

Research Article

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Fiscal federalism and a separate budget for the euro area

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Abstract: The core objective of this paper is to determine the main political and economic conditions and challenges related to the possible evolution of the integration process in the euro area toward fiscal federalism and fiscal union as a way to increase the capacity of the area to cope with future economic and financial crises. The issue of a separate budget for this area is of particular interest in this article. The idea of such a budget has recently become the subject of lively public debate in the European Union and has been a factor in encouraging the European Commission to propose new solutions at the end of 2017 in the field of economic governance of the euro area, including the establishment of a European Monetary Fund. The analysis carried out in this article leads to the conclusion that under the current conditions, there is little chance of introducing such regulatory and institutional changes that would significantly increase the scale of financial transfers between the euro area member states.

Keywords: EU, euro area, EMU, fiscal federalism, fiscal policy, fiscal transfers, budget, monetary union

JEL codes: E62, F36, H72, H77

1 Introduction

In contrast to monetary policy, fiscal policy in the euro area is not determined at the central level. It is decentralized, as it is the competence of Member States authorities to shape and implement it. These authorities have the right to decide themselves both about the size and structure of revenues, as well as expenditures, of public finance. However, they must take into account the restrictions, mainly, regarding the ratio of the budget deficit to gross domestic product (GDP) and public debt to GDP. Practice has shown that these restrictions are not sufficient to effectively limit the process of overindebtedness of some Member States. This was particularly evident during the financial crisis of 2007–2009 and in the years that followed. Experience related to this crisis has highlighted the weakness of the then-existing institutional and legal solutions in the euro area. It turned out that some countries without external financial assistance would not be able to cope with the problems associated with a significant increase in public debt.

The crisis also revealed the problems arising from macroeconomic imbalances within the Eurozone, reflecting the structural weaknesses of economies and a lower competitiveness of some countries in relation to other Member States. In a situation when monetary policy is set uniformly for the entire euro area by the European Central Bank (ECB) and when its Member States, due to the resignation from national currencies, no longer have the opportunity to change the exchange rate according to their preferences, fiscal policy has become a key tool for stabilizing the economy and indispensable, especially for cushioning against various shocks, both internal and external. Practice, however, has shown that too high public debt not only severely limits the possibilities of active use of fiscal policy to combat such shocks but may also threaten the disintegration of the euro area and strongly undermine confidence in its currency. In this situation, there are more and more voices that a solution to this problem may be a closer integration within the euro area,

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going in the direction of so-called “fiscal federalism”. This step would allow the euro area to strengthen its resilience to future shocks.

2 Fiscal federalism as a direction of evolution of the European integration process

Fiscal federalism is usually defined as a system of financial relations between the central level and other levels of government in the state, which means that the central authorities have a sufficiently high budget to perform functions that are important for the entire state organism, and regional authorities and local governments manage budgets that perform functions that are important to individual regions [Brooks, 2014; Grennes and Strazds, 2016; Schelkle, 2016; Snell and Jaakkola, 2016]. Fiscal federalism is therefore an element of a specific division of power between different decision-making levels in a state with a federal structure, i.e., a structure characterized by a large degree of decentralization of power and, at the same time, with a strong position of the central authorities in areas recognized as common to all regions, e.g., foreign and defense policy, public security, and income redistribution policy. Fiscal federalism functions through the application of various instruments by the federal government, mainly federal taxes, subsidies, and financial and material transfers to social groups and regions. Hallett [2017] points out that fiscal federalism introduces risk sharing by taking regional surpluses from those in good times (relative to trend) to those in bad times.

The concept of fiscal federalism was introduced to economic literature by Richard Musgrave [1959]. Then, federalism had become the subject of research by many different authors, such as Wallace E. Oates [1972] or James Buchanan [1995]. Fiscal federalism is often perceived as a way of dividing the risk between the constituent parts of the federal organism. Thus, while resource allocation functions are assigned to lower-level authorities, because they can be filled out most efficiently, the central government primarily has to provide an insurance function as a result of the various redistribution and stabilization programs implemented at the federal level [Brooks, 2014].

The idea of fiscal federalism was the axis of political debates that preceded the beginning of the process of economic integration in Western Europe in the late 1940s and early 1950s. This idea has also been one of the key issues undertaken each time in the discussion on the next stages of European integration. The roots of the concept of establishing a common market with a supranational currency can be found, among others, in *The Manifesto of Ventotene* of 1941, whose authors were Altiero Spinelli, Ernesto Rossi, and Eugenio Colorni, counted among the founding fathers of the European Communities [Vayssière, 2005]. In the postwar period, the development of the federalist idea in Western Europe was based on the conviction that only uniting states into one strong federal political and economic organism could be a safeguard against the repetition of the tragedy that Europe had experienced as a result of two world wars. However, this organism was supposed to be characterized by a high degree of decentralization, reflecting the diversity of its components, under the slogan “Unity in Diversity”. The federalist idea had a significant impact on the initiation of the European integration process in the 1950s, although this process has never reached the level of advancement advocated by the supporters of this idea.

Two important documents published in the 1970s contained proposals on concrete steps toward fiscal federalism as an indispensable prerequisite for the future common European currency. The first of these documents was the so-called *Werner Report*, published in 1970 and containing relatively radical proposals for the construction of economic and monetary union in the Community within 10 years. It was assumed that the establishment of a common currency and the centralization of monetary policy at the level of the Community would be accompanied by an even-closer coordination of the Member States’ fiscal policies. Although some increase in the common budget was envisaged, it would be still relatively small compared to the national budgets [*Werner Report*, 1970]. In turn, in the second document, the *McDougall Report*, published in 1977 and prepared by a group of independent experts appointed by the then-Commission of the European Communities, it was proposed that the common budget should increase during the prefederal

period from the then level of 0.7% of GDP to 2.5% of GDP and in the final, federal, phase up to 5%–7% of the total GDP of countries forming the monetary union [*McDougall Report*, 1977]. It is necessary to stress that even in this case, the common budget would be rather small in comparison with the level of the federal budget amounting to 20%–25% of GDP in such federations as the United States or Germany. The practice of the following decades has shown that proposals for setting, at the Community/Union level, a budget of even a few percent of the GDP have proved impossible to be implemented, mainly for political reasons.

Difficulties encountered in the attempts to create a common currency in the 1970s and the cooperation initiated between the states of the Community in the field of stabilizing foreign exchange rates stimulated the search for more realistic integration solutions when another attempt was undertaken in the late 1980s to establish economic and monetary union. Presented in 1989 by a group of experts led by Jacques Delors, then Chairman of the European Commission (EC), another document (the so-called *Delors Report*) included proposals for concrete actions to establish such a union [*Delors Report*, 1989]. It became the basis for negotiating the provisions of the *Treaty on European Union* in its part concerning the Economic and Monetary Union (EMU) and, as a result, strongly influenced the shape of the existing Eurozone. The main message arising from the *Delors Report* was the conviction that a common currency is possible without deepened budgetary integration or fiscal federalism. The creators of the current euro area have reached a certain consensus assuming that private financial markets will be able to fill the lack of a common budget and federal institutions. Such a pragmatic approach allowed to create the common currency, issued by a supranational central bank, despite the failure to establish a political union, which was necessary to create a fiscal union with a large common budget. Therefore, a solution was adopted in which, within the monetary union, a single monetary policy, defined at the central level by the supranational central bank, is accompanied by decentralized fiscal policy, i.e., the policy shaped and implemented independently by the Member States.

This consensus functioned without any main problems during the first few years of the existence of the euro. Its weaknesses became clearly visible in the global crisis that began in the United States in 2007 and then spread to Europe and the rest of the world. From a financial crisis affecting mainly banks, it has become a crisis of public indebtedness. Among the euro area countries, Greece, Ireland, Portugal, and Spain found themselves in the most difficult situation. Without external financial assistance, these countries will not be able to cope with problems related to high public debt. Important anticrisis measures taken within the European Union (EU) included the establishment, in May 2010, of the European Financial Stability Facility, which was subsequently transformed into a permanent solution in the form of the European Stability Mechanism (ESM)¹ from September 2012, under an intergovernmental treaty, constituting a source of financial support for countries affected by the crisis. The banking system of the euro area has been strengthened due to the implementation of the project in the form of a banking union, under which a joint banking supervisor was created and the rules of action for bankrupt banks were adopted. The extensive and unconventional actions taken by the ECB, including the large-scale purchase of Treasury debt securities issued by the Member States of the euro area, were also important for overcoming the crisis in the euro area.

All these measures have proven to be a fairly effective response to the crisis, but they do not constitute a systemic solution to the problem arising from the existence of a decentralized fiscal policy in the euro area and the lack of a common budget. Thus, the Eurozone is not a fiscal union. The scope of a given fiscal union depends on how much of the budgetary resources and competences in the sphere of shaping fiscal policy are transferred by the Member States to the supranational level for management by common institutions.

Only the monetary union is fully functional in the euro area in its current form. After surrendering sovereignty in the sphere of monetary policy and the right to issue their own currency, Member States no

¹ The European Stability Mechanism (ESM) is a crisis resolution mechanism established by the euro area countries. The ESM's mission is to provide financial assistance to ESM Members experiencing or threatened by severe financing problems, to safeguard the financial stability of both the euro area as a whole and its Member States. The ESM raises funds by issuing debt instruments, which are purchased by institutional investors. The proceeds enable the intergovernmental institution to provide its Members with different types of financial assistance, addressing weaknesses in their economies through reforms that are jointly agreed by that Member, the European Commission, in liaison with the European Central Bank (ECB) and, where applicable, the international Monetary Fund (IMF) – European Stability Mechanism [2018, p. 7].

longer have the opportunity to use this currency's devaluation to stimulate exports or to use their own monetary policy to lower interest rates in order to stimulate consumption and investment. They can only act in other areas of macroeconomic policy, especially in fiscal policy.

3 A separate budget for the euro area

Taking into account the experience of the euro area related to the financial crisis of 2007–2009 and the resulting public indebtedness crisis, in June 2015, the EC published *The Five Presidents' Report* containing proposals for action to complete Europe's Economic and Monetary Union [EC, 2015]. It was pointed out in the document that progress toward a fiscal union is necessary for ensuring both long-term budgetary stability and a fiscal stabilization mechanism. In the first half of 2017, the EC [2017a, 2017b, 2017c] presented several studies containing proposals on directions for further integration within the EU. These general proposals were followed by the Commission's documents published on December 6, 2017. The main documents relate to the following: (i) further steps toward completing Europe's Economic and Monetary Union [EC, 2017e], (ii) new budgetary instruments for a stable euro area within the union [EC, 2017f], (iii) a European Minister of Economy and Finance [EC, 2017g], and (iv) the establishment of the European Monetary Fund (EMF) [EC, 2017h].

The practical implementation of these proposals will not be an easy process, but finally it would be a fairly significant change compared to the role that the general budget of the EU has so far held. This budget has evolved gradually, as the process of economic and political integration into further areas has been expanding during the past decades. For a long time, the dominant item in the budget expenditure was the financing of the common agricultural policy. In the 1970s and 1980s, agricultural expenditure accounted for >80% of the total expenditure from the common budget. An important stimulus to change this state of affairs was the completion of the establishment of a single market for goods and services in the early 1990s. This was accompanied by the allocation of increasing funds from the EU budget for the purpose of supporting economic and social cohesion, as well as for goals such as research and development, transport, education, and assistance to less developed countries. Expenditure supporting the cohesion policy became especially important after the enlargement of the EU to include the countries of Central and Eastern Europe. Despite these changes, the general budget of the EU is still relatively small, since its expenditure does not exceed 1% of GDP of the Union as a whole and is <2% of the total public expenditure implemented by all Member States (EC, 2017c, p. 7).

The EU budget is therefore relatively small compared to the GDP and public expenditure of the EU as a whole. It can be concluded that in relative terms, the budgets of member countries (the entire public finance sector) are much higher than the EU budget, as the expenditure from them, for instance, in 2016, ranged from 28% of GDP in Ireland to 55% of GDP in Finland or France, while in the case of the entire euro area, this percentage was 47.6% of GDP [Eurostat, 2017]. This state of affairs results from the role that the EU budget plays at the current level of economic and political integration within the Union. This level, and hence the scope of the competences conferred on the Union, determines that the EU budget performs far less functions than the budgets of the Member States. Therefore, it has relatively much smaller resources. It is also of key importance that the proposals of the EC presented in the past to increase the ratio of the Union's budget revenues to the EU's GDP have generally met with strong opposition from the Member States being net contributors to this budget.

It is worth considering whether two separate budgets are indeed needed, namely, the general budget of the EU and the euro area budget, and whether all the functions that the euro area budget would fulfill could be implemented by the existing general budget of the Union. Wolff [2017a] draws attention to the fact that after the exit of the United Kingdom from the EU, the share of the Eurozone in creating the GDP of the Union as a whole will amount to 85% and in the whole population to 76%. At first glance, it would mean that the EU budget is essentially the Eurozone's budget, but it must not be forgotten that the EU budget in its present shape is of great importance for the Member States from Central and Eastern Europe. And moreover, with relatively modest resources, the EU general budget is not able to perform the redistribution and stabilization functions on a wider scale for the benefit of the euro area countries.

The debate on a separate budget for the euro area has gained momentum after the proposals presented by the current French President Emmanuel Macron during his campaign before the presidential elections in May 2017 and after the election. These proposals, concerning deepening integration in the EU, are still a part of the French government's program. The issue of a separate budget for the euro area and the creation of the post of Minister of the Economy and Finance of the Eurozone has so far raised the most discussion and controversy [Geeroms, 2017]. This separate budget, according to Macron, would fulfill three main specific functions, namely, investing in development, providing urgent financial support to Member States, and responding to economic crises. The use of funds from this budget would be conditional on compliance by Member States with common rules in the field of fiscal and social policies in order to avoid dumping in the euro area. The proposed Minister of Economy and Finance would be responsible for the budget of the Eurozone. The minister would be subject to control by the euro area parliament, similar to the European Parliament. These solutions would be accompanied by the establishment of a set of basic European social rights, which would be defined by minimum standards regarding the right to education, health protection, unemployment insurance, or minimum wages, taking into account the varied levels of development of the Member States [En Marche, 2017].

Justifying the need for radical changes in the Eurozone, the French President has repeatedly pointed out that the former's functioning has contributed to the deepening of differences between its Member States, and that, as a result, the previously heavily indebted countries have become even more indebted and those that were highly competitive have become even more so. Germany strongly benefited from such functioning of the euro area, and this is an unhealthy and unsustainable situation in the long run. A separate budget for the euro area would support countries with the greatest economic problems. Ensuring the development of the euro area in the future, therefore, requires the creation of a "strong solidarity mechanism" [Macron, 2017].

President Macron's proposals are seen by Rodrik [2017] as an ambitious step toward a fiscal union in the euro area. The union would ensure permanent fiscal transfers from the economically stronger countries to those having problems in functioning in the area of single monetary policy. A separate budget for the euro area, which would be funded by tax revenues from Member States, would be subject to scrutiny by a separate parliament. The fiscal union, supported by deeper political integration, according to Rodrik, has sense because it is a coherent way of redirecting the Eurozone from the current status of no man's land. The fiscal unification proposed by Macron would enable countries such as France to increase infrastructure spending and create new jobs without having to exceed budget deficit limits. Rodrik also emphasizes that such transfers from the remaining Eurozone countries, combined with the French government's program to make the labor market more flexible, would help France overcome problems in the field of economic growth and employment. Referring to the idea propagated by the President of France regarding the Finance minister of the Eurozone, Wolff [2017b] emphasizes that it is closely related to the idea of a separate budget for this zone and the need to create a proper institution entitled to manage it, as well as having significant competence to coordinate national budgetary policies [see also Geeroms, 2017].

A different approach to the concept of a separate budget for the euro area was presented by Schmidt [2017], who points out that the establishment of such a budget or unemployment insurance regime at the level of the euro area will be a source of future conflicts between member countries. National decision-makers, defending the interests of their states, will not be able to prevent the transformation of such agreements into a permanent system of asymmetrical transfers. In order to avoid possible conflict, which would undermine the integration project, all institutional reforms proposed under Franco-German cooperation should undergo a strict sustainability test. European decision-makers would have to show that there is consistency between decision-making powers and commitments resulting from decisions made. According to Schmidt, it would be naïve to think that Member States will not pass on the costs of their choices to other Member States if they would be able to do so. As long as the societies of the Member States are in favor of maintaining national sovereignty in matters of fiscal policy, a system of shared responsibility for obligations is an unrealistic solution. It is also important that the introduction of such a system would be a disincentive to governments to carry out structural reforms necessary to achieve higher economic growth. The relatively radical nature of the proposal submitted by the President of France regarding a separate

budget for the euro area has become a factor encouraging other politicians, as well as researchers, to seek alternatives to this solution.

4 The ESM and the EMF as alternatives to a separate budget for the euro area

One of the most discussed alternative solutions to a separate euro budget is the concept of strengthening the ESM and possibly transforming it into the EMF. It is worth noting that the idea of establishing the EMF was developed much earlier, among others, by Mayer and Gros [2010]. As Wolff [2017b] points out, the key difference between the budget and the fund is that a separate budget for the euro area would mean that it would have its own specific expenditure and means of revenue collection. On the other hand, the fund would have funds raised for some extraordinary purpose, but these funds would not come from taxes, rather from direct contributions from national budgets.

The ESM, in cooperation with the International Monetary Fund (IMF), has so far participated in providing financial support to those Member States of the euro area that had the biggest problems in raising funds on financial markets. In March 2017, German Finance Minister Wolfgang Schäuble [2017] proposed to increase the possibilities of the ESM by transforming it into the EMF. In his proposal, Schäuble pointed out that any new aid programs for the benefit of the Eurozone countries should be implemented without the participation of the IMF and only with the forces of the Eurozone countries. Transforming the ESM into the EMF would, in his opinion, contribute to reducing the risk of future crises in the euro area due to the fact that the latter would monitor the state of public finances of all its Member States. The idea of entrusting the EMF with such a role met with reservations primarily from the representatives of the EC, recognizing that monitoring the budgetary situation in the euro area is within its competence. However, the Commission's action in this area in relation to some Member States was sometimes perceived by Germany as being too weak. The establishment of an EMF would therefore ensure a more effective disciplinary action on the fiscal policies pursued by individual countries, which in turn would reduce the risk of crises in the euro area. The EMF would have an important role to fulfill, especially when Greece, after completing the third aid package, would need further financial support, which could be granted to the country without the IMF [Meier, 2017].

Criticism of the proposal concerning the EMF was presented, among others, by Boone [2017]. He pointed out that the role of the proposed future EMF would be limited to crisis management in the euro area. It would provide only relatively modest security in exchange for the possibility of interfering in economic policy, i.e., it would be something that the ECB ex-president Jean-Claude Trichet once described as "federalism by exception". Instead of that, as Boone suggests, the euro area should go toward fiscal federalism, which would mean that a real common budget would be created. It would be crucial for shaping macroeconomic policy in the area and the ECB would be freed from taking on the perplexing responsibility in the case of a crisis. According to Boone, the idea of the EMF, presented by Schäuble, is aimed at forcing indebted countries to carry out unilateral and often poorly shaped adjustment policy – similar to the current framework. To ensure the economic and political stability of the euro area, it needs a budget capable of supporting investments during periods of weaker economic conditions and to ensure at least limited temporary transfers through a special unemployment insurance scheme. Boone emphasizes that the history of fiscal federalism in the United States indicates that there is probably no other solution for the Eurozone than a federal budget that would have sufficient power to stabilize the macroeconomic situation. The EMF, which could arise from the transformation of the ESM, would not be able to do this. The main threat associated with the EMF is the possibility of continuing the existing dysfunctional management solution in the euro area based on unanimous decision-making. In contrast, the budget of the euro area, managed by the EC, would allow for the change of ineffective intergovernmental management in the euro area by increasing the powers of the Economic and Financial Commissioner instead of the President of the Eurogroup.

The tool in the form of ESM, which resulted from the crisis, as indicated by Barbieri and Vallé [2017], is too narrow in scope and, besides, it does not have enough democratic legitimacy. The EMS should, in their opinion, be subordinated to the EC and become the nucleus of the Eurozone budget managed by a competent Minister of Finance of this zone and subject to the control of the Eurozone Chamber in the European Parliament. According to these authors, this initial federal budget should fulfill three key functions: provide management during the crisis (as the EMS has so far provided to support the financial system), macroeconomic stability in the case of regional crisis (in the form of a common insurance system from unemployment), and financially support the Member States from the funds of a special fund pursuing the goal of convergence within the monetary union [Barbieri and Vallé, 2017].

On numerous occasions, the French President Emmanuel Macron had declared himself in favor of the idea of a multispeed Europe and upheld his demand that the countries in the “*avant-garde*” should lead the way toward deepening integration within the EU. Referring to these demands, Chancellor Angela Merkel underlined that Germany could support the idea of a separate budget for the euro area so that it would be possible to transfer funds to economically weaker Member States of the euro area in need of help in implementing difficult economic reforms. However, it would not be hundreds of billions of euro, but rather small amounts to start with, which could be used to support the reformers [Valat, 2017]. This means that Germany, similar to other member countries, is strongly against significant fiscal transfers within the euro area.

5 Fiscal transfers between the euro area countries

An important feature of the discussion on fiscal federalism taking place not only at the forum of the EU institutions is a clear emphasis on the fact that the transfer of higher powers to the Eurozone level in the sphere of fiscal policy should not lead to permanent or unidirectional transfers between Member States. This specific fiscal union should not be considered an income redistribution instrument. Such an approach by these institutions reflects concerns about the risk of a moral hazard occurring in all insurance systems and is crucial for obtaining political support for a given solution. Thirion [2017] points out that in the ongoing debate in the Eurozone on deepening integration, it is often emphasized that a fiscal risk sharing possible in any future fiscal union should be combined with mechanisms ensuring implementation of structural reforms and should protect against a fiscal policy that is too loose. In this context, Schelkle [2016] notes that the key element, still to be determined, of the possible fiscal union in the euro area should be the responsibility of its central budget for the obligations of the Member States. In particular, it would be necessary to determine the manner in which the no-bailout principle, generally binding in federations, would be combined with the principles of granting of various forms of financial support to Member States by the central level.

The phenomenon of moral hazard, i.e., the possibility of excessive indebtedness by lower-level authorities at the expense of the central budget, is a fundamental problem of fiscal federations. Grennes and Strazds [2016] emphasize that this problem is painfully obvious in the case of euro area countries wishing to reduce their risk related to, among others, Greece’s debt. In their opinion, budgetary discipline can be achieved either through the application of hierarchical rules or through the impact of financial markets. As a result of hierarchical rules, by limiting the expenditures or the level of indebtedness of lower-level authorities, higher-level authorities may limit their liabilities in this respect. Alternatively, they may refrain from imposing restrictive rules on lower-level authorities and, at the same time, announce that they will not pay back lower-level government obligations. The functioning of this solution requires that financial markets have the appropriate capacity to assess the creditworthiness of the borrowing countries and that it is credible to announce that the higher level is not responsible for the obligations of lower-level authorities. As Grennes and Strazds note, in the United States, for the past 200 years, Congress has never agreed to take over the obligations of individual states, even in times of crisis. In the Eurozone, so far, repeated rescue operations in the case of Greece and other Member States make for incredible reading any declarations that some countries are not responsible for the obligations of other states.

Dreyer and Schmid [2015] stress that fiscal transfers are a necessary condition for the proper functioning of the monetary union because they increase the possibilities of participating regions to react both in the case of symmetric shocks, i.e., affecting all these regions, and asymmetric shocks affecting only some. In the United States, net fiscal transfers (which are the difference between what a given state receives from the federal budget and what it pays to it) from richer to poorer states have a significant stabilizing and redistributive effect. In the event of an economic shock, the state pays less into the federal budget for taxes and, at the same time, various forms of federal spending for it, including unemployment benefits, automatically increases. For example, in the period 2000–2010, as many as 27 out of 50 states were net beneficiaries of funds from the federal budget and, in 13 cases, the total value of received net transfers was higher than their GDP level in 2010. Dreyer and Schmid estimated the net transfers in the case of the euro area, which would have taken place in the period 2000–2010 if the area were characterized by fiscal federalism of a scale similar to that in the United States. It turned out that transfers between countries belonging to the Eurozone would have to be much higher than those realized so far, even a dozen times. These real net transfers, being the difference between the payments to the general budget of the EU and the payments received from it, were so far small and actually insignificant compared to transfers between states in the United States both in absolute amounts and in relative terms. Fiscal federalism would mean economically weaker countries of the euro area possibly obtaining huge transfers for themselves and, for countries that have been net contributors so far, a significant increase in the burden necessary to finance these transfers. At the same time, it is important that some countries such as Italy (a net payer) would become net beneficiaries of funds from the common budget while others, such as Ireland, would cease to be such beneficiaries and would become net payers, which can be explained mainly by their relatively high GDP per capita [Dreyer and Schmid, 2015].

This estimated distribution of future benefits and costs largely explains the current approach of individual countries to the idea of fiscal federalism in the euro area. The Germans are skeptical about this idea, while Spain, e.g., is very enthusiastic. In this situation, the question arises regarding the reasons for the strong support of France for a separate budget for the euro area, given that as a result of fiscal federalism of the American scale, the country would bear a much higher burden than now. Answering this question, one can say that probably France does not expect such a negative scenario and assumes that establishing a stronger mechanism of fiscal redistribution in the Eurozone could be a way to mitigate the problems affecting some Member States. In practice, however, copying the American solution is not possible due to the different structures of the euro area, as well as the institutional framework in which it operates. In the United States, fiscal federalism is the result of a certain balance provided by state and federal elections, while in the Eurozone, there is no such solution or something similar to it. Dreyer and Schmid [2015] point out that the introduction of a large-scale system of transfers without a proper democratic system may end up destroying the euro project. Therefore, the long way is to go through to achieve, in the Eurozone, an institutional order that would provide similar fiscal federalism as in the United States.

Generally, it would be unjustified to treat the existing fiscal union in the United States as a model for the Eurozone because the creation of such a union in this country was a very long process (lasting from 1790 to 1930). In addition, unlike in the United States, most euro area countries are opposed to the idea of a union for fear of losing sovereignty. In the case of the Eurozone, in real terms, according to Borodo and James [2017], there may be a compromise between the status quo and a fiscal union similar to that in the United States, which can be defined as a partial fiscal union or partial fiscalization. It would include a banking union, a tax union, a union of capital markets, a social security union, an energy union, and a military union. All of these elements would constitute insurance mechanisms that protect against various types of risk concerning the Member States. Referring to this proposal, it can be stated that the implementation of some of its elements, such as the banking union or the capital markets union, is well advanced, while the others are only at the initial stage, and the chances are small that they will be established in the foreseeable future. This is due to the relatively diverse priorities implemented so far by individual countries, as well as the awareness that in each of these areas, apart from transferring significant national competences to the Eurozone level, it would also be necessary to transfer significant budgetary resources.

Supporters of the fiscal union propose various solutions in the context of sources of revenues that would go to the euro area's common budget. For example, Ruiz Devesa [2016] proposes that receipts from the Financial Transaction Tax (FTT) and carbon dioxide tax (CO₂ tax) be transferred to this budget. In addition, this budget could receive a portion of tax revenues using a uniform EU-wide solution in the form of the so-called "consolidated corporate tax base" if the solution was implemented throughout the Union. The source of revenue could also be a part of the receipts from VAT (apart from the one that is already in the EU general budget) and the tax on air travel outside the EU, as well as part of the profit earned by the ECB. Here, it is worth noting that all these sources were discussed in the period when the current financial perspective for 2014–2020 was created as a possible new revenue to the EU general budget. These proposals did not receive sufficient support from the Member States and, as a result, the range of sources of income for this budget remained unchanged. The chances that the budget of the euro area would be fed from the above-mentioned sources are still rather small. For example, regarding the tax on financial transactions, interest in its application within the framework of the so-called "enhanced cooperation"² has so far only been expressed by some EU countries, including only a part of the countries belonging to the euro area. On the other hand, regarding the other taxes indicated above, the basic obstacle to assigning the euro budget to the Eurozone – even a part of the proceeds from it – boils down to the Member States' refusal to limit the national budgets that would result from such a change. In addition, obtaining the consent of the other EU members not belonging to the euro area to such an amendment to the *Treaty on the Functioning of the European Union*, necessary for establishing a separate budget for the euro area, is unlikely.

Assuming that without a fiscal union the monetary union is incomplete, Demertzis and Wolff [2016] postulate three steps to achieve more centralized budget functions in the euro area. The adoption of each of these three steps should be preceded by the fulfillment of certain preconditions. Progress in the field of fiscal integration must necessarily be a matter of trust between Member States, which is still, however, at a low level. The first step would be to complete the banking union and establish a more reliable rule that the euro area and its Member States are not responsible for the obligations of other Member States (no-bailout clause). The second step would be to create funds to finance public goods and investments in the euro area, in particular, the framework for financial support for Member States in combating major economic shocks. It would be necessary to review the EU's general budget and provide it with additional revenues. In order to better deal with country-specific shocks, an important condition would be to achieve the appropriate structural convergence of their economies. The third step would be to shift a significant amount of public expenditure to the central level. This would allow full stabilization of the budget stabilization function at the level of the euro area. For such a step to be possible, the real economic divergencies between the countries of the euro area should be reduced. It would also be necessary to establish an appropriate political union with democratic legitimacy. This means that the level of political integration would significantly differ from what it is today. Given the scope of actions required to implement these steps, especially the second and third, it should be emphasized that the large scale of transfer to the central level of both budgetary resources and national powers calls into question the possibility of making these changes in the foreseeable future.

This is all the more difficult because, as Eijffinger [2017] notes, the fiscal union is not just a mechanism for sharing the present and new debts together. It must also set out the conditions for taking decisions at the national level in the field of fiscal policy, including the relevant budgetary rules. Just as the reforms undertaken by Alexander Hamilton in the United States in the past led to a shift of power from the states to the level of the federal government, the Eurozone countries would have to give up part of their national

² Enhanced cooperation is a procedure in which at least nine EU countries can establish advanced cooperation among themselves within the framework of the Union's nonexclusive competences. Such cooperation is open at any time to all Member States and aims to support the Union's objectives, protect its interests, and strengthen the integration process. Enhanced cooperation can be used to overcome paralysis when the proposal is blocked by a single country or a small group of countries that do not want to participate in the project. However, it does not allow the extension of powers beyond those allowed under the EU Treaties. Consent to enhanced cooperation shall be granted by the Council on a proposal from the Commission and after obtaining the consent of the European Parliament. Enhanced cooperation has been used, inter alia, in the field of divorce law and patents. The possibility of applying enhanced cooperation was first introduced in 1999 by the *Treaty of Amsterdam*. In the *Treaty of Lisbon* of 2009, the procedure was formalized and the possibilities of its application were extended to the field of defense.

sovereignty. The fiscal union, according to Eijffinger, is the only real solution to the structural problems of the euro area. Keeping what is now, including the *Stability and Growth Pact*, will mean that the fate of the euro will go from crisis to crisis. On the other hand, Henning and Kessler [2012] point out that the absence of a full political union in Europe is neither reason to despair nor an excuse for low expectations or half measures. Hamilton and the other founding fathers of the United States implemented their project under financial conditions considerably less favorable than what European policymakers face today.

6 Difficult path of reforms in the Eurozone

The long-standing divisions between the Eurozone Member States in relation to the future of the EMU and the lack of agreement between them, on how to make it more resilient to future economic shocks, was an important factor slowing down the changes in its architecture. Hacker and Koch [2017] reveal the lines of profound conflict affecting efforts to reform the Eurozone. They identify that fundamental differences between Member States over the ultimate objective of the monetary union form the central divide in the debate on necessary reform shape. Authors point out that a relatively coherent group around Finland and Germany would like to repair the existing status quo of the EMU in the context of the lessons learned in the euro crisis, but, in principle, preserving the perspective of a stability union, while a rather less clearly defined group led by Italy and France sees the lessons of the crisis as an essential shift toward a fiscal union.

It is known that creating a fiscal union would require enormous political capital and determination, which will be difficult to achieve [Sandbu, 2017]. Even if it was possible to implement it, it would not be able to prevent the outflow of capital from individual countries, as long as within this union, there is no ban on the government's indebtedness for their own account. As long as governments can do this, investors can decide to escape from bonds issued by governments, whose credibility would be jeopardized. Sandbu emphasizes that the only real reason for establishing a common budget and taking out loans would be to finance projects of mutual interest to all Member States. However, it would be difficult to answer the question why this would specifically apply to the euro area. If the aim was to implement such projects, it would be better to increase the volume and effectiveness of financing from the EU general budget. When assessing this proposal, it can be said that its implementation would not constitute a significant change compared to the current situation.

On the other hand, a more radical reform of the functioning of the euro area would require a change in the *Treaty on the Functioning of the European Union*. Without this, the deeper integration in this area will be less real. After the crisis of 2009, the majority of extraordinary intervention measures were based on agreements between governments because the Member States did not have enough determination to take up painstaking work to change the treaty. Negative experience related to the crisis showed the need to supplement the rules-based fiscal framework at the EU level by binding regulations at the national level to support sound fiscal policies in all Member States and create a sustainable mechanism against the emergence of excessive deficits. It turned out, however, that the European Council, when meeting in December 2011, failed to reach agreement on the application of the Community method for this purpose. In this situation, Member States that wished to adopt such domestic rules started intergovernmental cooperation, which led to the conclusion in 2012 of the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* (TSCG).³ The key part of the TSCG is its Title III, which defines the so-called "Fiscal Compact". The "Fiscal Compact" is binding on the Eurozone Member States⁴. It sets an obligation to incorporate in permanent national provisions, preferably constitutional, a balanced-budget rule in structural terms, equipped with a correction mechanism automatically triggered in case of significant deviation. Article 16 of the TSCG stipulates that within 5 years of its entry into force (i.e., by January 1, 2018), necessary steps are to be taken with the aim of integrating its core provisions into the EU legal framework.

³ The TSCG was signed on March 2, 2012 by all EU Member States (except the Czech Republic and the United Kingdom), and it entered into force on January 1, 2013. Croatia, which acceded to the EU in July 2013, also signed the TSCG.

⁴ And on a voluntary basis on Bulgaria, Denmark, and Romania.

It means that the Fiscal Compact, being an effect of intergovernmental cooperation, was seen only as a temporary device. The intergovernmental approach used to adopt the TSCG was a way to take the necessary measures without delay when, at the height of the economic and financial crisis, progress in applying the Community method was blocked in the European Council.

When it comes to the way of incorporating the Fiscal Compact into EU law, Luckner [2018] points out that there are two main viable options: it could be incorporated either into secondary law or into EU primary law through a treaty amendment. In practice, the first option was chosen, as, in December 2017, the EC [2017i] published, as a part of its December 6, 2017, package of proposals, a proposal for a directive that would implement the Fiscal Compact into EU law. The proposed directive stipulates that each EU Member State should set up a framework of binding and permanent numerical fiscal rules that are specific to it. This framework should include in particular a medium-term objective in terms of structural balance, in order to ensure that the ratio of government debt to GDP at market prices does not exceed the reference value⁵ (i.e., 60%) or approaches it at a satisfactory pace [EC, 2017i]. According to Horvath [2018], the proposed directive would explicitly hand a lot of control over budgetary affairs to Member States, as long as their conduct is consistent with a commonly defined long-term target for public debt. The result could be a much simpler system, with a lot less intrusion “from Brussels” in the absence of gross failures. Despite this positive potential effect, the idea of incorporating the Fiscal Compact into EU law arouses much controversy. This is mainly due to the concerns of some countries about the negative impact of reducing debt on the economic situation.

Brugnolini and Corrado [2018] estimated the macroeconomic effects of a debt consolidation policy in the euro area taking into account one of the main rules enshrined in the Fiscal Compact, i.e., the rule requiring the signatory states to target a debt-to-GDP ratio <60%. The authors studied different debt consolidation scenarios, assuming different timings for absorption of the excess debt, and showed that compliance with the debt consolidation rule can exacerbate the effects of the shocks in the economy and that the effects on output, employment, real wages, inflation, and interest rates may be sizable.

Opponents of the Fiscal Compact point out that, enshrining it in the EU’s legal framework will restrict Member States’ ability to respond to the economic cycle through fiscal policy and commit EU countries to permanent austerity. After a decade of stagnation, some authors see austerity as a failed ideology, with piling evidence showing that economic crises are triggered and prolonged by austerity programs [Matias et al., 2017]. Previously, in 2013, a very large group of economists from various EU countries, as well as from countries outside the EU, published in the *Financial Times* [2013] a warning that austerity policies may cause severe damage for the economic prospects of the Eurozone. In December 2017, another large group of economists also published an appeal against the inclusion of Fiscal Compact in the European treaties or the EU secondary law [Arestis et al., 2017]. Authors of the appeal emphasize that it would be counterproductive and undesirable to do this, because it would reinforce the usual deflationary environment. In general, it can be said that the issue of the Fiscal Compact reflects the above-mentioned significant conflict of interest between the countries of the euro area, a conflict affecting the direction and speed of reforms.

In the speech on the State of the Union, delivered on September 13, 2017, to the European Parliament, Jean-Claude Juncker, Chairman of the EC (2017d), opposed the creation of parallel structures for the Eurozone, in addition to those already existing in the EU, including the idea of creating a separate parliament for the euro area. He stressed that the parliament for this zone is the European Parliament. The directions of changes presented in the address indicate that the EC is in favor of not separating the euro area from the rest of the EU countries by establishing a separate budget and a separate parliament for it. The EC’s proposals published on December 6, 2017, mentioned previously, show that significant changes are to be made in the euro area governance system, although they will not be as radical as those proposed by fiscal federalism supporters. The Commission has advocated that the EMF, established under intergovernmental treaty, be included in the EU Treaty and be supervised by the new Minister of Finance and Economy of the euro area. This minister would be not only a Commissioner but also a member of the Eurogroup. One can

⁵ Set out in Article 1 of Protocol No. 12 (annexed to the *Treaty on European Union* and to the *Treaty on the Functioning of the European Union*) on the excessive deficit procedure.

generally say that after these changes, the euro area would continue to rely mainly on national budgets for macroeconomic stabilization.

This situation will not change significantly even if, according to the recent Franco-German proposal, a separate budget for the euro area would be implemented. The proposal is about establishing a Eurozone budget in 2021 within the framework of the EU to promote competitiveness, convergence, and stabilization in the euro area, as stated in the so-called “Meseberg Declaration”, agreed by the French President Emmanuel Macron and the Chancellor of Germany Angela Merkel on June 19, 2018 [Meseberg Declaration, 2018].

According to the Declaration, decisions on funding should take into account the negotiations on the next Multiannual financial framework. Resources would come from national contributions, allocation of tax revenues, and European resources. The Eurozone budget would be defined on a pluriannual basis and would support competitiveness and convergence through investment in innovation and human capital. It could finance new investments and come in substitution of national spending. Strategic decisions on the Eurozone budget would be taken by the Eurozone countries and decisions on expenditures should be executed by the EC. When analyzing this proposal, it should be noted that the size of a separate budget for the euro area, or specific sources of its financing, have not been indicated. It can be assumed that both issues can be the subject of a serious dispute between the euro area countries, as well as between them and other EU Member States. For the latter, it is important whether the funds that will be directed to the Eurozone budget will reduce resources available from the EU general budget.

7 Conclusions

The public debt crisis in the Eurozone, which is one of the consequences of the financial crisis of 2007–2009, has contributed to the introduction of various changes in the management of the euro area since 2010. The purpose of these changes was to increase the effectiveness of existing regulations aimed at disciplining the fiscal policy of countries belonging to this zone, in particular, reducing the risk of excessive budget deficits. Only recently, a debate was held on such systemic changes that would overcome or at least mitigate the key weakness of the euro area construction resulting from the decentralized nature of fiscal policy.

The problems that have hit the euro area as a result of the recent sharp public debt crisis have highlighted the need to create solutions that would enable the joint institutions to respond more effectively to the crisis than was the case in practice after 2010. This need revived the discussion in the Eurozone on fiscal federalism and the possibilities of the evolution of the integration process toward a fiscal union. This discussion has been reflected in the proposal recently put forward by the EC, especially in 2017.

In the search for alternatives to the idea of a separate budget, the attention of politicians and representatives of EU institutions has been focused in the recent period, among others, on proposals to strengthen the role of the ESM and, in the longer term, transform it into an EMF, which would be able to not only provide Member States with financial support in crisis situations but also oversee their policies. However, putting these even less-radical measures into practice may prove difficult, given the profound divisions between Member States over the direction of needed reforms. As regards the prospects of a fiscal federation, the Eurozone Member States are not ready to make any significant political leap. For reforming the Eurozone, these countries will rather opt for a small-step method. Taking this into account, it can be considered that the hope is quite weak that a comprehensive anticrisis mechanism will be established in time before the next crisis inevitably comes.

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