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TO THE FISCAL
AND POLITICAL UNION**

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Summary

This paper focuses on the search of viable fiscal mechanisms for fixing the euro area predicament, beyond the partial governance reforms already decided by the Eurogroup governments. After a critical survey of different forms of fiscal union, from the standard instrument of supranational risk sharing in the tradition of the OCA theory and fiscal federalism, to the variants of stability and transfer union, European unemployment insurance schemes are identified as a viable target for continuing progress towards an ever closer continental integration. In view of the fact that they are based on devices working to the benefit of eurozone creditor countries too, if necessary, they could overcome the German idiosyncrasy against any form of what they call “transfer unions”. Their political acceptability could be thus enhanced also in the face of a general public opinion that considering initially the euro as a paradise discovered that the single currency can become also a threatening hell. All that, if only in the new favourable mood for European integration due to results of several European elections in 2017 possible fresh political reforms could include new powers for the European Parliament to democratically control future forms of European risk sharing.

Key words: EMU, Fiscal union, European unemployment insurance

1. *Introduction*

In a long-run perspective the current travails suffered by the EU economic and political achievements can be traced back to the ancient controversy which presided over the debate on the features of monetary integration in the run-up to the first, unsuccessful attempt to set up the European monetary union during the Seventies, well before the Maastricht treaty and the subsequent launch of the single currency. As a matter of common knowledge, the contrast between the two competing schools of the so-called approaches of “economists” and “monetarists”, led respectively by the German scholars and policymakers, who considered the currency union as the coronation of the full economic integration of member countries, and the French decision makers, who supported the opposite path of exchange-rate disciplining devices, was politically decided in favour of the latter at first by the Werner Plan and later on and definitively by the compromise reached by Mitterrand and Kohl to swap the euthanasia of the Deutsche Mark with the European acceptance of the newborn German unified state in Europe’s heartland.

In such a way, the single currency was achieved through an *ex-ante* nominal convergence of financial conditions by partner countries, without a solid real economic background, which justifies the well-known De Grauwe’s warning (2006) that the eurozone design had a number of fatal flaws, putting in jeopardy its survival. In view of this, the partial remedies decided in a hurry by member countries under the leadership of a revamped German state to freeze the eurozone with the crucial help of the ECB President Draghi, who fully deserves his fame as a European Hamilton, together with attempts by EU authorities to go along a difficult journey leading to forms of fiscal union, may be interpreted as a vindication of the “economists” approach.

This note aims at identifying types of fiscal union which are technically effective and politically feasible in order to fix the eurozone predicament and pave the way towards an ever closer integration in the European public space. The remainder of the paper is organised as follows. Section 2 briefly focuses on a number of key roots of the eurozone crisis, with a critical evaluation of the governance reforms decided by Eurogroup governments in the aftermath of the crisis outburst in order to clarify their future impact on the EMU's fragile setup. At this point, in Section 3 it is possible to elaborate on different forms of fiscal union and in Section 4 to deepen the inquiry into European unemployment insurance schemes as a viable target for future reforms and their link with developments in the field of political union institutions. The last Section 5 concludes the note with a few final considerations.

2. EMU's Fragile Setup

Amongst the manifold roots of the eurozone predicament suffice it here to recall two major faults related, in that order, to the single currency building very configuration, on the one hand, and the policies adopted in order to fix it in the aftermath of the sovereign debt crisis outburst, on the other. As to the first point, following the two main theoretical references produced in literature on monetary integration an *ex-ante* judgment clarified that the Maastricht treaty could at best deliver only an incomplete currency union. Indeed, according to the chartalist view of money it was a commonplace that a viable currency not backed by a sovereign state could not exist¹. However, according to a less demanding political approach, the Optimum Currency Area (OCA) theory, separate countries could merge into a currency union,

¹ The same holds for the modern theory of money too, which can be considered as an updated version of the chartalist approach. See Mosler (2013).

provided the latter is endowed with buffers absorbing asymmetric shocks, such as labour mobility and a common budget, providing sufficient automatic stabilisation effects². In the case of EMU, taking into account the scant record of European countries in terms of international worker mobility, all this required to complement the monetary union with a large enough centralised budget or equivalently with a fiscal union, allowing inter-country stabilisation effects to properly functioning as automatic shock absorbers³.

Under these circumstances, in the absence of sizeable stabilisation effects linked to a common budget⁴, when the global financial crisis translated in Europe into a sovereign debt predicament, the periphery member countries suffered two intertwined damages. Not only they had no means of guaranteeing their external debt, which was denominated in a currency, the euro, over which they had no direct influence as De Grauwe (2015) emphasised, but beyond what can be dubbed the trap of the euro as a foreign currency asset they faced another obstacle. Owing to the strong disciplinary effects exerted

² The nutshell specification given in the text is a poor definition of the much richer content of the OCA theory, which deals with other absorbing-shock mechanisms, such as in general terms common and flexible input and product markets, also concerning credit and capital transactions. If necessary, we add that an asymmetric (negative) shock is an idiosyncratic event pertaining to one or a few countries reducing current growth (think of a recession hitting a periphery country), which cannot be countered by the common central bank, that can manage the main instrument at its disposal, i.e. the interest rate setting (a case of the so-called “one-size-fits-all policy”). The member country in recession needs a reduction in interest rates, but this could damage other member countries experiencing a boom, and the central bank is powerless.

³ Within a fiscal union a common system of taxation and spending implies a temporary income transfer to the benefit of the country or region (mainly via unemployment benefits and tax reductions), which is financed by countries or regions whose income and tax receipts are booming.

⁴ Recall that the eurozone lacks an autonomous budget and that the EU budget has a risible size of about 1 per cent of GDP, providing tiny stabilisation effects.

on them in view of such a state of affairs by international financial markets through the growing interest spreads over German bonds and the eurozone rules starting from those of the Stability and Growth Pact (SGP), they could not reflate enough their economies by budget measures in order to lessen the real burden of their external liabilities.

Here we find the second major source of the eurozone predicament: the procyclical measures⁵ by which the Eurogroup, resorting to the old approach of intergovernment bargaining among member countries, tried to fix the sovereign debt crisis. Besides the setting up of a first system of common financial backstops aimed at avoiding a sudden break-up of the eurozone, in which also the ECB took part, the task to provide an adjustment in the periphery economies was assigned to austerity programmes implying spending cuts and tax increases. Both the initial rules capping the budgetary autonomy of debtor countries as a poor substitute of a lacking European fiscal system and the belief of creditor countries in the virtues of the so-called expansionary austerity⁶ conspired to render such a choice unavoidable, with huge costs for the former in terms of unemployment and foregone income⁷, without reducing the burden of the national debt on GDP.

In short, the setup given by the Maastricht treaty to the incomplete monetary integration based on the single currency lacked a standard coordination between monetary

⁵ Generally speaking, in most cases trying to fight a downturn with a fiscal retrenchment, implying higher taxes and lower spending, or measures which have the same sign in terms of growth, translates into a worse recession.

⁶ If self-citation is allowed, on the shaky scientific basis of the theory that austerity, improving the international financial markets willingness to invest in a debtor country in the aftermath of a fiscal consolidation, delivering as a rule an economic expansion, see Praussello (2016).

⁷ With the caveat that the costs of austerity in terms of output losses might have been particularly high for programmes based on tax increases instead of spending cuts (Alesina *et al.*, 2015), and due to real fiscal multipliers - the negative relative impact of austerity measures on income- larger than initially forecast (Blanchard and Leigh, 2013).

and fiscal policies at the European level, making the austerity measures for member countries predictable in case of downturns. With the crucial warning that the worst periods of the crisis were overcome only by the credible commitment by Draghi to do “whatever it takes” to preserve the single currency and the following ECB monetary policy of quantitative easing. Without the reaction of the main federal institution of the EU possibly the fate of the euro was destined to be sealed.

So far, we have reminded only a part of the story. Indeed, the subsequent chapter of the sovereign debt predicament saw the Eurogroup and the EU institutions to devise and introduce into the technical framework of monetary integration a number of piecemeal reforms deemed to be conducive to fixing the initial fault lines of the euro area in order to really make the single currency irreversible. From the Two and Six Pack regulations and directives to the Fiscal compact the reform strategy was double-sided: to strengthen the EMU rules, transferring budgetary powers from the national to the European levels, on the one hand, and progressively creating new steps towards an ever closer community on the other, along the road heading to a banking union, to a capital union and to forms of fiscal union, included a future necessary federal political union.

However, if future steps of such a demanding economic and political project are somewhat clear enough⁸, the real deadlines are often missed. Indeed, only the banking union has been partially achieved, since its last pillar of the European deposit insurance is currently blocked⁹. In short, it

⁸ See a number of recent documents such as the Four (Van Rompuy, 2012) and Five Presidents’ Report (European Commission, 2015) along with Commission reflection papers on the future of euro (European Commission, 2017a), and the European budget (European Commission, 2017b).

⁹ According to ongoing rumours, the German opposition to the last step of the banking union before a large reduction of risks attached to the presence of public bonds in bank budgets might have been increased after the Italian rescue of the two Veneto failed lenders, which has been deemed as a breach of the bail-in rule (Kyriakopoulou, 2017).

seems that, with the partial exception of the ECB measures, that anyway are destined in the future to leave the field of unconventional policies such as that of the quantitative easing, official interventions for strengthening the incomplete currency union have possibly been too limited and too late. EMU's fabric is still fragile and a possible adverse shock in the future could put anew in jeopardy its viability.

3. *The Search for Feasible Forms of Fiscal Union*

According to a number of official statements¹⁰ and an increasing strand of literature, the safest method for making the eurozone foundations sounder and resilient consists in complementing the current monetary integration institutions with some forms of fiscal union, mimicking the structure of many federal countries all over the world. Indeed, in favour of such a conclusion stand the bulk of technical studies on this topic¹¹, whereas a few papers cast into doubt that advancements in this area are necessary, employing however counter-arguments that often are not fully convincing¹².

¹⁰ See in particular the documents quoted in footnote 8.

¹¹ Amongst the most recent surveys on these studies see Thirion (2017), Kamps *et al.* (2017), and Bénassy-Quéré and Giavazzi (2017).

¹² As a case in point we can quote Gros (2013), who maintains that a European fiscal union is not necessary, since the case of the US shows that a well functioning banking union could be a sufficient condition to insure against local financial shocks, however missing the fact that in the eurozone a lot of general features are different from those prevailing in the US, where markets are flexible and integrated since at least in the aftermath of the Great Depression in last century, namely requiring an appropriate starting period to be reformed in order to be fully compatible with OCA characters. A more extreme view is expressed by Von Hagen (2012), according to whom a European fiscal union can be a root for debt and deficits, since it cannot allegedly overcome the standard public finance common pool problem, implying competition for financial resources among different political constituencies, even though a standard remedy to externalities is in reality to shift their control from the local to the super-local level: from the national to the European institutions when it comes to the need for some form of common countercyclical policy,

That said, we have to notice that in literature there is no a single definition of fiscal union and of its possible components. Without going into much detail, we can distinguish a number of different kinds of fiscal and fiscal-related unions in the following terms.

The starting point is the union providing fiscal transfers deriving from a super-local system in order to insure a region or a country at a local level against the occurrence of asymmetric shocks. It is the type of fiscal device working in a national economy to the benefit of its different regional areas or with reference to several national economies belonging to a currency union, following the OCA theory approach. Most of the literature on the relationships between the eurozone and a possible fiscal complement of it shares this characterisation, which could be dubbed the “standard definition of a fiscal union”, or a “transfer union”, as in Germany is often considered politically correct to call it¹³. In addition, von Hagen (2014) considers three other options encompassing also fiscal-related unions: a fiscal union with strong centralised competences and resources with collective sovereign risk, that can be defined as a “centralised fiscal union”, a “debt union” with decentralised fiscal attributes and resources joined with collective sovereign risk, and a “monetary union with fiscal autonomy and individual sovereign risk”.

The centralised fiscal union may be considered as a fiscal straitjacket imposed on member countries by a federal-type centre, which is the sole public authority allowed to issue a European debt, whereas the former are not entitled to borrow in front of the benefits deriving from the sharing of the common debt among them, the lower interest rates due to the latter’s better creditworthiness and the common insurance mechanism against asymmetric shocks. It could become a eurozone choice

as shown in Wyploz (2015), elaborating on the classical fiscal federalism theory as developed in Oates (1972).

¹³ On the real meaning of the wording “transfer union” in the German political and economic context, see *infra*.

in the future, as a possible unbalanced compromise between the needs of its debtor countries and the creditors led by an austerian Germany. And indeed, the German government has long been putting forth the need to centralise the budgetary management within the eurozone, in what it calls a “stability union”, another nominal version of this type of union (Thirion, 2017).

A debt union, in turn, implies the freedom of member countries to issue their own liabilities, in the presence however of a weak central union providing a common guarantee. Lastly, a monetary union is void of a common risk insurance device and member countries are free to borrow in a regime of fiscal independence. With the consequence that the present state of affairs within the eurozone is a mix between the last two situations, taking into account the partial freedom enjoyed by member countries in the aftermath of the shift from the national to the European levels of fiscal powers, along the presence of some forms of common guarantees such as the European Stability Mechanism (ESM) and the ECB policies.

The key character of the standard fiscal union, the kind of fiscal structure generally deemed to be necessary in order to definitely fix the eurozone predicament, consists in being an international budgetary mechanism helping the monetary union to work as an asymmetric shock absorber, along the lines of the OCA model¹⁴ and the theory of fiscal federalism. More in detail, beyond the optimality conditions linked to flexible input and product markets, it offers a European public consumption-smoothing stabiliser which complements other tools for alleviating the negative impact on income during a downturn, such as national countercyclical policies, together with private international credit and capital markets, allowing to borrow abroad or to resort to extra earnings deriving from portfolio diversification or a varied

¹⁴ For an up-to-date discussion on the state of play of different channels allowing to smooth the effects of country-specific shocks following the EU broad governance reforms see Alcidi and Thirion (2016).

portfolio of international investments or insurance contracts (Bluedorn *et al.*, 2013). All that, in the framework of a stabilisation task centrally attributed to the European level over local national jurisdictions.

As to the content of the standard fiscal union, beyond the completion of the banking and capital market unions which are part of the financial union along with the economic union advocated by the Five presidents' report, a possible non-exhaustive list of its components has recently been suggested by Thirion (2017), who identifies five main building blocks of a fiscal union, classified in order of increasing fiscal integration. The first three describe the steps already at least partially achieved as a consequence of the sovereign debt crisis: i) the rule and coordination stage in terms of shared-sovereignty (from the SGP to the Fiscal compact); ii) the crisis management mechanisms (from the ESM to the Outright Monetary Transaction (OMT) facility, to which other ECB policies could be added too, with specific reference to the quantitative easing measures); and iii) the incomplete banking union, by which a further stage of the incoming capital market union (CMU)¹⁵, or the second pillar of the financial union (FU), together with the economic union could be followed. The last two stages are betting on the future since they are founded on risk-sharing schemes at the European level: iv) the fiscal insurance, and v) the joint debt issuance steps.

The common fiscal insurance within the euro area or the EU includes a number of different elements, which range from rainy-day funds to unemployment insurance instruments. The former imply the setting-up of a common credit instrument financed by countries experiencing an economic expansion and transferring resources to countries possibly hit by a severe downturn (Gros, 2014), while the latter could represent an innovative form of delivering a positive European message to the

¹⁵ On this point see Hübner (2016), Hoffmann and Sørensen (2012), along with European Commission (2017c).

continental public opinion at large, after long years of suffering and hardship. However, the said elements specifically singled out by the author could be better comprised within a large enough centralised budget, a standard component of the set of conditions focused on by the OCA theory.

The next, final stage of Thirion's list (2017) has to do with what could be dubbed the mother of all fiscal EU struggles: the joint debt issuance, the issue popularly known as the Eurobonds controversy on which here it is probably in vain to elaborate due to the long public debate it has aroused, with the irreconcilable views between eurozone creditor and debtor countries. With the caveat that perhaps, it would be more useful to level a criticism against the incompleteness of Thirion's enumeration (2017), which might be better concluded by evoking the ultimate step of the political union, as we shall see later.

At this point in our research, before trying to identify the more suitable forms of fiscal union among those so far described, taking into account the whole configuration of conditions characterising the current state of affairs of integration, we have to take stock of a number of stumbling blocks challenging the continuing drive towards an ever closer union, beyond the physiological reaction of nation states to give up the remainder of a vanishing national sovereignty. Suffice it here to emphasise one of most difficult to overcome: the stubborn refusal of German decision makers of any type of what they call "transfer unions".

At the root of the refusal lies the old alternative between the conflicting views concerning the need to improve the eurozone capacity to alleviate the consequences of country-specific shocks, even in the aftermath of recent governance reforms (Alcidi and Thirion, 2016). In front of those, such as the German decision makers, who maintain that the latter will heighten the working of private risk-sharing channels and countercyclical national policies, without requiring new tools, we find those who

suggest additional developments at the EMU level in terms of European risk-sharing mechanisms. A dividing line which is mirroring a deeper contrast between debtor countries, who often advocate increasing risk sharing among euro area partners, and creditor countries which are nominally available to concede, but only when common risks will be controlled and reduced enough¹⁶.

Put differently, the ultimate reason of the German idiosyncrasy against a transfer union is the fear¹⁷ that following a risk pooling at the European level the German tax payers will be obliged to share the debt burden of partner countries. Inter-country solidarity within the EU seems to have become a rare good, even though a basic tenet of our liberal democracies is that the power to tax belongs to the citizens through their political representation in elected parliaments, a precondition not yet fully realised in the case of EMU¹⁸.

However, it should be added that the transfers which are not acceptable in this context must be permanent, direct and horizontal among partner countries (Heinen *et al.*, 2011). Furthermore, it has to be underlined that EMU has been already functioning, at least partially, as a transfer union. In a number of key cases cash flows between partners have already taken place, e. g. in the framework of Greek bailouts, whereas potential transfers have been materialised, e.g. owing to interest changes linked to ECB measures, while others might follow, should current guarantees attached to EMU governance

¹⁶ On this point see Allard *et al.* (2013), along with Stuchlik (2017).

¹⁷ For a case in point of such an obsession see Sinn (2011), according to whom financing the eurozone peripheral countries by the Target 2 account managed by the ECB represents a bailout, with the consequence that in the future the euro area could fall apart or a transfer union could be established, “in which the current account deficits will be financed with inter-country donations”. A response to Sinn’s arguments is given in Whelan (2011).

¹⁸ Hence the manifold interventions of the Frankfurt Constitutional Court, which makes Germany’s European obligations conditional upon approval by its Parliament.

interventions be mobilised or in the event of a country failure¹⁹.

Having thus elucidated a number of relevant points, we can conclude that perhaps some forms of fiscal union elements are at hand, which could overcome Germany's opposition to advancements beyond the already accepted instruments for fixing the eurozone shaky structure. Would-be candidates are surely not a large centralised budget or worse a joint Eurobond issuance, but other piecemeal instruments could do the job. Between the remaining choices in Thirion's list (2017) I would exclude the rainy-day funds, which are too technical to be sold to policymakers and public opinion in general, and bet on unemployment insurance, my preferred option.

4. A European Unemployment Insurance as a Viable Target

The suggestion to resort to a European Unemployment Benefit Scheme (EUBS) in order to provide European institutions with a macroeconomic stabilisation capacity dates back to the Seventies of last century and was put forward, namely, in the Marjolin Report (1975), with missions in areas of stabilisation and income redistribution among regions. However, the bulk of literature on this issues was developed in recent times in the run-up to and above all in the wake of the Great Recession triggered by the global financial crisis and the eurozone predicament, as it was to be expected. Recent surveys of significant papers on EUBS with reference not only to European but to external experiences too, starting with that of the US's system, are to be found in Dullen (2017) and in general in the studies made available to EU institutions in the last couple of years by the Centre for European

¹⁹ Only in 2009, for instance, Germany transferred to Greece a cash flow of about 866 million, whereas potential transfers due to EMU rescue packages and ECB supporting measures for partners in trouble amounted, in that order, to 580 and 408 bn euros (Heinen *et al.*, 2011).

Policy Studies (CEPS): Beblavý *et al.* (2015), Laenerts *et al.* (2017), alongside Beblavý and Laenerts (2017).

In this context, particularly influential have been lessons deriving from the US model, where unemployment insurance is organised at two levels of Federation and local states, complementing each other and solving co-ordination issues among the latter, thus optimising social protection of the whole structure (Lenaerts *et al.*, 2017). At the same time public spending in unemployment benefits increased US GDP by multipliers in the 0.7-1.9 range (Beblavý *et al.*, 2015), whereas in the aftermath of an unemployment shock around 34 per cent of its impact was absorbed (Dolls *et al.*, 2009).

In the EMU case a similar system, where benefits are directly paid out to individual unemployed will imply an extra stabilisation capacity added to the national ones, which are constrained by eurozone governance rules, high public debt and other restraints within financial markets.

However, moral hazard issues, which begets every kind of insurance, have to be dealt with, introducing backstops that have long been identified in literature, preventing the chosen schemes from giving rise to permanent transfers between winners and losers (Lenaerts *et al.*, 2017).

In fact, against this background EUBS have a major advantage of avoiding to make transfers among partner countries permanent, given that a number of studies show that the temporary tax-payments mechanisms on which these schemes are based might benefit creditor countries such as Germany too (Furceri and Zdzienicka, 2013; Bornhorst *et al.*, 2013), should the need arise.

In such a way, also the link between fiscal and political unions could clearly come to the fore, since as a matter of stringent logic a long-term risk-sharing capacity among EMU countries could only be introduced under the political supervision of the European Parliament.

5. *Final Remarks*

This note focuses on the search of viable fiscal mechanisms for fixing the euro area predicament, beyond the partial governance reforms already decided by the Eurogroup governments. After a critical survey of different forms of fiscal union, from the standard instrument of supranational risk sharing in the tradition of the OCA theory and fiscal federalism, to the variants of stability and transfer union, we have identified as a viable target for continuing progress towards an ever closer continental integration European unemployment insurance schemes.

In view of the fact that they are based on devices working to the benefit of eurozone creditor countries too, if necessary, they could overcome the German idiosyncrasy against any form of what they call “transfer unions”. Their political acceptability could be thus enhanced also in the face of a general public opinion that considering initially the euro as a paradise discovered that the single currency can become also a threatening hell²⁰.

All that, if only in the new favourable mood for European integration due to results of several European elections in 2017 possible fresh political reforms could include new powers for the European Parliament to democratically control future forms of European risk sharing.

²⁰ This notion was introduced by De Grauwe (2013).

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