDF/EI\\_51-4.pdf](http://www.cepii.fr/IE/PDF/EI_51-4.pdf).

<sup>4</sup> Jacques Delors, *Report on economic and monetary union in the European Community* (Delors Report), 17 April 1989, <http://aei.pitt.edu/1007>.

<sup>5</sup> As a result of the concerted action of the British, the Dutch and – to a lesser extent – the Germans, assistance was finally limited to cases in which a member state is affected by “natural disasters” or “exceptional occurrences beyond its control” (see Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht. Negotiating Economic and Monetary Union*, Oxford, Oxford University Press, 1999). Ironically, the clause (art. 100 of the Maastricht Treaty, currently art. 122 of the TFEU) was used for the first time in 2010 to provide the legal basis for the creation of the European Financial Stabilisation Facility (EFSF), which, together with the European Financial Stability Mechanisms (EFSM), provided the first bailouts to Greece, Portugal and Ireland.

<sup>6</sup> Initially created for the period 1994-99, the Cohesion Fund was explicitly designed to help those countries whose GDP level was below 90 percent of the EU average (Greece, Ireland, Portugal and Spain) and which were applying a convergence program to join the EMU. In 1999, in view of the

Two further points are worth mentioning as regards the early 1990s debates on fiscal integration. The first is that the risks of financial stability linked to the establishment of a single currency were underestimated, and little attention was paid to the needs for fiscal risk-sharing in this area.<sup>7</sup> The second is that there was hardly any debate on the political implications of further moves towards fiscal integration. The assumption at that time was that a transfer of budgetary powers to the Community level would imply an expansion of the Community budget and a reinforcement of the powers of the Commission, with some involvement from the European Parliament.

## 2. Fiscal union for the euro area: the debates today

The current crisis has translated into important reforms in the fiscal arrangements for EMU. New financial assistance mechanisms have been created since 2010 to calm down sovereign debt markets<sup>8</sup> and the rules and procedures for fiscal discipline has been strengthened, both through the reform of the Stability and Growth Pact and with the adoption of a new intergovernmental Treaty (TSCG) that mandates the establishment of constitutional-level fiscal rules at the national level.

In parallel to these substantial reforms, the crisis has reopened the debate about the appropriate fiscal arrangements for EMU. The nature of the debate has changed from the past, and it has evolved over time following changes in the dominant narrative of the crisis and policy responses to it. Even if there are interconnections between them, one can identify at least five different debates on fiscal integration, with different implications as regards the pooling of fiscal resources and powers.

### 2.1. Fiscal discipline and public debts: what type of Eurobonds?

During the first years of the crisis, attention was very much focused on how to handle unsustainable debts and restore fiscal discipline in EMU. In this context, the lack of credibility of the “non bail out” clause demonstrated by the crisis as well

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enlargement to 10 new member states and the still-weaker situation of some EMU countries, the European Council agreed to maintain this instrument for the following budgetary period.

<sup>7</sup> The Delors report did not include an analysis of the financial implications of setting up a single currency, and there was no mention of the specific challenges of ensuring financial stability in a monetary union. By the same token, it did not recommend any transfer of sovereignty in the field of financial regulation, supervision and banking resolution, apart from conferring to the new monetary authority (ESCB) a limited role in the coordination of national banking supervision authorities. The report’s approach to financial market stability was embraced by the Maastricht Treaty with few amendments. Art. 105.5 stated that the ESCB “shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system”, though the Treaty did leave open the possibility for the Council to confer “specific tasks” on the ECB on financial supervision (art. 105.6).

<sup>8</sup> The EFSF and the EFSM, later on replaced by a more permanent mechanism, the European Stability Mechanism (ESM).

as the inability of the new emergency loan facilities (the EFSF, EFSM and ESM) to calm down sovereign debt markets sparked a lively debate on whether or not to mutualise public debts.<sup>9</sup>

The debate on Eurobonds is less salient today. Some would argue that Eurobonds already exist in the form of the debt issued by a permanent crisis resolution mechanism (ESM), and the creation of the ECB's Outright Monetary Transaction scheme has weakened the case for a more permanent joint issuance of debt to compensate for the absence of a "lender-of-last-resort." Yet, most people are dissatisfied with the current status quo. To start with, the ESM falls short in terms of legitimacy and accountability. Second, in some spheres there is dissatisfaction with the heavy involvement of the ECB in government bonds markets, and some believe that the rulings of the German constitutional court will jeopardise the ECB's ability to act as an effective lender of last resort. Finally, the third Greek bailout negotiation has made clear the political difficulties of confining the use of ESM to problems of liquidity and, despite all the efforts to strengthen the EU's fiscal discipline rules, there are serious doubts about the capacity of EU rules to put certain countries on a sustainable debt path.

While the question is currently off the table, sooner or later there will be a need to re-think the euro area crisis resolution system and its overall fiscal discipline regime. A minimum necessary step is to reform the governance of the ESM. Converting it into a pure Community-based instrument would be desirable but seems unrealistic as long as contributions are provided by national governments. One can, however, envisage some modest improvements, such as extending the use of QMV and eliminating asymmetries in national parliaments' influence on ESM by harmonising procedures or transferring the control and decision-making powers to an inter-parliamentary committee based on Article 13 of the Fiscal Treaty.<sup>10</sup>

As for the long term, two options emerge. One is to generalise Eurobonds; that is, to move towards a system in which access to a buffer of mutually-guaranteed debt is offered to all euro-area members in normal times, and not only those in crisis situations. This could be done by expanding the size and functions of the ESM, eventually converting it into a sort of European Monetary Fund.<sup>11</sup> A regime of this

<sup>9</sup> Between 2010 and 2012, the sovereign debt crisis prompted policy leaders, civil society actors and academia to develop various possible schemes for joint issuance of debt. Most of the mutual debt insurance schemes combined a short-term objective (to bring back extraordinary yield spreads and stabilise the Eurozone sovereign debt markets) with more permanent, long-term objectives (creating permanent insurance against a liquidity crisis, improving the governance framework through enhanced fiscal discipline and fostering the integration of financial markets through the creation of a safe and liquid asset). For a review of the various proposals of Eurobonds made at that time, see Stijn Claessens, Ashoka Mody and Shahin Vallée, "Paths to Eurobonds", in *IMF Working Papers*, No. WP/12/172 (July 2012), <https://www.imf.org/external/pubs/cat/longres.aspx?sk=26034.0>.

<sup>10</sup> Valentin Kreiling, "An Inter-Parliamentary Conference for the EMU", in *Jacques Delors Institute Policy Papers*, No. 100 (October 2013), <http://www.delorsinstitute.eu/011-16883>.

<sup>11</sup> See Henrik Enderlein and Jörg Haas, "What Would a European Finance Minister Do? A Proposal", in *Jacques Delors Institute Policy Papers*, No. 145 (October 2015), <http://www.delorsinstitute.eu/011->

sort would have the advantage of guaranteeing fiscal stability by releasing the ECB from the function of lender of last resort for sovereigns. However, it would require a major expansion of top-down budgetary surveillance and controls, possibly as far as seeking the right to veto national budgets *ex ante*. Such a transfer of sovereignty is politically difficult to envisage, except perhaps in a scheme such as is suggested by Enderlein et al., in which a loss of sovereignty is only envisaged for countries in critical debt situations.<sup>12</sup>

The other option is to move towards a system based on market discipline, inspired by the US model. This would require creating a euro-area insolvency regime and eliminating ESM or, more plausibly, limiting its use to the countries affected by temporary liquidity problems. A regime of this sort would require less transfer of political power to the center. However, to be credible, public debt ratios in the euro area would have to be significantly lower.<sup>13</sup> Hence, a euro-area debt redemption fund<sup>14</sup> might become a necessary condition to make it politically viable. Besides, the non-bailout approach in countries such as the US or Canada is credible because of the amount of fiscal risk-sharing offered through other means (a common resolution and deposit guarantee fund for banks, common social security provisions), which guarantees that a region or state failing into bankruptcy will not be without minimum government services, social security and financial stability. Thus, contrary to what some people believe, a market-based approach would not spare the euro area from the need to have common fiscal powers to stabilise the economy and guarantee financial stability.

### 2.2. Cross-country stabilisation: what type of fiscal shock absorber?

Since the publication of the Van Rompuy report in 2012, the idea that the euro area needs a fiscal risk-sharing capacity to help countries absorb asymmetric shocks has gained ground. Since then, a rich literature has emerged and different

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<sup>12</sup> Henrik Enderlein (ed.), "Completing the Euro. A Road Map Towards Fiscal Union in Europe", in *Jacques Delors Institute Studies and Reports*, No. 92 (June 2012), <http://www.delorsinstitute.eu/011-3317>.

<sup>13</sup> As pointed out by Pisani-Ferry, the public debt of Italy amounts to nearly 20 percent of euro-area GDP, whereas that of California represents less than 3 percent of the US GDP. An Italian debt default would have catastrophic consequences for the whole euro area, whereas the default of California could be absorbed by the US. Jean Pisani-Ferry, "Rebalancing the Governance of the Euro Area", in *France Stratégie Document de travail*, No. 2015-02 (May 2015), <https://shar.es/1GyQyk>.

<sup>14</sup> A euro area debt redemption fund would consist of a fund aimed at reducing, through temporary mutualisation of debt, the current public debt overhang of Eurozone member states. A proposal for a "European Debt Redemption Fund" (ERF) was made by the German Council of Economic Experts in November 2011. According to this proposal, all Eurozone countries that have debt exceeding 60 percent of GDP would transfer the part of the debt exceeding 60 percent of GDP into a European Debt Redemption Fund, for which all members would be jointly and severally liable. In return, countries would agree to repay ERF the transferred debts within some 25 years, with these obligations senior to remaining national debts and possibly backed up by collateral and dedicated tax revenues from each country. Text available at: <http://www.sachverstaendigenrat-wirtschaft.de/schuldentilgungspakt.html?L=1>.

modalities for fiscal risk-sharing mechanisms have been proposed. Four in particular have been the object of intense discussion. The first is the establishment of an intergovernmental insurance mechanism that would work as a “rainy-day” fund, that is, a fund where member states’ contributions and disbursements would be calculated on the basis of some cyclically-sensitive economic indicator, such as the output gap or unemployment levels.<sup>15</sup> The second proposal is to directly stabilise household income by creating an EMU-wide basic unemployment scheme. Under such a system, a certain share of contributions to the unemployment insurance would be paid to a European fund which would provide basic unemployment insurance to the short-term unemployed (up to 12 months).<sup>16</sup> A third proposal is to create a re-insurance system for national unemployment schemes. Inspired by the US’s “extended benefits scheme,” this system would be funded by regular contributions from national schemes and would support them in cases where the unemployment rate reaches a certain level.<sup>17</sup> Finally, some advocate for the establishment of a fully-fledged euro-area budget with counter-cyclical effects.<sup>18</sup>

Each proposal has its pros and cons. The first would be technically the least-challenging option. It can be created relatively quickly through an intergovernmental treaty, and it would be light to manage. However, its pertinence and stabilisation effects depend very much on the choice of the parameters of intervention, and there is no ideal choice in this respect. Besides, from a political point of view, a system of cross-country transfers has major drawbacks: it would reinforce the vision of one state paying another and weaken the perception of pooling resources for a common good. The second option is probably the most politically appealing. It would ensure a direct link between EU institutions and citizens and would have big stabilising effects. However, it requires a non-negligible effort to harmonise labour market policies and would need strong mechanisms to limit moral hazard at the national level. The third option requires much less labour market harmonisation, and it is far easier to implement than the EMU basic unemployment insurance. Politically speaking, it would be easier to communicate to citizens than an intergovernmental transfer system based on output gaps. However, its stabilisation effects would be rather limited. Finally, the creation of a fully-fledged euro-area budget would have major stabilisation effects and could also serve other important purposes (such as helping to stabilise the euro-area economy over the course of the cycle), but it would require a strong euro-area executive with discretionary powers, and thus a

<sup>15</sup> See for instance the proposal of Henrik Enderlein, Lucas Guttenberg and Jann Spiess, “Blueprint for a Cyclical Shock Insurance in the Euro Area”, in *Jacques Delors Institute Studies and Reports*, No. 100 (September 2013), <http://www.delorsinstitute.eu/011-16659>.

<sup>16</sup> See Sebastian Dullien, *A Euro-Area Wide Unemployment Insurance as an Automatic Stabilizer: Who Benefits and Who Pays?*, Paper prepared for the European Commission, DG EMPL, December 2013, <http://ec.europa.eu/social/BlobServlet?docId=10437&langId=en>.

<sup>17</sup> See Miroslav Beblavý and Ilaria Maselli, “An Unemployment Insurance Scheme for the Euro Area: A Simulation Exercise of Two Options”, in *CEPS Special Reports*, No. 98 (December 2014), <https://www.ceps.eu/node/9952>.

<sup>18</sup> Nicolas Caudal et al., “A Budget for the Euro Area”, in *Trésor-Economics*, No. 120 (October 2013), <http://www.tresor.economie.gouv.fr/File/392340>.



major transfer of sovereignty to the centre.

Beyond these technical considerations, one should not minimise the political difficulties of putting into place a cross-country risk-sharing mechanism. To start with, the need for such a mechanism is not consensual. A popular argument against it is that a well-functioning capital and banking union could probably absorb enough of the economic fluctuations without the need for a public risk-sharing mechanism. This argument might have flaws, but it is powerful in debates and might reinforce the perception that fiscal risk-sharing is superfluous.

Second, the major political obstacle is the fear of an unpredictable transfer burden for strong economies. This is widely recognised, and all the above-mentioned proposals are designed in a way to minimise the risks of unidirectional or permanent transfers. Yet, too much effort on rendering the system “neutral” from the point of view of redistribution might be counterproductive. Some for instance suggest equipping the mechanism with a rule by which all individual countries should maintain a balanced account with the common fund over the medium term. That seems reasonable and would strengthen member states’ stabilisation capacity, but, in essence, it would convert an insurance system into a system of implicit debt and would eliminate the advantage of sharing risks across a pool of countries. Besides, the idea that one should render the system “neutral” is based on the assumption that all potential redistributive effects are unjustifiable because they reflect free riding or moral hazard at the national level. This is false, however: euro-area countries might differ with regards to their vulnerability to shocks for objective reasons that are beyond national governments’ control (i.e. smaller countries have less-diversified economies and are thus more prone to idiosyncratic shocks than bigger countries).

To conclude, the design of the instrument should have strong mechanisms to limit free riding and moral hazard, but there is no sense in trying to eliminate all redistributive effects. The goal should be avoiding all policy-induced redistributive effects, and the best way to do so is by making sure that all participant countries have made efforts to increase their capacity to adjust to shocks. That is why the proposal of the five presidents’ report to create such a scheme after the culmination of a process of convergence, and to make the adoption of certain reforms a condition for access to a shock-absorption mechanism, makes full sense.

### *2.3. EMU-wide stabilisation: how and in which circumstances?*

The Van Rompuy report essentially conceived the “fiscal capacity” as a mechanism to absorb asymmetric shocks. Since then, however, the depth and length of the recession triggered by the euro crisis and the difficulties of stimulating the euro-area economy afterwards have opened a debate on the need to endow the euro area with some capacity to pursue a counter-cyclical policy for the area as a whole.

Contrary to the situation in the early 1990s, today there is a general consensus that the goal should not be to give to the euro area the capacity to fine-tune the aggregate budgetary stance in normal times, but only in exceptional circumstances.<sup>19</sup>

In principle, a fully-fledged euro-area budget could fulfil this function.<sup>20</sup> However, nobody envisages a euro-area budget bigger than 1-2 percent of EMU GDP, and it is difficult to imagine that such an instrument would be able to stabilise the whole euro-area economy on its own. Two other options – not necessarily mutually exclusive – seem more adapted to this function. The first is to give to a strong euro-area executive the capacity to coordinate budgetary policy positions in exceptional circumstances. This is politically very ambitious, however, as it would imply giving to this executive the capacity to force a member state to run a higher deficit if the latter is needed to have an appropriate aggregate stance.<sup>21</sup>

The second option is to give to a euro-area executive the possibility to borrow in predefined circumstances. This would be legally possible, as the Treaties allow the Union to borrow for specific purposes,<sup>22</sup> but would raise tricky questions with regards to how the borrowed money would be spent (given that there is no clearly-defined EMU-related spending). Besides, this borrowing would have to be backed by an EU budget's guarantee,<sup>23</sup> and it is difficult to imagine non-euro-area-members agreeing to share the risks of borrowing without receiving its benefits. A second-best alternative could be modifying the statute of the European Investment Bank in order to force the Bank to play a more active, anti-cyclical role in exceptional circumstances. One could for instance stipulate the obligation for member states to increase the capital of the Bank up to a certain percentage, or for the Bank to increase its lending capacity, in certain circumstances. In this case, action would benefit the whole EU and not only the euro area, but there would be fewer doubts

<sup>19</sup> This last statement might seem in contradiction with the fact that the five presidents' report explicitly states that a future euro-area stabilisation capacity should "not be an instrument for crisis management" (p. 15). In the same report, however, it is argued that "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" (p. 14). The latter seems to indicate that the term "crisis" on p. 15 is used in a narrow sense, to refer only to sovereign debt crisis (for which there is already an instrument, the European Stability Mechanism), and not to classical demand or supply-side crises. See Jean-Claude Juncker et al., *Completing Europe's Economic and Monetary Union* (Five president's report), 22 June 2015, [http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidentsreport\\_en.pdf](http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidentsreport_en.pdf).

<sup>20</sup> See Nicolas Caudal et al., "A Budget for the Euro Area", cit.

<sup>21</sup> Sapir and Wolf, for instance, propose the creation of a Eurosystem of Fiscal Policy (EFP) with a governing council composed of all euro-area finance ministers, five independent experts and a euro-area minister of finance. They propose giving this Council the right to take joint binding decisions in exceptional circumstances, on the basis of qualified majority. See André Sapir and Guntram B. Wolff, "Euro-Area Governance: What to Reform and How to Do It", in *Bruegel Policy Briefs*, No. 2015/01 (February 2015), <http://bruegel.org/?p=7367>.

<sup>22</sup> While the Union is subjected to a strict annual balance budget rule and thus cannot enter into deficit to finance its normal operations, the Treaty allows the Union to enter into borrowing-and-lending operations for specific purposes (art. 352 TFEU).

<sup>23</sup> Art. 352 TFEU allows the Union to borrow providing that the general budget contains the guarantee for the Community's borrowing-and-lending operations.

on the capacity to spend the extra-borrowed money in order to maximise its macroeconomic impact.<sup>24</sup>

Finally, a crucial question in these debates is how to define exceptional circumstances. Shall we restrict the use of this exceptional capacity to situations in which there is a real drop in EMU growth, or also permit it in cases in which there is an accumulated loss of output during a protracted period of very low growth? This second option seems preferable, as it would be in line with the definition of “severe economic downturn in the euro area” used by the Commission in the application of the Stability and Growth Pact. However, it opens the door to a not-so-exceptional use of this capacity (it would be for instance applicable to current economic conditions).

### *2.4. Convergence: need for budgetary support?*

A fourth issue of debate is whether current efforts to boost structural convergence within the euro area shall be accompanied by some EU budgetary support. As seen in section 1, this was the case in the transition to EMU. Today, there is general consensus on the need to embark on a new convergence process. However, the mainstream view (which one finds for instance in the recent five presidents’ report) is that there is no need for such a budgetary support. Sustainable convergence, it is argued, requires the reduction of cost-competitiveness divergences within euro-area member states. This should be done through the monitoring and controlling of wage developments at the national level, the adoption of tailor-made structural reforms and, eventually, the establishment of common binding standards (on labor markets, competitiveness, public administrations or taxation, for instance).

This vision has two main flaws. First, it takes for granted that reforms and fiscal consolidation can go hand-in-hand. Yet, we know that slow growth and budgetary consolidation severely hamper the capacity of governments to reform. Second, it reduces problems of convergence to differences in cost-competitiveness. However, data shows that the current euro-area competitiveness gap is mostly explained by differences in non-cost-competitiveness factors (such as the capacity to innovate or the quality of public administration).<sup>25</sup> This gap is likely to increase due to the crisis and the resulting budgetary cuts some countries have been forced to apply in areas such as education or research.

<sup>24</sup> The five presidents’ report proposes, as a first step towards an EMU-wide stabilisation function, to build on the recently-created EIB fund for strategic investments (EFSI). In particular, the report suggests “identifying a pool of financing sources and investment projects specific to the euro area, to be tapped into according to the business cycle”. It is however unclear how the latter could be consistent with the current functioning of EFSI (which is conceived as a demand-driven instrument and lacks any type of geographical pre-allocation). See Jean-Claude Juncker et al., *Completing Europe’s Economic and Monetary Union*, cit., p. 15.

<sup>25</sup> Eulalia Rubio, “Promoting Structural Reforms in the Euro Area: What for and how?”, in *Jacques Delors Institute Policy Papers*, No. 119 (October 2014), <http://www.delorsinstitute.eu/011-20321>.

Given these considerations, there is a plausible case for providing some budgetary support to weaker euro-area economies in their efforts to reform and boost their competitiveness. Different approaches can be imagined. One option could be establishing something *ex novo*, either an instrument to provide limited and temporary financial incentives to euro-area countries willing to reform (the “contractual arrangements” proposed in the Van Rompuy report) or a new fund to channel investment to weaker euro-area economies (as suggested by Jacques Delors or Enderlein and Pisani-Ferry<sup>26</sup>). Another option is building on existing EU convergence instruments; that is, structural and cohesion funds. One could for instance deepen recent efforts to provide for more flexible use of structural funds to help crisis-hit economies (i.e. by changing co-financing rates), or strengthen the capacity of the funds to induce reforms. This second option would be technically and politically less challenging. At the same time, it would be difficult, if not impossible, to restrict this action only to the euro-area countries.

### 2.5. Banking union: what type of fiscal backstop?

Finally, one last issue of debate is how to equip the banking union with a credible fiscal backstop. While the Single Resolution Mechanism (SRM) is already operational, and a proposal for a common deposit guarantee will follow soon, there is overall agreement that these two instruments would not be able to deal with a systemic banking crisis unless accompanied by a last-resort financial safety net. Some proposals have been made in this respect. One option (suggested by the five presidents’ report) is to allow the SRM to borrow from the ESM when facing a systemic crisis. Another option is to link this borrowing capacity to a future euro-area fiscal capacity.<sup>27</sup> The first is clearly more realistic and easy to put into practice in the short-medium term.

## 3. Designing a fiscal capacity for the euro area: some general recommendations

As shown in the previous section, there are different potential reasons for pooling fiscal resources and powers in the euro area. Attention is mostly focused on how to endow the euro area with cross-country stabilisation capacity, but one should not neglect other possible rationales. There are disagreements as regards the importance of these different rationales. Some consider that a public fiscal risk-sharing mechanism to absorb asymmetric shocks is not needed; others question the need to endow the euro area with capacity to handle the aggregate fiscal stance.

<sup>26</sup> Jacques Delors, “Rethinking the EMU and Making Greater Europe Positive Again”, in *Jacques Delors Institute Tribune*, 28 June 2013, <http://www.delorsinstitute.eu/011-16329>; Henrik Enderlein and Jean Pisani-Ferry, *Reforms, Investment and Growth: An Agenda for France, Germany and Europe*, Report to Sigmar Gabriel and Emmanuel Macron, 27 November 2014, [http://www.economie.gouv.fr/files/files/PDF/rapport\\_enderlein\\_pisani-en.pdf](http://www.economie.gouv.fr/files/files/PDF/rapport_enderlein_pisani-en.pdf).

<sup>27</sup> See Nicolas Caudal et al., “A Budget for the Euro Area”, cit.

A first step when thinking about possible modalities of a euro-area fiscal capacity is to clarify the needs for fiscal risk-sharing in the euro area.

Second, different risk-sharing needs might require different types of instruments.<sup>28</sup> The best would be consolidating as much as possible these different functions into a single tool, but it might not always be possible, or desirable. In some cases it might be preferable to use instruments that are already in place to build the new function (e.g. structural and cohesion funds for providing support to the process of convergence). In other cases, we might impose requisites on the new instrument that render it useless for other purposes. Thus, for instance, if we consider that a rules-based scheme submitted to a strict annual budget-balance rule is the best choice to fulfil the function of cross-country stabilisation, we will have to think on other options to equip the euro area with capacity to stabilise over the cycle and to react to major financial systemic crises (both requiring discretion, flexibility and some capacity to incur in debt).

Third, it is also very important to reflect on the consistency between different logics of fiscal integration and possible substitution effects between fiscal-sharing mechanisms. For instance, if we decide to create a buffer of mutually-guaranteed debt and offer to all euro-area countries access to this debt, the need for a euro-area cross-country stabilisation mechanism clearly diminishes. On the contrary, if we opt for moving towards a market-based fiscal discipline regime, the establishment of a powerful euro-area macro-economic stabilisation mechanism is essential.

Fourth, all things being equal, it is preferable to create a tax-based instrument rather than a fiscal capacity financed by national contributions. This would avoid the “net return” logic that is so harmful in EU budgetary negotiations.<sup>29</sup> Likewise, a future euro-area fiscal capacity could be placed outside the EU budget, but it would be preferable to establish this new mechanism within the EU budget. As noted by Repasi, this would be possible: the rules governing the EU budget allow for the establishment of a new budget heading to the benefit of some member states, and it is also possible to assign certain revenue to a specific budget line.<sup>30</sup>

Finally, the creation of a common fiscal capacity should be accompanied by governance reforms. However, different possible designs for a future fiscal capacity pose different requirements in terms of governance. Two variables are crucial in this

<sup>28</sup> See Eulalia Rubio, “Eurozone Budget: 3 Functions, 3 Instruments”, in *Jacques Delors Institute Tribune*, 15 November 2012, <http://www.delorsinstitute.eu/011-14473>.

<sup>29</sup> In any case, decisions concerning the way of financing the new fiscal capacity cannot be totally detached from ongoing debates on how to reform the system of “own resources” (that is, the general system for financing the EU budget). A high-level expert group on own resources, chaired by Mario Monti, is expected to release a report on this issue in the following months. This report will probably set the basis for discussion in the context of the 2016 mid-term review of the multi-annual financial framework.

<sup>30</sup> René Repasi, *Legal Options for an Additional EMU Fiscal Capacity*, Brussels, European Parliament, January 2013, [http://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL-AFCO\\_NT%282013%29474397](http://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL-AFCO_NT%282013%29474397).

respect: where do resources come from (from national budgets or from a common tax-based resource) and whether the mechanism is a rules-based instrument or requires the exercise of discretionary power. The first determines the nature of the future euro-area executive (more intergovernmental-based if resources come from national budgets and vice versa) and the type of democratic control required (coming from national parliaments, the European Parliament or both). The second determines the type of supra-national body required (an independent agency supervised by member states and/or the Commission or a political body capable of discretion and political judgment).

### 4. Looking forward: different choices

Taking into account the various rationales for fiscal risk-sharing as well as the varying appetite for further integration, different possible configurations of “fiscal union” can be imagined for the future.

A first possible scenario is an improved *status quo*. In this scenario, a political agreement is only reached to slightly improve EMS governance (i.e. harmonising national procedures for parliamentary control) and to establish a fiscal backstop for the banking union (possibly in the form of an ESM special credit line). All other steps towards further fiscal integration – either strengthening fiscal rules or creating joint fiscal mechanisms – are politically unattainable. And no budgetary support is given to the process of convergence.

A second scenario can be defined as *sui generis* fiscal federalism. It corresponds to a euro area equipped with a Eurobond scheme or a European Monetary Fund with extensive competences to issue mutually-guaranteed debt. This scheme essentially serves to stabilise sovereign debt markets and prevent liquidity and solvency crises, but in doing so it contributes to reducing the negative feedback loop between domestic banks and their sovereign and also provides a financial buffer to countries affected by shocks, thus enhancing macro-economic stabilisation capacity at national level. In this scenario, the need for a euro-area cross-country stabilisation mechanism is less evident and it is probable that the establishment of such a mechanism would not find enough political support once a system of Eurobonds is in place. However, to be politically acceptable, a scheme of mutually-guaranteed debt requires a major strengthening of fiscal surveillance rules and procedures (including the right to veto national budgets in extreme circumstances) and effective efforts to promote convergence. Finally, as the joint issuance of public debts is based on mutual guarantees from national governments, the executive power will logically remain at the hands of the Ministries of Finance. Executive capacities can be strengthened, however, by equipping the Eurozone with a full-time president or extending the use of QMV, and competence can be given to the new executive to coordinate national budgetary responses in case of major systemic crises. Democratic accountability will also rest at the national level, even if some improvements can be made to eliminate asymmetries among national parliaments

and ensure the involvement of the European Parliament.

A third scenario can be defined as a market-based decentralised regime. This corresponds to a euro area in which fiscal discipline is basically ensured through market pressure. This requires the establishment of a euro-area insolvency regime and the confinement of ESM to temporary liquidity crises. To be credible and politically acceptable, such a scheme has to be accompanied by a temporary debt redemption fund as well as a common fiscal stabilisation capacity – and the establishment of the latter must be preceded by effective efforts to promote convergence.

One might imagine two variants of this third scenario, depending on whether the stabilisation capacity consists of a rules-based mechanism or a more discretionary mechanism (such as a Eurozone budget with stabilising effects). In the first case, the Commission can assure the management of the scheme, which works automatically. A strong “political” executive will be needed, however, to take joint decisions or mobilise resources in exceptional circumstances (major economic shocks, systemic financial crises). In the second case, the best would be to create a single strong euro-area executive in charge of managing the euro-area budget, supervising the implementation of fiscal rules and mobilising resources in exceptional circumstances. As regards the specific form of this executive, the most appropriate would be an executive backed by both the member states and the EU Commission, such as the “double hat” European Finance Minister suggested by Enderlein and Haas.<sup>31</sup>

Which scenario are we heading towards? The first is the most likely one, but its long-term political and economic viability is clearly questionable. If we want to avoid this first scenario, we should decide now which of the two other scenarios we want to move forward and take decisions accordingly. In the short term, both scenarios require the same: taking concrete steps for the establishment of a common backstop for banking union and putting into place budgetary measures to accompany the process of convergence (those might be negotiated in the context of the 2016 EU budgetary review). In parallel to that, however, political negotiations should start either on possible paths and options for a future package of a debt insolvency regime, debt redemption fund and EMU stabilisation capacity, or for the conversion of the ESM into a truly European monetary fund. It is not the place here to detail the possible initiatives, options and potential obstacles to put into place each of these two scenarios, but two main aspects need to be highlighted. The first is that, in both cases, there will be a need to build up large policy packages able to satisfy the interest of different Eurozone members (and particularly to convince both northern and southern Eurozone governments). The second is that the interest of non-Eurozone member states should be taken into consideration at the moment of designing future Eurozone common fiscal capacities. Having

<sup>31</sup> See Henrik Enderlein and Jörg Haas, “What Would a European Finance Minister Do? A Proposal”, cit.

said that, it is important to recall that all EU member states, except for the UK and Denmark, are obliged to join the currency union in the medium term, and that it is in all EU members' interest to ensure a well-functioning, crisis-resilient EMU. In this respect, it seems more intelligent to convince "pre-ins" to adopt a constructive approach and eventually offer them the possibility of joining future EMU fiscal capacities rather than reinforcing the separation between EU and EMU regimes.

**Table 1** | Different long-term scenarios for "fiscal union" and their implications for pooling fiscal resources and capacities

	Improved status-quo	Sui generis fiscal federalism	Market-based decentralised regime (I)	Market-based decentralised regime (II)
<b>Fiscal discipline</b>	Minor changes to ESM governance (i.e. harmonisation of national parliaments' control procedures)	European Monetary Fund with extensive competences to issue mutually-guaranteed debt  Stricter euro-area fiscal rules and procedures (including the power to veto national budgets in extreme cases)	EMU insolvency regime accompanied by a temporary debt redemption fund  ESM confined to temporary liquidity crises	EMU insolvency regime accompanied by a temporary debt redemption fund  ESM confined to temporary liquidity crises
<b>Cross-country stabilisation</b>	Full use of flexibility rules of Stability and Growth Pact	No need for specific instrument	Rules-based stabilisation scheme	Euro-area budget with stabilising effects
<b>EMU-wide stabilisation</b>	Full use of flexibility rules in applying Stability and Growth Pact, extension of Juncker Investment Plan after initial three-year period	Euro-area executive with capacity to coordinate national budgetary policies/borrow in exceptional circumstances	Euro-area executive with capacity to coordinate national budgetary policies/borrow in exceptional circumstances	Euro-area executive with capacity to coordinate national budgetary policies/borrow in exceptional circumstances
<b>Budgetary support for convergence</b>	No	Yes, through a new instrument or changes in allocation/function-ing of existing EU funds	Yes, through a new instrument or changes in allocation/function-ing of existing EU funds	Yes, through a new instrument or changes in allocation/function-ing of existing EU funds



## Federalising the Eurozone: Towards a True European Budget?

<b>Fiscal backstop for Banking Union</b>	Yes, ESM credit line to European bank resolution scheme	Yes, in the form of EMF credit line	Yes, in the form of ESM credit line, or exceptional borrowing capacity	Yes, as a function of the euro-area budget
<b>Governance</b>	No changes	Stronger euro group (i.e. full-time euro group president, extension of QMV) with exceptional powers to react to major crises	Stronger euro group with exceptional powers to react to major crises  Commission in charge of managing the rules-based fiscal capacity	Single euro-area executive in charge of managing the Eurozone budget, supervising the implementation of fiscal rules and mobilising resources in exceptional circumstances
<b>Democratic accountability</b>	No changes	National parliaments	National parliaments and European Parliament	National parliaments and European Parliament

## Conclusions

Discussions about a future fiscal capacity for the euro area are too often limited to a comparison of the technical advantages and disadvantages of different modalities of cross-country fiscal shock absorbers. This paper aims to broaden the debate, by pointing to the existence of other possible rationales for pooling fiscal resources and powers in EMU and discussing how they fit together.

Four key messages stand out from the paper. First, any discussion about the modalities of future euro-area fiscal mechanisms should start with a broader reflection on the model of fiscal integration (or type of “fiscal union”) we want to head towards. Second, there are different long-term options of EMU “fiscal union” but, to be viable, all require a non-negligible degree of fiscal risk-sharing. Third, the creation of major solidarity instruments is for the long term. However, some decisions can and should be taken in the short term (particularly taking steps towards the establishment of a common backstop for banking union and deciding on some temporary budgetary measures to accompany the process of convergence). Fourth, all things being equal, it is preferable for a future euro-area fiscal capacity to be financed by a tax-based instrument rather than through national contributions, and included in the EU budget rather than established outside of it.

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