Responsibility Versus Solidarity? Key Issues for the EMU Reform

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Abstract: *The 2008 economic recession, followed by the sovereign debt crisis, made it clear that the original design of EMU was unsustainable. Together with the most urgent adjustments, the need for a profound reform of the system has been on the agenda for more than a decade. Despite significant steps being taken, no comprehensive reform has yet been delivered. In this paper, the background and the focus of the EMU reform will be reviewed. The research argues that it is necessary to create a better balance between the common shock absorption instruments (i.e., risk sharing) and to give a greater role for markets as incentives for fiscal and financial discipline (i.e., risk reduction). A new synthesis of the two dominant narratives could form the conceptual core of EMU reform. In this way, the need to create a sustainable system of resilience (the ability to respond and adapt) can be the decisive factor. At the heart of the EMU reform there can be deeper economic and financial union, resilient structures, the increase of risk sharing and the reduction of inherited risk.*

Keywords: *EMU, deepening, risk reduction, risk sharing, responsibility of member states, solidarity, resilience, fiscal union, reform package.*

JEL classification: *F02, F15, F17, F43, F55.*

Introduction

The need to create a *"genuine"* Economic and Monetary Union (EMU) provides a framework for a comprehensive reform process. In 2012, Olli Rehn, then member of the European Commission, announced, on the basis of the criticism of EMU 1.0, the need to move towards EMU 2.0[2]. On 28 November 2012, the European Commission published its Blueprint for "a deep and genuine EMU". Based on the previous assessments, the "Four Presidents' Report" was submitted to the December 2012 EU summit. On 20 March 2013, the European Commission revealed its Communication "Towards a Deep and Genuine Economic and Monetary Union". After some pause, the next milestone in this process was the Five Presidents' Report on the programme and roadmap for strengthening EMU, published on 22 June 2015. (Juncker et al., 2015)

The mechanisms and measures of economic governance are largely directed at the euro area and its member states. The scheme envisages a multi-speed approach: the deepest integration (and the delegation of competences to the greatest extent) can be achieved in the core area. Non-participating member states engage in integration at a

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[2] EMU 2.0 refers to the new system of a "complete", "deep" Economic and Monetary Union, which can be built largely in the future. André Sapir, however, considers the system transformed by short-term or systemic measures introduced during the crisis management period as EMU 2.0, which appears to be temporary, and identifies the "complete" (future) system as EMU 3.0. For example, see Sapir, Shoenmaker, 2017. The current transitional regime can be called EMU 1.1, as it goes beyond the limits of 1.0 in many respects, but it does not represent a qualitative shift and cannot be considered a "complete" EMU.

lower level and the transfer of competences is less pronounced.

The reform measures, some of which have already been adopted and introduced, but most of which are planned, indicate the direction of fundamental changes. During the Juncker Commission, a sweeping reform of EMU seemed feasible. In 2017, a Reflection Paper (COM (2017) 291) was firstly published, followed at the end of the year by the comprehensive set of proposals and a "Roadmap" for implementation, issued by the Commission.

Considering the stages previously mentioned, the main objective of this paper is to provide a theoretical background to the reform package and a systematic analysis of the theoretical approaches to the reform package and its possible shortcomings. Key issues for the EMU reform remain relevant, and the functional problems of EMU still need to be addressed.

However, within this framework, the impacts of the coronavirus crisis and its aftermath on EMU reform, as well as the possible interrelationships of crisis management (including reconstruction plans), can be addressed only to a limited extent.

1. Differences in member states' reform positions

The debates on EMU 2.0 focus in no small part on overcoming differences between member states. Some views emphasise national responsibility and risk reduction, others risk sharing and solidarity. These two main dimensions can provide a framework for an overview of the whole issue. Despite the reforms of the last decade, there is a general consensus on the need to take further steps to complete EMU. There are diverging views both on the problems that need to be overcome, and on the measures to be taken.

Building on the proposals in the Five Presidents' Report, the European Commission relaunched the debate with a Reflection Paper (EC, 2017) published in spring 2017. The EMU reform proposed a series of concrete steps on how to complete EMU by 2025. The document marked an important shift: it called for a better balance between common tools for shock absorption (i.e., risk sharing) and a greater role for markets, as incentives of fiscal and financial discipline (i.e., risk reduction). The need for a sustainable system of resilience (the ability to respond and adapt) was included.

After its publication, prominent French and German economists presented proposals for the euro area reforms with similar, but, in some respects, different emphases (Bénassy-Quéré et al., 2017, 2018, commonly referred to as the 7+7 Report). Pisani-Ferry, a French member of the expert group of economists comprising of seven French and seven German leading economists, expressed that the group's fear was that their two countries would settle on a "small bargain" that "would not make the euro area more stable" and that might "induce a false sense of security". (Pisani-Ferry, 2018). However, the starting point for this package of proposals was similar to that of the Commission: (Bénassy-Quéré et al., 2017 – main proposals are summarised in Table 1.)

Table 1. Key proposals of the 7 + 7 Report

1. Reform of fiscal rules, including the enforcement device
- Introduce debt-corrected expenditure rule (acyclical discretional spending) - Ditch EU sanctions, assign more individual responsibility to countries
2. More and better risk sharing
- Reduce home bias in bank sovereign portfolios through concentration charges - Introduce common deposit insurance with national compartments - Promote safe asset based on diversified sovereign debt portfolio (e.g. ESBies) - Create low conditionality access to European Stability Mechanism (ESM) liquidity for pre-qualified countries - Create unemployment/employment insurance fund
3. A targeted role for market discipline
- Enforce the fiscal rule via mandating the insurance of subordinated (junior) bonds for the financing of excess spending - Make sovereign debt restructuring a credible last resort when debt clearly unsustainable
4. Clarify role of institutions
- Separate "prosecutor" (watchdog) and 'judge' (political) - Upgrade ESM to International Monetary Fund (IMF)-like institution, introduce political accountability - Strengthen national fiscal councils

Source: Bénassy-Quéré et al., 2017.

This document did not reflect the views of the French and German governments. France had reservations about the possibility of restructuring national debt as a last-resort option, and feared some form of its automaticity. For Germany, the main areas of concern were the European Deposit Guarantee Scheme and the proposal for a European Stabilisation Fund requiring at least temporary fiscal transfers.

These documents gave rise to a lively debate on possible solutions and their basic elements until the end of the schedule according to the roadmap, in the summer of 2019 (Pisani-Ferry - Zettelmeyer, 2019b). After the temporary pause of the reform, and following a provisional break, a wider debate on this issue has been relaunched in the wake of the COVID-19 crisis. (Krahnen et al., 2021) The following section displays a review of this issue.

2. Unsustainable balance of EMU 1.0

Despite the progress made in the past few years, EMU 1.0 continues to rely on an unsustainable equilibrium. Its main features are: the incomplete nature of the Financial Union (shortcomings of the banking union and the capital markets union), and the lack of a central fiscal stabilisation function[3]. In this context, the system does not include a satisfactory shock absorption mechanism, either for private or government channels. The supervisory procedure is asymmetric: it puts more emphasis on correcting fiscal or external (current account) deficits than on handling significant surpluses. Linking this

[3] These features, notwithstanding the changes so far, are also valid for EMU 1.1.

scheme to fiscal stabilisation mechanisms at the member state level would not allow for the achievement of an appropriate fiscal stance or an optimal distribution of fiscal burden for the euro area as a whole (the latter would allow to strike the right balance between stabilisation and sustainability at the national level). This combination results in an overburdening of monetary policy for stabilisation purposes. Thus, an inappropriate policy mix is emerging, especially near the zero lower bound for policy interest rates. This equilibrium is even more fragile. High public debt and insufficient reforms in several member states create vulnerabilities. This hampers adjustment within and across countries. Moreover, in recent years, this has been achieved as a result of "ultima ratio" decisions with agreements often partial and not fully owned by all the sides.

There is no consensus on the way forward. During the debates so far, **two approaches** have typically emerged. They take different positions in terms of the interaction of solidarity and responsibility, and of risk sharing and risk reduction. The two distinct approaches have sometimes become "a battle of ideas" along the "Rhine-divide" (Brunnermeier et al., 2016). Some saw the need for a 'return to Maastricht'. This would entail the strict implementation of a rules-based fiscal capacity, including its sanctions, and the reaffirmation of the "no bail-out" clause. They stressed the central importance of risk reduction. Others highlighted the need for introducing better, more prudent rules and common risk-sharing instruments, both private and public. More developed financial and capital markets can promote a "bail-in" by the private sector. However, in the absence of fiscal risk-sharing, specific shocks will hit harder, impose higher potential costs on other EMU member states and reinforce the need for ad hoc interventions, and ultimately for a disguised "bail-out".

In fact, solidarity and responsibility are two sides of the same coin. Under a balanced agreement, they could be implemented simultaneously, in principle. Consequently, the new synthesis of these two points of view allows substantive progression. In the financial sector, risk reduction without a proper risk-sharing mechanism is likely to result in higher risks of market instability. Conversely, risk-sharing without an effective risk reduction strategy entails moral hazard and can ultimately increase risk.

The Reflection Paper also attempted to bridge the two dominant narratives. Identifying realistic and desirable solutions can help member states to reach an agreement as soon as possible. However, beyond the issues that can be resolved in the short term, other elements that can only be settled in the longer term – including a new institutional balance – are needed for a profound and effective EMU reform. The possible basic elements for a new synthesis are summarised in Figure 1.

Figure 1. Elements for a new political synthesis

Source: Buti et al., 2017.

3. Main directions of the EMU reform

3.1 In focus: deeper economic and financial union, resilient structures, the increase of risk sharing and the reduction of inherited risk

The convergence of member states towards resilient economic and social structures is a prerequisite for the long-term success of EMU. A high level of economic resilience creates the ability to resist to shocks and recover quickly to the potential output (Giudice et al., 2018). These are fundamental for the EMU. Experience of recent years has shown how lack of resilience can have a lasting impact not only on one or several euro area economies, but also on other member states and the euro area as a whole. Resilience strengthens cyclical convergence (i.e., reduces the divergence of national economic cycles) and the effectiveness of the single monetary policy. Policies that affect economic resilience could become part of the convergence standards in EMU. Compliance with these standards could even be a condition for access the new stabilisation capacity. An integrated and well-functioning financial system is a key feature of an efficient and stable EMU. In particular, the fundamental conditions for progress are: (1) increasing financial market stability, reducing financial market risks; (2) sovereign and banking risk management; (3) creating a truly European safe asset. These factors will be reviewed in the following sections of the paper.

Increasing financial market stability, reducing financial market risks. Completing the banking union and reducing the risks in the banking sector is an ongoing priority[4]. Establishing a Single Resolution Fund and a Single Deposit Insurance Scheme are essential for the functioning of the system together with implementing other elements of the financial union. First, comprehensive strategies need to be adopted and materialised to reduce the rate of non-performing loans. Second, building a capital markets union should be promoted to provide households and businesses with more innovative, sustainable

[4] The banking union is not yet complete. Two important parts are still to be agreed: a common deposit insurance and limits on banks' holdings of sovereign bonds. In his review, Angeloni (2020) emphasised, among other things, the issues of managing sovereign concentration risk and designing a deposit insurance scheme.

and diversified sources of funding. As part of this process, the European Supervisory Authorities needs to be reviewed. A single European capital markets supervisor should be put in place. Progress in the capital markets union could also contribute to increasing the shock absorption capacity of financial markets. There is still little risk sharing through private channels in EMU. Excessive savings, also resulting from persistently different balance of payments positions, could flow back to the member states concerned on the opposite side through capital investment rather than loans. This (i.e., capital investment instead of loans) could significantly reduce the risk of financial instability.

Sovereign and banking risk management. The banking union and the capital markets union could reduce the stress that the banking sector puts on sovereign states. However, the other direction of the "doom loop" – from sovereigns to banks – is only partially addressed by the measures foreseen. Sound fiscal policies and public debt reduction can mitigate the risks to banks from sovereign bond market developments. With a single monetary policy and free capital mobility, a European financial system based on national bond markets creates the possibility of sudden capital flows between these markets. These sudden capital flows represent a significant risk to the stability and convergence of the euro area.

Greater diversification of bank balance sheets can contribute to addressing the issues of credit relationships between banks and the member states concerned. One option to promote greater diversification is the development of *Sovereign Bond-Backed Securities* (SBBS) (Brunnermeier et al., 2017). However, SBBS are unlikely to become a benchmark for European financial markets, with the potential comparable to US Treasury bonds or Japanese government bonds.

A possible reform of the Regulatory Treatment of Sovereign Exposures (RTSE) has emerged during the debates on how to deliver the banking union as an additional measure to break the bank-sovereign loop.

To this end, a number of options have been considered (ESRB, 2015). Reform of the RTSE may be relevant once the banking union is complete (Single Resolution Fund, common deposit insurance) and a common European safe asset is created.

Bénassy-Quéré et al. (2017) recommended the introduction of sovereign (i.e., different for each member state) concentration charges for banks and a common deposit insurance to prevent the vicious circle between bank and sovereign debts. The cornerstone of the 7+7 Report: 'penalising' banks' concentrated sovereign exposures (to specific sovereigns) (Pisani-Ferry - Zettelmeyer, 2018). Its main objective is to price the diversification of the bank portfolio and the country-specific risks. The former could also provide a strong incentive for prudent policies at the national level. At the same time, they urge to achieve a breakthrough in the capital markets union, the cross-border integration of banking and capital markets. The proposed measures could impose sufficient discipline in the "good times" and would not artificially exacerbate the trend of economic recession.

European (euro area) safe (risk-free) asset. In federal states (such as the United States), government securities issued by the central government are generally considered risk-free. They serve as a benchmark, contributing greatly to the efficient functioning of financial markets. In the euro area, however, the volume of securities that can be classified as federal is low. In each euro area member state, sovereign debts issued by the individual member states are considered to be the main benchmark. But there is a significant difference in risk and therefore a substantial widening of yield spreads. This harms the competitiveness of financial institutions operating in different countries.

Experience has shown that during stressed periods, the current structure of sovereign bonds and banks' excessive holdings of sovereign exposures have amplified market volatility. It has an impact on financial sector stability and the real economy of euro area member states.

Breaking the "doom loop", requires a more ambitious solution. The European bond market itself needs to be reformed. In the medium term, this would require the development of a *truly euro area safe asset* (Moscovici, 2017). A *euro area yield curve* could contribute to the maintenance and transmission of monetary policy, and foster long-term investment and risk capital. An essential requirement is that the euro area should also have an asset class commensurate with the weight of its economy, and be able to offer third countries an alternative investment opportunity in the European Union. A truly European safe asset should maintain the possibility for governments to finance themselves at reasonable costs and with continuous market access. At the same time, it should improve the incentives for sound fiscal policies.

To deliver its full potential, a European safe asset should meet a couple of conditions (Buti et al., 2017) It should provide liquidity at the lowest possible cost in Europe and globally compared to other similar assets, without adverse effects and additional risks. Its structure should be transparent, allowing for easy pricing for investors and should also be considered of the safest standard. In addition, a European safe asset should be sizeable enough to become the euro area's benchmark bond for collateral and liquidity purposes, and to meet global demand. Finally, it should cover a wide maturity structure that can serve the objectives of different investors, including those with long-term perspectives.

In recent years, a number of proposals have been made with different design features to create a European safe asset. They ranged from full to partial. Some of these would lead to common obligations, others would not (EC, 2011).

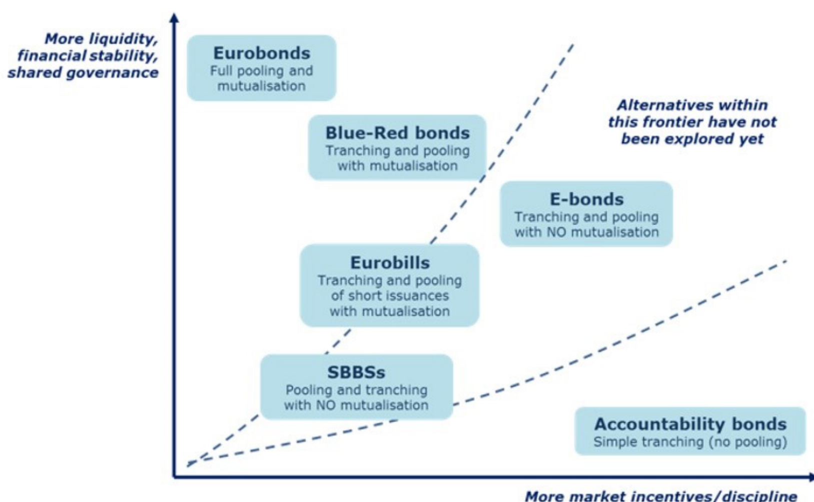
Leandro - Zettelmeyer (2018) argue that safe assets could be created without mutualisation if euro area banks held a more diversified portfolio of sovereign bonds. They would then become even more resilient to sovereign default. Some options, like e-bonds[5] do not embed mutualisation, and can directly raise fiscal discipline (by raising the marginal cost of sovereign bond issuance without raising the average cost for lower-risk operators). It can be a realistic option to overcome the lack of trust between member states: it maintains a balance and imposes a firm obligation to common issuance with strong market discipline. The introduction of a European safe asset would allow for the progressive application of concentration charges. This could help build up a common deposit insurance and a backstop, while allowing the ECB's balance sheet to be reduced without disruption.

A number of proposals have already been put forward to create a risk-free euro area asset (Figure 2). However, member states with sounder public finances are not willing to provide direct guarantees to weaker countries to finance their budgets[6].

[5] They subordinate all national debt to funding from a Common Issuer, the ESM or the European Investment Bank (EIB).

[6] The latest concept is also remarkable in this respect. See Amato et al. 2022.

Figure 2. Possible options for new forms of safe assets in Europe



Source: Buti et al., 2017.

3.2. Market discipline and fiscal surveillance – better balance

More effective market discipline could allow for a better balance in the functioning of economic governance in EMU. Markets have so far been exercising their role in disciplining fiscal policies across the euro area with uneven stringency.

Strengthening market discipline is essential, but it should be addressed without disrupting the recovery process. The risk of "sudden stops" should be avoided (Philippon, 2015). The experience of the recent crisis shows that market discipline operates too late and in an abrupt fashion under the current framework. A new institutional regime (including a truly European safe asset) could increase the degree of linearity in financial market reactions, and help avoid 'cliff effects' (sudden action of pricing of risks) in interest rates. The completion of the banking union and the setting up of the common euro area safe asset could allow risks pertaining to excessive exposures to sovereign bonds to be recognised. Supported by stronger economic, fiscal, and financial integration, it would also pave the way for simplifying the current EU fiscal rules (Buti et al., 2017).

Bénassy-Quéré et al. (2017) argue that fundamental changes to fiscal rules focusing on structural deficit are needed. They point out that current rules lack flexibility in both "bad" and "good" times. They recommend that structural deficit should be replaced by a simple (countercyclical discretionary) expenditure rule guided by a long-term debt reduction target: "government expenditure must not grow faster than long-term nominal output, and should grow at a slower pace in countries that need to reduce their debt-to-GDP ratios."

At the same time, Bénassy-Quéré et al. (2017) suggest that monitoring compliance with the fiscal rule should be devolved to independent national and euro area-level institutions. Governments that violate the expenditure rule would be required to finance excess spending using junior ('accountability') subordinated bonds. "The need to issue such bonds would be far more credible than the present threats of fines, which have never been enforced." The cost at which these junior sovereign bonds are issued

would depend on the credibility of government policies to tackle fiscal problems in the future. Financing excess spending would become more costly.

Bénassy-Quéré et al. (2017) foresee the creation of economic, legal and institutional underpinnings for the extraordinary sovereign debt restructuring of member states whose solvency cannot be restored through conditional crisis lending ("last resort"). It is essential to prevent instability in sovereign debt markets. They recommend an ESM lending policy that is conditional but also available for preventive (precautionary) purposes, as well as the use of sovereign concentration charges for banks. The proposed measures need to be combined with other reforms. These could reduce sovereign risk under the proposed risk-sharing mechanism. Pisani-Ferry - Zettelmeyer (2018) explain the 7+7 position by adding that the solvency of euro area member states is not exogenous. The endogenous conditions for national solvency could improve as a result of the proposed policy regime through stronger incentives to fiscal responsibility and the weakening of the doom loop between banks and sovereigns. This could greatly reduce the risk of euro area disintegration[7], and redenomination.

The foregoing was questioned by several participants in the debate. Buti et al. (2018) argue: „As costless defaults are an illusion, rather than forcing defaults it would make more sense to work to reduce the economic, financial, and political costs in the extreme and unlikely case that a sovereign debt default becomes inevitable in the euro area. This alternative approach would involve: (1) making the financial system more resilient to such a default event (see below); (2) improving the EMU architecture to make defaults even less likely; and (3) clarifying ex ante 'who' would bear the cost of a government default."

3.3. Creating a central stabilisation capacity

A central fiscal capacity[8] aimed at improving macroeconomic stability in the euro area could be based on the following *principles*: it should not lead to permanent transfers between member states, should minimise moral hazard, and be strictly conditional on clear criteria and continuous sound policies; it should be within the EU framework; and it should not duplicate the role of the ESM.

There are several options for institutionalising this function: (1) a European *Investment Protection Scheme* would protect investment in the broad sense, in the event of a downturn by supporting well-identified priorities and already planned projects or activities at national level, such as infrastructure or skills development. (2) A European *Unemployment Reinsurance Scheme* could act as a 'reinsurance fund' for national unemployment schemes. The scheme would provide more breathing space for national public finances. It can help economies to emerge from the crisis faster and stronger. The unemployment reinsurance scheme would, however, probably require some prior convergence of labour market policies and characteristics[9]. (3) A "rainy day" fund could accumulate funds on a regular basis. Disbursements from the fund would be made on a discretionary basis to cushion large shocks. The "rainy day" fund would normally limit its payments strictly to its accumulated contributions.

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[7] Or the risk of self-fulfilling exit expectations *per se*.

[8] For fiscal union proposals, see e.g., IMF, 2013; Thirion, 2017; Berger et al., 2018.

[9] For an overview of the discussions on the stabilisation mechanism based on unemployment benefits, see Beblavy - Lenaerts, 2017.

These instruments could, as *ultima ratio*, contribute to stabilisation in the event of large shocks. To increase its stabilising effects, the function can be equipped with borrowing capacity. At the same time, it should provide for savings at other times and limit indebtedness. A euro area budget could ensure broader objectives, covering both convergence and stabilisation. This requires a stable revenue stream. A significant transfer of competences to the European level is essential[10].

Bénassy-Quéré et al. (2017) propose the creation of a fiscal stabilisation scheme, a euro area fund financed by national contributions, to absorb the effects of major economic crises. Small fluctuations can be offset through national fiscal policies. Pay-outs from the euro area fund would be triggered only if employment falls below (or unemployment rises above) a pre-set level. To avoid permanent transfers, national contributions would be higher for member states that are more likely to draw on the fund. Good incentives could be maintained through three mechanisms: smaller losses would continue to be borne at national level, participation in the scheme would depend on compliance with fiscal rules and the European semester, and higher drawings would lead to higher national contributions.

3.4. Strengthening euro area institutions and accountability

EMU reform requires greater democratic accountability and higher transparency at each level of governance: who decides what and when. There may be a need to extend and formalise the dialogue between the European Parliament and other institutions of the euro area. Further political integration could involve a rethinking of the functioning of the *Eurogroup* as a more formal and transparent decision-making body. The appointment of a permanent Eurogroup chair could be envisaged, which could be merged with the Member of the Commission responsible for EMU. Increased attention needs to be paid to the external representation of the euro area. A number of competences and functions, including the *Fiscal Union Function*, could be developed and regrouped within the institutional framework of the euro area and the EU. The *Treasury*, preferably with a euro area budget, could be responsible for the fiscal surveillance, the macroeconomic stabilisation function, and the issuance of the European safe asset.

In its current form, the ESM provides liquidity support to member states. In the future, it could act as a common backstop to the Banking Union. The ESM could evolve into a *European Monetary Fund* (EMF). Decoupled from other financial institutions, the EMF can grant greater autonomy to the euro area. There are different possible designs for the creation of a euro area Treasury. For example, the EMF could be the arm of the Treasury for financial stability. A basic pre-condition is that the ESM or the evolving EMF is integrated into the EU Treaties and it is supervised by the European Parliament[11].

3.5. Concerns about fiscal union

The concept of fiscal union is deeply connected to national sovereignty. According to the minimalist interpretation, it can be implemented without transfer of competences

[10] However, Maduro et al. (2021) for example, argues that the current framework of EU primary legislation is sufficient for a central fiscal capacity, i.e., it does not require any amendments to the Treaties.

[11] Buti et al. (2020) underlined the need for the establishment of a Treasury and a European Minister of/High Representative for Economy and Finance in the field of development of the euro area institutional architecture.

in the areas of allocation and distribution, which remain under national control[12]. The fiscal union can be built on fiscal surveillance rules enshrined in a simplified Stability and Growth Pact, as a backstop for the Single Resolution Fund and a stabilisation capacity. An essential structural, efficiency-based argument for fiscal union is: in a currency union, purely national fiscal responses are less effective in response to permanent shocks than an intergovernmental transfer system (Kennen, 1969).

Creating a fiscal union is a key issue for the future of EMU (and the EU). A fiscal union will presumably require the adoption and development of new mechanisms involving further transfer of competences and the extension of supranational institutional responsibilities. The transfer of competences would entail a further loss of national sovereignty. It is unclear when the political and social framework conditions will improve sufficiently for this. It is still not clear what elements would be needed to create a fiscal union, and how competences could be shared between the member states and the Union.

Fiscal "federalism" is the distribution of fiscal functions within an existing fiscal union. The European Union's current common budget does not even reach the pre-federal level. Fiscal federalism would strengthen the economic (more narrowly, the fiscal) side of EMU. It would also lead to a deeper and stronger integration structure. It is typical of federal countries, where the centralisation or decentralisation of budgetary functions is a priority. For federal states, the main question is: which functions should be placed to lower levels? In the case of EMU, the question is rather the other way round: it is necessary to consider *which functions/competences need to be transferred to the supranational level* (what also means limiting the member states' sovereignty), to achieve more effective economic governance and integration. At the same time, the scope for fiscal federalism in the European Union is substantially limited by differences in national preferences and development.

A single, clear definition of fiscal union is still missing. Dabrowski (2015) claims that fiscal union is the transfer of fiscal resources and competences from the national to supranational level. Bordo et al. (2013) state that "fiscal union entails fiscal federalism among its members". They could be either sub-national (regional) political entities or nation states. According to Thirion (2017), the fiscal union comprises five different elements: (1) rules and coordination, (2) crisis management mechanisms, (3) banking union, (4) fiscal insurance, and (5) joint debt issuance. They allow for shared-sovereignty and risk-sharing. The EMU has already made significant progress in the first two areas, while further deepening is underway in the third area. Additional steps are still to be taken.

What are the elements of fiscal union that seem most essential to be created in the context of EMU reform? *Fiscal risk-sharing among euro area member states is a crucial factor.* (Berger et al., 2018)[13] Its possible main elements are: a common fiscal backstop to the banking union, a targeted "rainy day fund", an (initially small) euro area budget, and unemployment insurance. These imply a central fiscal capacity. In parallel with the introduction of fiscal risk-sharing, fiscal discipline and policy coordination should be further strengthened. In particular, it is important to reduce moral hazard (e.g., free-riding) through stronger rules and market discipline. Fiscal union implies a coordinated, system-wide fiscal policy.

[12] However, fiscal union with supranational political responsibility is also conceivable, rather than the minimalist interpretation of it.

[13] The importance of cross-border risk sharing is stressed, for example, by Beetsma et al., 2022.

The main value of the Commission's Reflection Paper is the comprehensive package, the complex approach. (Buti et al. 2018) In addition to the possible options, it is also essential to ensure the right order and timing. The Commission initially proposed two stages in deepening EMU: the first one by the end of 2019 and the second one from 2020 to 2025. In view of the elections, defining and agreeing on a strategy by the final stage of the European institutions' mandate seemed absolutely necessary. Moreover, this period would have coincided with the timing required by the markets. The ECB's adjustment policy was coming to an end. In the absence of further measures to deepen EMU, this could once again give rise to the increased vulnerability of some euro area member states[14].

4. Visions and reality

The development of European integration has always been preceded by bold visions. Although a comprehensive EMU reform has been slow to get off the ground, it is now one of the most fundamental issues to be decided in the European Union. What is the reality of creating a "complete" (2.0) EMU?

First, it needs clarification: what would be included in this reform in terms of content? A wide range of possible reform measures have been reviewed. *The critical mass of measures* could be based essentially on the initiatives launched by the European Commission in December 2017 ("*Roadmap*"): (i) proposal to establish a European Monetary Fund, within the framework of Union law; (ii) proposal to incorporate the Fiscal Pact into the EU legal framework; (iii) proposal to introduce new budgetary instruments in the euro area for stabilisation purposes, embedded in the EU legal framework; (iv) Structural Reform Support Programmes, with support from the EU budget; and (v) European Minister of Economy and Finance.

In fact, there were many other initiatives. (e.g., the Commission's banking union package launched in autumn 2016; initiatives on the capital markets union; the proposal for a common euro area budget as of November 2018, based on Franco-German reform proposals, etc.) The leading European institutions sought to reach a political decision on these issues, i.e., the reform of EMU, before the new European Parliament was formed in 2019.

However, within the timeframe indicated, most of the outstanding issues of the EMU reform were not settled.

Bénassy-Quéré et al. (2019) argue that a limited euro area budgetary instrument may indeed constitute a first step. However, it would not fulfil any macroeconomic stabilisation function in the euro area, nor would it be an appropriate tool to support national fiscal policies in the event of an economic slowdown or recession.

In autumn 2019, the new European Parliament, the Commission and senior officials took office. What are the chances of a breakthrough in EMU reform in the coming period? At the time of writing, no well-founded response can be offered. However, it is worth reviewing some points:

- *Euro area in focus.* The EMU reform concerns mainly the euro area. It is the most important for euro area member states.
- *Slow preparation.* The process so far has been particularly slow in producing working documents. This is due to the great complexity and importance of

[14] This has been put in a fundamentally new light by the coronavirus crisis.

the issues at stake, but in particular to the sometimes radically different views of the actors involved.

- *Prolonged debates, slow and poor decisions.* The overall EMU reform process so far has been extremely slow. For example, the decisions taken during the December 2018 or June 2019 Eurozone summits showed very little progress compared to the Commission's initial proposals. The more ambitious elements of the latter have not been mentioned in the communication.
- *High degree of division.* There are strongly diverging views within and between member states. Even between the French and German positions, which are the most committed to deeper integration, there are significant differences, for example on the issue of solidarity and/or responsibility, or on the common euro area budget. Non-euro area member states opposed the euro area budget, but many member states criticised the concept even within the euro area.
- *Brexit effects.* Brexit is one of the most dramatic events in the history of European integration. At the same time, it can be a textbook example of a "post-factual society" or "post-truth politics". Moreover, it was an "endless horror" for the Commission apparatus: Since the summer of 2016, a significant part of its professional and negotiating capacity has been tied up in managing Brexit for years. After Brexit, the euro area will account for more than 85% of EU GDP. A new geometry could emerge: non-euro area Member States could be pushed to the periphery. Euro area matters can clearly be the defining element of EU affairs.
- *New priorities?* There is also increased attention and political pressure in the EU to strengthen new economic dimensions in the areas of climate change, external security, competition, trade and industrial policy, and, in particular from the end of 2019 onwards, disease management. The four main priorities agreed at the June 2019 summit did not explicitly include the EMU reform.
- *Time factor.* The original timing requiring a comprehensive decision by mid-2019 has failed, although it could hardly be described as hasty, given the directions already outlined in the Four Presidents' Report in December 2012. The fundamental question is whether *there will be a breakthrough* in this area or the decisions will further be delayed.
- *"Hibernated" reform.* Despite progress in several areas, the comprehensive EMU reform agenda, which was formulated in 2012 and became more concrete in 2017, has failed to achieve breakthroughs. The European Commission's programme, which took office in 2019, does not explicitly address the need for a GMU-2. Implicitly, however, incremental reform can be pursued.

Under given conditions and with rampant inflation following external shocks, the ECB's room for manoeuvre is necessarily limited near the ceiling for the potential sovereign bond holdings that do not crowd private investors out of the market. Monetary policy is overburdened in maintaining financial stability. At the same time, a fiscal stabilisation mechanism is missing. The original problems still remain, while new issues (international trade conflicts, slowdown in the fastest growing areas in the world, followed by the coronavirus crisis and, more recently, the war crisis in the wake of Russia's invasion

of Ukraine, as well as the growing risk of stagflation) are on the horizon.

From the beginning of 2020, economic governance has focused on tackling the Covid-19 crisis. Crisis management measures have been implemented at EU and national levels. In addition to monetary policy actions, significant fiscal impulse measures have been taken. By having room for manoeuvre under the fiscal framework, temporary exemptions have been granted from the state aid rules and the general escape clause in the Stability and Growth Pact (SGP) has been activated. The EU has adopted new budgetary instruments with a strong supranational element to support recovery in the member states and to safeguard the EU's internal market objectives and the stability of the euro.

The European Commission relaunched the public debate on the review of the EU's economic governance framework in October 2021 (COM (2020) 55, COM (2021) It will revise the changing conditions of economic governance following the Covid-19 crisis. These challenges make a transparent and efficient budgetary framework particularly important, according to European Commissioner for Economy P. Gentiloni. A broad agreement among member states on possible changes to the economic governance framework is sought before 2023. The main focus of this review is thus on fiscal rules. The review of the fiscal framework for economic governance in the EU has been a priority on the French Presidency's agenda. However, efforts to reform the SGP are dividing member states. The ideas put forward so far have not included the need to deepen fiscal union.

In the broader context of economic policy, an extensive theoretical debate on the future of EMU reform has recently been relaunched. (See Krahnen et al. 2021) This debate could contribute to rethinking some contentious issues (e.g., the need for a central fiscal capacity). Clear positions can also provide the impetus for future reform. The brutal shocks of the recent period, the COVID-19 crisis and the geopolitical shock of Russia's invasion of Ukraine, particularly underlines the importance of deepening European integration. Under these circumstances, further incremental reform could move forward, and there is scope for a far-reaching reform of the EMU.

Concerning the euro area as a whole, these priorities on further deepening of EMU are essential conditions for European reform efforts aiming at boosting productivity, growth and fiscal consolidation primarily at national level. Without stronger efforts to reform EMU, both at the euro area and the EU level, Europe will not prosper.

5. "Large package" versus gradual deepening

In the aftermath of the last crisis, remarkable progress has been made towards the establishment of a "complete" EMU. After 2010, it looked as if a comprehensive, far-reaching *'large package'* of EMU reforms could be pushed through the EU decision-making system.

Although there are differences in the economic approaches to EMU reform, as seen before, the main directions of the necessary transformation can be identified. Pisani-Ferry - Zettelmeyer (2019a) rightly point out: „In fact, there is a remarkable convergence of views among economists on what a currency union really entails. While certainly not universal, this consensus is both broad and deep, and provides a basis for comprehensive reforms that would significantly improve the resilience of the euro area and would help turn it into a basis for shared prosperity."

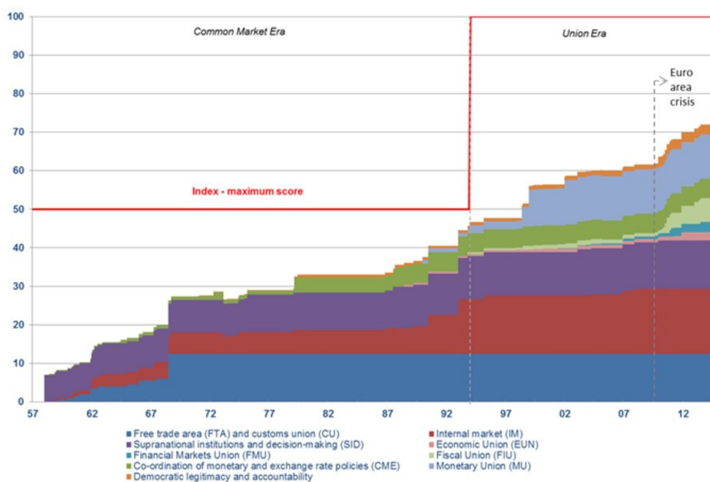
The adoption of a *"large package"* would lead to a significant breakthrough in EMU reform, the completion of EMU. However, given the heterogeneous interests of

member states, the adoption of this kind of "large package" in the EU's decision-making system can be achieved only in exceptional circumstances. The EU has supported such a "large package" on several occasions in its history, for example when adopting the internal market or EMU 1.0. The 2008 financial and economic crisis, then its second phase in the EU, the risks and dangers of the sovereign debt crisis, seemed to force a breakthrough towards EMU 2.0. There have been several such periods in the last decade.

However, the experience of European integration also shows that *gradual processes* cannot be underestimated. Using the European Index of Regional Institutional Integration, Dorrucci et al. (2015) took stock of the process of deepening integration from 1958 until early 2015. Their analysis clearly shows that the recent crisis has acted as a catalyst for the rapid acceleration we have witnessed in the pace of European governance reform. *The documents calling for a comprehensive EMU reform* represent a milestone in this process, with setting four broad, complementary goals: the need for a more effective economic union, a fiscal union, a financial union and a commensurate political union.

Figure 3 illustrates the progress in European integration and the components of advancement. A maximum score of 50 points is assigned to each of the periods, the "Common Market Era" from 1958 until 1993, and the "Union Era" thereafter. The cumulative value calculated on 1 January 2015 was above 76 points, as shown in the figure. "The gap between 100 points – i.e., the maximum total score that would be assigned in the index if all objectives of the Common Market and Union Eras were fully accomplished – and the current score, gives an indication of the distance still to be covered until a 'new perceived steady state' is achieved in the process of European economic integration under EMU."[15] The figure clearly shows the shortcomings of the integration process after 1993. At the same time, it shows convincingly that a substantial deepening has taken place since 2010, which attains 16 points in Figure 3.

Figure 3. European Index of Regional Institutional Integration



Source: Dorrucci et al., 2015, 37.

[15] In the applied version of the index, the identified goals for the "Union Era" were based on the Four Presidents' Report of December 2012.

Notes: Concerning the Common Market era, the index draws on the traditional classification of regional economic integration by recognising five 'stages' of integration (Balassa 1961), as shown in Figure 3:

- *A free trade area and customs union (stages 1 and 2);*
- *The gradual build-up of the European internal market (stage 3);*
- *Some degree of coordination of, for instance, exchange rate policies (stage 4); and*
- *A number of institutions, laws, and decision-making processes which can be defined – though to different degrees – as supranational in nature (stage 5).*

The figure shows that in the post-crisis period substantial progress has been made on each of the essential components. The most notable achievements have taken place in the areas of banking union and fiscal union, and much less progress has been achieved in economic union.

Europe has always seen a deepening process of economic integration, which has often been "completed in crises" (Monnet, 1978, 417). This is a natural state of European integration, *provided that the ultimate goals of integration have been well identified and the process has been well understood from the outset*. The former can be promoted by comprehensive documents, including drafts, which correctly indicate the need and the desired direction of reforms. In particular, if they subsequently form the basis for further series of actions (reform measures).

It took three and a half decades to complete the internal market. At that time, there was no doubt about the path to follow for economic integration. However, in the case of EMU, uncertainties and misunderstandings may arise as to the ultimate objectives. This is linked to the understanding of national sovereignty and European democracy. Since the last crisis, significant progress has already been made. Despite the fact that no single, comprehensive and far-reaching reform document has been adopted. Successful integration can be achieved through inclusive reforms that are well explained, fully comprehended and widely accepted. This is not only possible through "large packages"[16].

6. Critical mass of EMU reform. Conclusions

In the light of the foregoing, the minimum set of measures (critical mass) for the EMU 2.0 reform can be defined. (This is known as a "small package".) Achieving critical mass requires, first and foremost, radical reform decisions in three areas: (1) establishing – at least partially – a European Deposit Insurance Scheme (EDIS); (2) new fiscal rules – including risk-sharing – for stabilisation purposes in the euro area, embedded in the EU legal framework; (3) limiting excessive exposures of euro area banks to sovereign bonds, breaking the "doom loop".

These reform decisions are central to a systemic reform ("complete" EMU). There may be political resistance in some member states. It is also possible that the critical mass of measures can only be implemented gradually. But proceeding with caution in the basics could compromise the depth and effectiveness of EMU reform . The process of European integration so far shows that it is not hopeless to introduce sweeping changes.

The three main strategic reform decisions would simultaneously promote risk-sharing necessary for financial stability and resilience, as well as the incentives for fiscal discipline and sound policies. Each of these reform steps, as well as the subsequent

[16] And not just by amending the Treaties, but also by taking smaller steps. However, contractual consolidation of reforms is still necessary.

steps, are subject to the *institutional economics approach*. In other words, it is not only a question of what to do, but also of who should do it and when. What institutions and rules are needed, and when? Financial, fiscal and institutional reforms are needed. The institutional architecture should be more focused than hitherto. Possible principles for reforming euro area institutions are: sovereign member states participate in risk-sharing while maintaining market discipline and minimising moral hazard. To introduce fiscal risk-sharing, a central fiscal capacity is also needed. The EMF could deliver appropriate risk-sharing in the areas of liquidity and solvency of member states, while promoting market discipline. As a result of EMU reform, the ECB could focus on monetary policy and, where necessary, liquidity support to banks.

A gradual introduction of fiscal risk sharing would seem feasible: first in supporting the banking union, then more broadly, as "insurance" against macroeconomic risks between countries. This entails an effective management of moral hazard. Some forms of risk-sharing, such as the provision of a wider range of public goods across the area, may be possible if progress is made towards political union.

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