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The European Sovereign Debt Crisis and Fiscal Policy in the Monetary Union: Could a Fiscal Union offset the impact of future asymmetric shocks and ensure economic stability in the Eurozone?

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I. Introduction

The latest European Sovereign Debt crisis, triggered by the 2008 American subprime mortgages financial crisis, and the recent debate about fiscal flexibility have clearly and doubtlessly brought to the light how the Eurozone's atypical structure of a monetary union with centralised monetary policy and decentralised fiscal policy isn't able to ensure economic and financial stability in the case that financial speculation or asymmetric shocks hit some of its member countries.

Indeed the view is widespread that the single currency combined with the lack of elements of proper fiscal integration, such as fiscal equalisation tools or a common insurance fund (to be used not only when a Member State fails to meet its obligations), have been responsible for forcing those nations who were put under pressure by capital markets, to adopt pro-cyclical and counterproductive fiscal and, ultimately, budget policies. In other words, EMU's current structure and policies might have contributed to push the aforementioned countries into new and severe recessions.

Currently some Member States are still struck in recessions and the Eurozone's average output growth is stagnating. Even Germany, the economic champion, is facing a slowdown, displaying the high degree of correlation that exists between EMU's economies.

Moreover, despite years of austerity measures which have been imposed on Member States, the Eurozone's average overall debt burden with respect to GDP has grown to an unprecedented high of 93.9% and the lower than potential economic performance of EMU core economies has led to current inflation rates dangerously close to zero.

This combination of inexistent growth, rising debt and low inflation is considered to pose a significant threat to the sustainability of many of the Member States' public debt.

The mentioned circumstances, the French announcement that it will not respect the budget deficit limits foreseen by EU treaties and the Italian decision to further postpone the application of the Fiscal Compact, are the clear evidence European institutions have failed to provide the Union with effective regulations.

This paper's aim is to assess to which extent further fiscal convergence and eventually a European Fiscal Union could restore the Eurozone's ability to ensure economic and financial stability by offsetting the effects of both, pro-cyclical budget measures during economic downturns and pressures by capital markets.

Insofar the degree to which fiscal policy externalities and spillovers affect other countries in EMU, by harming or favouring their economic cycles, will be evaluated to establish whether policy coordination in this field might come to the benefit of the Eurozone as a whole, thus being legitimized, or not.

In order to do so, the first section of this paper will deal with the most significant steps of European monetary and fiscal integration until the outbreak of the sovereign debt crisis in 2010, such as the Treaty of Maastricht, the Stability and Growth Pact and its revision. Such regulations will be evaluated on the basis of existent academic analysis and with the help of secondary data.

Subsequently, the new treaties and agreements that have been introduced to counter the sovereign debt crisis with the purpose of stabilizing the distressed Member States' public finances will be analysed and, based on the evidence provided by the trend of key economic indicators, their effectiveness at resolving the prevalent issues will be briefly assessed.

Finally, the set of different alternatives to existing regulations, stemming from different approaches to European Integration and including the hypothesis of the creation of a European Fiscal Union, will be considered and a first and second-best solution will be formulated.

LITERATURE REVIEW

1. From the Treaty of Maastricht to the Stability and Growth Pact

1.1 The Genesis of the Pact

Countries entering a monetary union, give up their sovereign power of using monetary policy as a macroeconomic stabilization tool. This is equal to stating that they are left with the only other macroeconomic adjustment instrument available to governments: Fiscal policy.

Nonetheless, the latter is considered to have major implications and spillover effects on other countries in a set of different ways. For that reason, fiscal discipline is seen as contributing to maintain an economic environment in which monetary policy can effectively pursue its main goal, that is - at least according to German ordoliberalism which also emerged as the dominant school of thought in the Eurozone- price stability. To this extent, in addition to the monetary side, a fiscal framework has been gradually developed for the Economic and Monetary Union since its very beginning.

The Treaty on the European Union, better known as the Treaty of Maastricht, signed in February 1992 by the members of the European Community, in addition to formally launching the single currency project, set a number of convergence criteria that applicant Member States would have had to meet in order to be allowed to enter the third stage of EMU, the euro. The health, soundness and stability of Member States' public finances were at the center of such criteria. As far as fiscal policy is concerned article 121 of the Treaty on European Union states, among the others, that the ratio of annual budget deficit to GDP must not exceed 3%, while article 126 declares that the stock of public debt to GDP has not to be greater than 60% at the end of the year preceding the entrance in the third stage of EMU. This requirements of achieving fiscal discipline to be part of the single currency were at the core of the treaty. However, even if it also attempts to make sure that Member States keep on staying within the fiscal boundaries after having entered EMU, some governments, mainly led by the German one, questioned the treaty's effectiveness in this sense by arguing that by leaving several issues open and by being subject to interpretation, it still left an

excessive degree of discretionary power to national governments which could represent a serious threat to the continuation of fiscal discipline in the monetary union.

This is why in 1995 the German Finance Minister, Theo Weigel, proposed the "Stability Pact for Europe" which was intended to complement the provisions of the treaty with a number of regulations aimed at making fiscal prudence in the Eurozone not only as strict as possible, but also the core principle of its economic culture. According to the document presented by Weigel, "Member States should commit themselves to a uniform medium-term deficit target of 1% of GDP and a system in which sanctions would be automatically applied when an excessive deficit (that is a budget deficit higher than 3% of GDP) occurred." Moreover he also put forward the idea of establishing a European Stability Council in charge of the supervision of the strict application of the Pact. The reason at the base of the *German Initiative* was considered to lie in the concern that fiscal indiscipline could lead to excessive inflation, which would have been in conflict with the mandate of the later established ECB, that is, to exclusively pursue price stability.

After tough negotiations and opposition by some Member States at the ECOFIN, the council of finance ministers of the Eurozone, the proposal found wide acceptance among EU countries and was signed and formally adopted during the Amsterdam European Council of 1997 as *The Stability and Growth Pact.*

As expressed by Juergen Stark in its working paper "Genesis of a Pact", the resulting pact went far beyond the initial German proposal by imposing even stricter fiscal boundaries and most of all by establishing a semi-automatic mechanism of imposing sanctions. Additionally the pact, instead of being just another political commitment, entered into force as a EU law and is thus triable before the European Court of Justice in case of breach.

1.2 The Structure of the Stability and Growth Pact

The SGP consists of two arms, the preventive and the corrective one, which include a clear definition of what constitutes an excessive deficit and obviously sanctions. And while the preventive arm applies to all EU countries, the corrective arm is valid for Eurozone Member States only.

Finding its legal base in articles 121 and 126 of the *Treaty on the Functioning of the European Union* (contained in the Maastricht Treaty), the pact defines the deficit as excessive when it

is above 3% of GDP and public debt must not exceed 60% of GDP or should at least be converging towards this level. Moreover the pact also points out that Eurozone Member States commit themselves to a medium-term budgetary objective of "close to balance or in surplus". Additionally the pact allows for automatic suspension of its provisions in case of exceptional circumstances such as severe recessions, during which the implementation of contractionary fiscal policies could worsen a country's drop in output. The pact specifies that conditions are considered as exceptional when GDP declines by at least 2% or real GDP declines by less than 2%, but by more than 0.75% in the year at steak. Objectives are country specific, meaning that EU Member States set independently their medium-term budgetary plans in so called *stability and convergence programmes* (SCP) which are submitted annually and then examined in the first place by the commission, issuing its assessment, and then ultimately assessed by the ECOFIN, in which Finance Ministers perform the duty of multilateral mutual fiscal surveillance. It is particularly important to mention that the country specificity of the medium-term objectives cited above is granted by the fact that the Pact relies on the cyclically adjusted budget balance, an indicator providing more appropriate targets than the actual deficit. This is the functioning of the preventive arm which relies on the concept of peer pressure as to incentivize Member States to respect budgetary discipline, and so to avoid the employment of the second arm of the SGP, that is, the corrective arm.

However, if a country is found breaching the SGP criteria, the ECOFIN initially starts issuing early warnings coupled with recommendations in which it states that a country is going to see its budget in excessive deficit. Next the *Excessive Deficit Procedure* (EDP) is implemented, consisting of a formal statement of the ECOFIN, in which the country's budget is formally defined as in excessive deficit and further suggestions by both the Commission and the Finance Ministers are issued. It is clear that at this point the breaching country loses some of its independence.

Finally, if no prompt reaction follows, and the Member State stays in excessive deficit, sanctions, in the shape of not interest paying deposits at the Commission, are imposed by the ECOFIN. If the breaching budget position is not corrected within the two following years, the deposit turns into a fine.

As it is possible to observe the Pact doesn't officially remove any fiscal policy sovereignty from Member States, nor does it impose any predetermined fiscal paths other than so called

upper boundaries of sustainability like the ones discussed above. One further important aspect to underline is that its scope is doubtlessly pre-emptive, as a long series of procedures and a time span lasting some years from the moment excessive deficit is first observed by the ECOFIN and the Commission are called for before sanctions turn into fines.

Thus, the pact seems to converge on what are considered the three main principles that should characterise fiscal policy in a currency area, that are, discipline, autonomy and coordination.

In fact, the literature about Optimal Currency Areas confirms that budget discipline should avoid unsustainable deficit and debt paths in order not to put at risk the independence of the ECB and its mandate to pursue price stability, whereas budgetary autonomy should be preserved to make it possible for governments to use fiscal policy to tackle asymmetric shocks in the absence of sovereign and independent monetary policy. As to coordination, a matter that has not been discussed so far, it is considered to be of particular importance as uncoordinated policies could lead to undesired spillovers and externalities.

The rationale behind the SGP seems quite clear and is that, in years with normal growth, budgets should be balanced or in surplus to leave enough room for the government to implement expansionary fiscal policy and for the automatic stabilizers to come into play in bad years without breaching the 3% boundary.

In the next section it will be discussed whether the SGP criteria were too strict and the exposure of the pact to political pressure will be analysed.

1.3 The French-German breach and the revision of the Pact

The experience of France and Germany during the beginning of the first decade of this century proved that protracted downturns, even if small and not definable as exceptional by the SGP, could gradually lead to seriously worsen budget deficit and most important, the respect of the Pact in such conditions would have prevented the automatic stabilizers, like the spontaneously expansionary fiscal policy due to reduced aggregate income and consequently tax collection or the automatic increase in spending related to unemployment insurance, from operating. This would obviously result in a greater contraction of the business cycle and therefore of the budget deficit, triggering a sort of vicious circle.

In fact a 1% decrease in the level of growth is, on average, considered to be associated with a 0.5% deterioration of the budget balance.
This is why in 2003, when the Eurozone’s GDP growth rate slipped from a high of 3.5% in 2000 to a low of 1%, the budgetary discipline champion and promoter Germany , facing a GDP contraction of slightly less than 0.75%, the required minimum to claim extraordinary conditions, decided to let the automatic stabilizers come into play and consequently found itself as first Member State crossing the 3% excessive deficit cap closely followed by France and Portugal, which was the first state to exceed a 4% deficit.
This breach of the SGP meant that the above cited countries were to be sanctioned, but due to the strong influence of the French and German Finance ministers on their colleagues, the ECOFIN’s final decision was to not implement the SGP, which induced the Commission to take the Council of Finance Ministers in front of the European Court of Justice for violation of the pact.
Predictably, these facts, also considering the widespread academic scepticism about the initial design of the pact, raised the debate on whether the SGP should have now been redesigned. Thus, the Commission, admitting that the provisions were too strict to be actually enforceable, prepared a reformulated version of the pact, which was finally adopted in 2005.
The new version of the pact, stated that cyclically adjusted terms, also taking into consideration one-off budgetary measures which only have a temporary effect on budget positions, should have been considered when checking compliance with the “close to balance or in surplus” provision. Moreover, some new elements of flexibility, such as the recognition that negative growth of any entity or a loss in real output due to a protracted period of very low growth, could be defined as “exceptional condition” and thus result in the suspension of SGP provisions. Additionally, the updated pact specifies that “all other relevant factors” should be taken into account, which leads to increased space of interpretation of the pact, implying less strict application. Finally the previously precise set of deadlines within which sanctions had to be imposed is not only extended, but also made more flexible, as sanctions timing is now at the discretion of the ECOFIN. Finally, the agreement was reached that in the medium-run Member States with deficits are to achieve an annual improvement in the cyclically adjusted budget deficit of 0.5% of GDP.

Critics argue that the reformulation of the pact, due to the failure of respecting its constraints, is the shining example of EU bureaucracy, which too often sets rules as strict as to prevent most Member States from complying with them.
This in turn poses a serious threat to the credibility of the SGP and the Eurozone as a whole.

1.4 Does EMU really need a Fiscal Stability Pact?

The main reason why a fiscal framework is considered to be necessary in a monetary union such as the Eurozone is that fiscal contractions as well as expansions in one country can affect the other Member States' economy in very different ways. This phenomena are called spillover effects.
The first way, and probably the one that promoters of the pact had in mind, is that one country running into budgetary disorder, because of its loose public finances, has to be bailed-out by the other Member States or, most likely, by the ECB through a monetary bail-out (purchase of the country's debt on secondary markets). Such an event would result in an increase of the money supply and hereby in higher inflation, which would ultimately further help the distressed country by eroding the real value of its outstanding debt. The point is, that such measures would collide with the mandate of the ECB, which is to ensure price stability and most important that, through inflation, the cost of the debt would be carried by all other EMU members. And debt sharing is exactly what most countries in the Eurozone want to avoid. That's why, the Maastricht Treaty clearly states with article 104 that "the Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities" and that the ECB is not enabled to purchase any debt instrument from the institutions above, implying that, at least formally, any bail-out as above is strictly forbidden, unless if previously discussed by the Commission (art 103).
However, it is a widely accepted view that this would be far less expensive than the ECB allowing the banking system to systemically collapse because of a country's default on its debt, while a formal bail-out system is considered as leading governments to engage in moral hazard, that is, to have practically no incentive to keep deficits under control.
In any case this first kind of spillover effect would already justify the existence of a fiscal stability pact.

In its paper "Does EMU really need a Stability Pact ?" Roel Beetsma states that "excessive deficits or large debt build-ups in the future cannot be ruled out if the governments' hands are not in some way bound, for example, by means of a fiscal rule". According to Beetsma, unless of extraordinary outside pressure such as treaties and agreements at the European level, budgetary reform is often politically too difficult to achieve. Therefore with ageing population, implying increasing pension-funding expenditures, and the practically inexistent threat of exclusion from EMU, it is possible to expect steep increases in public spending and thus, in budget deficits. In fact, the view that the first and most important threat to budgetary discipline resides in the costs related with the steady ageing of the European population is widespread. He argues that the first-best solution to *fiscal profligacy* is to eliminate the distorsions in the budget process, which are present at the national level, with common and legally binding fiscal rules.

Furthermore, the author introduces a second and more direct kind of international spillover effect due to excessively expansionary fiscal policy, which is the upward pressure of a rise in a country's debt stock on worldwide interest rates, but especially on those countries' interest rates with which the former shares its currency. This results from the worldwide increase in demand for capital, which in turn takes place through the emission of securities (debt instruments) denominated in the country's specific currency, which in a monetary union is the same of the other countries.

In other words, the increased demand for euros generated by one Member State's fiscal profligacy increases the debt cost of capital for all of the Eurozone's members, not even mentioning the fact that having any kind of exchange rate risk faded in EMU and the susbstitutability of public debt increased, the correlation of the Eurozone's interest rates has increased further.

According to Beetsma, this is another relevant argument calling for a common fiscal framework, imposing a fair amount of restrictions on national governments within the Eurozone.

Finally, the last kind of international spillover is based, as stated by the author, "on the standard Mundell-Fleming argument that fiscal policy is more effective under fixed than under floating exchange rates." The advantage of using fiscal stimulus in a fixed exchange rates regime derives from the fact that unilateral expansionary fiscal actions won't lead to an exchange rate appreciation with respect to other Member States, which implies a larger

effect on output and employment. This would imply upward pressure on prices and therefore result in an implementation of contractionary monetary policy by the ECB, at the expense of the other union's participants. Such actions could become particularly tempting for short-sighted governments, especially before elections.

As countries participating in EMU shouldn't bear the costs of another country's excessive fiscal profligacy, the introduction of some degree of common regulation seems legitimate.

So far we come to the conclusion that fiscal discipline and strong budget rules, ensuring the independence and the ability of the common central bank to effectively pursue the target price stability and preventing Member States' economies from suffering of externalities generated by other countries, are a needed requirement for a monetary union to work properly.

But, provided that there's more than some logic for the Stability and Growth Pact to exist, do the specific and rigid boundaries of the pact really make sense and, besides providing the needed space of manoeuvre during economic downturns, is the SGP alone enough for EMU to efficiently face asymmetric shocks?

1.5 Weaknesses and Shortcomings of the Pact

In their economic paper "The Stability and Growth Pact: Lessons from the Great Recession", published by the European Commission in December 2010, Martin Larch Paul van den Noord and Lars Jonung make a strong statement about the SGP and how well it appeared to have worked during the first years (2007-2010) of the recent financial and sovereign debt crisis. "Policymakers ended up doing the right things, not because of the framework, but in spite of it".

The authors of the article reject the view that the SGP is a dead body on which no additional tear should be shed, but contemporarily acknowledge and analyse its shortcomings. They also seem to recognise something which has not been mentioned before in this paper, that is, the uniqueness of the Eurozone in the sense that a monetary union was founded in absence of a strong political and fiscal union (The notion of Fiscal Union and its possible establishment will be discussed in the second part of this paper). As to the shortcomings of the SGP, the authors identify two first crucial elements that, according to them, must have been overlooked during the design of the Pact in the late 1990's, that are, the lack of

effective measures of enforcement of the set of commonly shared rules, which were substituted by an entrusted sense of responsibility in the name of common interests among Member States. The enforcement of the pact was basically left to the simple power of peer pressure and moral suasion. Using the authors words the SGP "does not provide for effective instruments at the EU level to cope with deviations from the path of virtue".

Additionally the fathers of the pact would have not taken into account the fact that it didn't really cover the case of extreme contingencies like a sovereign debt crisis or a severe and symmetric recession. EU fiscal architecture lack "robust escape clauses" to come into play when rules designed for normal times are objectively not adequate.

Instead, they argue, that the flexibility elements added to the Pact during its reformulation in 2005 would have only introduced marginal flexibility responsible for a weaker commitment of Member States to the rules in normal times, instead of that kind of flexibility needed to adequately counter major unforeseen events.

Although the SGP has attracted academic scepticism from before it actually entered into force, in the first years of its implementation a broad consensus had formed, recognising that it had given raise, at least compared to the 1980's in which governments were running double digit deficit ratios, to a wave of fiscal rectitude to which nearly all Member States were committed.

However, the recent financial and sovereign debt crisis made the limits of the SGP doubtlessly clear and most observers converged on the fact that it had a vast number of flaws. Specifically, the authors of the above cited paper identify and analyse seven flaws in the SGP, that are, weak statistical surveillance, the (non)preventive arm of the pact in good times, major macroeconomic imbalances that are ignored, weak EU enforcement, lacking provisions for mitigation of severe economic stress, lacking provisions for sovereign debt default and the fact that fiscal consolidation and structural reforms are seen as substitutes rather than complements.

First, they claim that for effective surveillance purposes public finance data should be reliable, complete and timely. The SGP provides a set of provisions precisely specifying which information, with which frequency of reporting, what quality of information should be forwarded, and in which way the Member States' statistical offices should interact with Eurostat. What happened is that those provisions didn't guarantee the necessary quality of the data required for fiscal surveillance across all countries in the same way. The result was

heterogeneous indeed. In most of the cases small reporting issues were observed, but the Greek case brought to the light all of the deficiencies of a system based on trust and on the willingness of national authorities. In fact, a series of revisions of Greek government data undertaken by EU authorities in 2010 revealed that domestic authorities had been masking the real magnitude of their budget imbalances to delay adequate reforms.

Finally the conclusion is reached that, even if in most of the cases the principles of trust and voluntariness proved to work acceptably well, the crisis made clear that the cases of non-compliance were severe enough to call into question the existing statistical reporting as well as data monitoring system.

Second, the authors of the paper argue that the preventive arm of the SGP isn't in fact as preventive as it should be during expansionary phases of the business cycle. Concretely, the provisions of the preventive arm proved extremely less effective than expected particularly when it came to fighting pro-cyclical fiscal policy during growth periods.

In fact, Member States showed repeatedly never to exploit economic expansions to adjust their budget balance to find out during the subsequent economic downturn that no fiscal space was left for letting the automatic stabilizers come into play, not even mentioning the possibility of implementing discretionary expansive fiscal policy. This is how, the authors claim, the strong and apparently tax rich economic recovery in the second half of the 2000s ended in what they call the "Great Recession", where governments' space for manoeuvre was very limited, because of its previous failure to adjust their budgetary position. In simple words, the preventive arm of the pact wasn't preventive enough to force Member States to exploit the opportunities offered by economic expansions. This became even worst with the reform of the Pact in 2005, which introduced a higher and vague degree of flexibility in the application of the corrective arm.

Third, the SGP, having been designed by following the belief that a combination of monetary stability and fiscal discipline was enough to ensure macroeconomic stability in the long run, seems not to take into account other major economic imbalances like the threat to public finances related to macroeconomic imbalances not inside the government sector, which have ultimately come to the light during the latest crisis.

A prominent example, testifying a major failure of the SGP, was the Spanish one in which case the deficit to GDP ratio was just at 2% of GDP in 2006. Even if not close to balance or running a budget surplus, Spain was nevertheless in compliance with the provision of the

SGP. What the Pact didn't see, as it wasn't designed and supposed to do so, was the fact that such sound budgetary position was based on the tax rich growth provided by a housing bubble and loose conduct in the mortgage policy of its private financial institutions. The result was that as soon as the sub-prime mortgage crisis spread from the US to Europe, the Spanish government had to step in massively to bail out these troubled financial institutions and prevent the domestic banking system from collapsing. This meant that in 2009, just three years later, the Spanish deficit to GDP ratio was at an astonishing high of 11.2%, making it clear that a such an impressive degradation of public finances had gone far beyond the percussion of the economic downturn. Even if those facts were not fully ignored by European authorities, the narrow focus of the SGP's provisions on fiscal matters deemed Spain as fully compliant with the existing regulation and no further form of peer pressure was exercised neither by the Commission nor by the ECOFIN. The situation later developed in a sovereign debt crisis.

Fourth, the authors strongly criticize the Council's ultimate decision making power when it comes to implementing the provisions of the pact. While the Commission issues initiatives and recommendations, Member States represented at the ECOFIN are the ones deciding whether to approve or not the implementation of the rules meant to ensure the well-functioning of the pact. And such decisions are generally taken with qualified majority. This implies that even if formally Member States can, with a majority decision, act against a non-compliant participant, a blocking coalition like the one of 2003 can be easily formed and prevent both the recommendation of the Commission and the implementation of either preventive arm peer pressure or corrective arm sanctions by the Council from being put into effort. The point is that the Commission, effectively carrying out its fiscal surveillance task and whose independence from Member States is granted by its statute, has no other enforcement power than moral suasion. Oppositely, the Council, which is obviously not a governments independent institution and has acted against the Pact multiple times, has all of the enforcement power. This imbalance of powers is deemed to have eroded the credibility as well as the effectiveness of the pact.

Fifth, Larch, van den Noord and Jonung state that one more flaw of the SGP that emerged during the latest crisis is the absence of provisions dealing with the resolution of serious economic stress as recessions and other severe unforeseeable events.

To this extent, it is important to recall how, unless a country hasn't overachieved its medium term budgetary objective (MTO) and this didn't happen quite often throughout the history of the pact, under its provisions, the output stabilisation function is left alone to the automatic stabilizers, while discretionary fiscal policy should just be intended for the purpose of fiscal consolidation. During the crisis a strict enforcement of such provisions would have prevented any Member State to effectively counter the macroeconomic shock. Therefore, through its European Economic Recovery Program (EERP), the Commission as well as the Council encouraged Member States to employ targeted and temporary expansionary fiscal measures to offset the drop in aggregate demand caused by the crisis. Contemporarily the Commission, by following the provisions of the pact, took the decision to open excessive deficit procedures against all countries with a deficit to GDP ratio exceeding the limit of 3%, that is, to open it against all Member States. The contradictory nature of this action is quite clear. The Commission encouraged Member States to loosen their budgets to react to the crisis on one side, and sanctioned them for doing so on the other. The authors of the paper argue that, if this was made to preserve the credibility of the pact and the one of the Eurozone's institutions, the attempt is likely to have miserably failed.

The greatest flaw in this case is considered to be that, even in case of recessions, the SGP allows countries to exceed the 3% deficit limit only by an amount which allows deficits to stay close to the said threshold. This was not possible for any of the Member States.

Here we come to what the authors identify as a point of crucial importance, that is, that provided there will always be a threat of major unforeseen events, for the SGP to stay credible and sustainable it should include "robust escape clauses" in order to allow governments to handle those strongly adverse shocks, as the latest financial crisis, without formally breaking the rules, as following the rules in these conditions is no longer viable.

Escaping the provisions for a determined amount of time and in a pre-designed way is finally considered to be the way to maintain a rule-based framework in the long term.

Sixth, the complete absence of provisions for the resolution of sovereign debt defaults seems, especially in the light of the Greek and Portuguese examples, probably the greatest flaw of the SGP. The most recent sovereign debt crisis in the Eurozone has disclosed the real drawbacks of the lack of a pre-designed crisis resolution mechanism. Once the debt crisis in Greece reached its peak and the fact that sticking to the no-bail-out clause, implying a Greek default on its debt, couldn't be an option as it would have resulted in the collapse of the

European banking system, Eurozone governments and the IMF stepped in with a loan package to provide financial support to Greece. This solution wasn't found overnight. Instead it required a lengthy and painful search for an agreement with the Greek authorities, which in turn committed to a serious and severe reform program to be undertaken in exchange for the rescue.

However, even if this solution provided financial markets with confidence for a period of time, shortly after the Commission and the IMF had agreed on further adjustment reforms with the Greek government, pressure in sovereign debt markets skyrocketed again, this time spreading also to Portugal and Spain.

It became clear that, at least for the time period until which tensions on sovereign debt markets would have lasted, a temporary crisis resolution mechanism had to be adopted. On 9 May 2010 an emergency meeting of the European Council took place and the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) were established. Those were practically rescue mechanisms and funds put on the table to rescue euro area countries who faced the risk to default on their debt on the one hand, and on the other to increase investors' confidence on sovereign debt markets. In fact, this was seen as a policy necessary to mitigate the risk of contagion of amplified investors' risk aversion towards debt securities of other euro area countries such as Spain or Italy, which despite being still liquid and solvent had public finances strained by the crisis.

Finally, the SGP's lack of proper crisis resolution mechanisms has also harmed the ECB's independence, which was doubtlessly forced to fill this vacuum and engage in non-orthodox monetary policies to preserve the Eurozone's financial stability, contemporarily risking to act against its statute and the Treaty of Maastricht, which define price stability as the one and only goal of the ECB. And as we have learned by now, by acting against an institutions' own statute and rules policymakers undermine the credibility of such institutions and of the Eurozone as a whole.

Finally, the authors claim that the tendency to consider fiscal consolidation under the SGP as a substitute to structural reforms rather than a complement to them, could represent another serious flaw of the SGP. As first stated by Eichengreen and Wyplosz (1998), under the provisions of the SGP the requirement to meet the annual deficit to GDP ratio ceiling, may generate the priority among governments to first pursue short-term fiscal discipline at the expense of reforms intended to bring about long-term economic growth, which mostly

coincides with long-term budgetary sustainability. This view is based on the assumption that economically beneficial reforms, such as the one of the labour market, always result in short term budgetary deterioration which implies the risk of breaching existing fiscal limits. To this extent, the example of the German government led by chancellor Gerhard Schroeder in 2003 is often brought up. In that occasion a mix of exogenous factors and the government's labour market as well as unemployment insurance reform, led Germany, as already mentioned above, to exceed the deficit to GDP ratio limit of 3%.
Should governments avoid the implementation of long-term economically beneficial structural reforms to stay within the boundaries set by the pact or should the SGP be modified to incentivize governments to undertake those reforms?
In this section the wide accepted shortcomings of the SGP and the commonly shared call for a reform of the fiscal framework of the Eurozone were brought to the light.
In the next sections the changes made to the SGP and to the fiscal framework as a whole will be examined.

2. The Reform Process of the Eurozone's Fiscal Framework

2.1 The Six-Pack

As the sovereign debt crisis was escalating and the flaws of the SGP were becoming clear and formally acknowledged by national governments as well as by the highest European institutions, a new piece of regulation with the primary purpose of modifying and reinforcing the existing SGP was about to be introduced. The EU economic governance, most commonly referred to as the "Six Pack", because of the number of regulations and directives (respectively five and one) it contains, formally entered into force on 13 December 2011, and was intended to restore the SGP's ability to induce consistent reductions in budget deficits, to make the pact more effective in countering macroeconomic imbalances and informally to reassure financial markets and gain back the credibility lost during the crisis. The six pack has been signed by all 28 EU members, even if the most stringent regulations only apply to Eurozone countries.
As to fiscal policy, three out of the five regulations contained in the six pack and the only directive are involved with the strengthening of the SGP.

Specifically, as far as the preventive arm is concerned, it provides stricter application of the provisions of the SGP, by precisely quantifying and establishing when a country has failed to meet its medium term obligations (MTO) or the adjustment course towards it.

Another important change introduced by the pack of regulations is the operationalization of the debt criterion, meaning that also a failure to meet the debt to GDP ratio limit value of 60% or the failure to display values at least converging to this level, will result in the opening of an excessive deficit procedure (EDP) against the non-compliant country.

Curiously the six pack also mentions the possibility of fining Member States which have engaged in manipulation of statistics related with their budgetary or debt position.

Moreover, the pack introduces reverse qualified majority voting (RQMV) for almost every sanction, meaning that a proposal or recommendation of the Commission will be considered officially adopted, except that a qualified majority of Member States in the Council votes against it.

Finally, the only directive of the pack "on requirements for budgetary frameworks of the Member States", clarifies that national budgetary policies must be carried out according to specific provisions and that budgetary plans should be produced in a multiannual perspective.

From a broader economic point of view, the pack also introduces a Macroeconomic Imbalance Procedure that as suggested by the two regulations related to this point, is aimed at the prevention and correction of macroeconomic imbalances through a specific surveillance procedure covering all EU Member States and through enforcement action to correct those imbalances in the euro area only.

It is clearly possible to observe how the new set of regulations is primarily focused on the achievement of fiscal discipline through the tightening of fiscal surveillance and enforcement mechanisms partially already present in the SGP.

Oppositely elements of flexibility, of a robust escape clause to exploit under unforeseeably severe circumstances or of a very much required asymmetric shock absorption mechanism are not mentioned in the pack.

2.2 The Treaty on Stability, Coordination and Governance and The Fiscal Compact

The European Fiscal Compact is formally embodied in the Treaty on Stability, Coordination and Governance (TSCG), a supranational intergovernmental agreement signed in March 2012 by all EU Member States with the exception of the United Kingdom and the Czech Republic, and entered into force on 1 January 2013 for the 16 states who achieved ratification before this date. In spite of the fact that the objective is to turn the fiscal compact into European law within five years from entry into force, the agreement is actually binding for members of the Eurozone only.

Following the rationale of the previously discussed six-pack, the compact is the latest and greatest step made to impose stricter fiscal constraints on countries participating to EMU and to further foster fiscal discipline. It builds on the reinforced SGP introduced through the six-pack and, according to the ECB Monthly Bulletin published in May 2012, is intended to address those which the central bank considers the five main shortcomings of the EU fiscal framework still present despite recent reforms.

First, as presented by the ECB, there would still be a too vast number of exceptional situations to be allowed to be claimed by countries in order not to observe the SGP's provisions in such particular conditions. This would clearly result in a weak application of regulation and of the prescribed procedures. To this extent the ECB also underlines how, since its latest reform in 2011 through the six-pack, the SGP would also take into account exceptional conditions and not launch any EDP for countries substantially exceeding the 3% deficit to GDP ratio, but with a debt ratio below the 60% of GDP reference value.

Second, the ECB's analysts claim that, the improved SGP would still be short of sufficient automaticity in case of a country's non-compliance with the rules, as the Council is still in possession of excessive amounts of discretionary power. The example is made of the Council still deciding, through qualified majority vote, about the existence of an excessive deficit.

Third, the reinforced SGP's effectiveness would still depend too much on the strict and rigorous application of the pact's provisions by the Commission. In the first place, as for the case of the excessive discretionary power hold by the Council, the Commission's dominant role in assessing the existence of an excessive deficit or whether Member States have taken sufficient action to correct the existing excessive deficit or not, could potentially hamper the improved fiscal framework's correct application. Then, the power of the Commission to give

recommendations to the ECOFIN to reduce or cancel new or existing financial sanctions, either with the motivation of the presence of exceptional economic circumstances or due to a request of the involved Member State, could still expose the well-functioning of the reinforced SGP to the risk of being affected by the degree of political power exercised on the Commission.

Fourth, the ECB states that, the fiscal framework's increased complexity, could reduce both its transparency and enforceability and, consequently make accountability more difficult.

Specifically, under the reinforced SGP, a much more complex analysis of the structural budget balance and of expenditure including discretionary revenue measures would be required to assess a Member State's convergence towards its medium term objective (MTO). This could make the verifying of all the necessary data within the prescribed time span more difficult.

Finally, the tightening of the fiscal frameworks at the national level would be too strongly dependent on the national government's intentions and political will to implement sound fiscal regulation.

The Treaty and especially its third title, that is, the fiscal compact mainly relies on two fundamental elements in order to remove the shortcomings mentioned above. Those fundamental elements are the introduction of a balanced budget rule to be implemented into national legislations, preferably into constitutions, which will be complemented by a fully automatic sanctions mechanism and a further strengthening of the excessive deficit procedure.

Precisely, as far as the first element is concerned, the Eurozone and ERM II countries commit to introduce in their national law a fiscal rule that mandatorily requires government budgets to be in balance or in surplus. This regulation is considered to be respected when the annual structural balance, that is, the annual cyclically adjusted balance net of one-off and temporary measures, is consistent with a country's MTO. As already defined in the preventive arm of the SGP, country-specific MTOs have not to exceed the boundary of a structural deficit of 0.5%. Only Member States whose debt to GDP ratio falls within the limit of 60% and whose risk of running into long-term fiscal sustainability troubles is considered low are allowed to run a structural deficit to GDP ratio of at most 1%. While, as in the reinforced SGP introduced through the six-pack, improvements towards and respect of the MTO are still assessed through the structural balance including an analysis of government

expenditure net of discretionary revenue measures, the fiscal compact requires from the contracting Member States a “rapid convergence” towards the country-specific MTO.

Moreover, the balanced budget rule to be introduced in national legislation is also required to include an automatic correction mechanism to be activated in the case that significant deviations from the MTO or from the adjustment path towards it are observed. This automatized mechanism is to be activated also if a country is faced with exceptional conditions and is discretionarily deviating from its MTO or from the path of adjustment.

To this extent, while the definition of exceptional circumstances is not modified, the fiscal compact includes detailed provisions that, under very strict circumstances, allow for deviations from a country’s MTO even larger than the ones granted up to now in case of substantial structural reforms or pension reforms which are considered to improve fiscal sustainability in the longer term.

The effective introduction into national legislation of such regulation has been overseen by the Commission which was given the power by the TSCG to make, through a report, one or more contracting parties take the non-compliant contracting Member State before the European Court of Justice, which could issue a binding ruling and eventually impose a penalty payment up to 0.1% of GDP in case of protracted non-compliance.

The second fundamental element of the fiscal compact is the further strengthening of the corrective arm of the SGP and especially of the excessive deficit procedure with respect to its already strengthened version of the six-pack. Specifically, the regulations introduced by the compact are aimed at increasing the EDP’s automaticity in case of a country’s breach of the deficit criterion. In fact, new regulation is introduced stating that Eurozone governments commit to support the Commission’s recommendations and proposals for Council’s decisions regarding important procedural steps in the context of an EDP, unless a qualified majority (not including the member state involved) withstands such a decision. The introduction of such reverse qualified majority voting mechanism for all critical procedural steps from the opening of an excessive deficit procedure to the decision, following the required assessment by the Commission, on whether a non-compliant Member State has taken sufficient effective action, substantially increments the automaticity of all corrective arm’s procedures. This obviously implies that the Council’s discretionary power is largely reduced as well as the effect of Member States’ political pressure on it.

Additionally, another point of the fiscal compact which is considered crucial, at least by and for those Eurozone countries abundantly exceeding the 60% debt criterion, is the legal obligation for them to reduce or converge towards the reduction of all government debt in excess of the said reference value. More into detail, the fiscal compact declares that Member States exceeding the debt to GDP ratio of 60% are required to cut all of the debt in excess of such reference value "at an average rate of one-twentieth per year as a benchmark". Nonetheless, the debt cut down is due to begin only after a three years transition period from the termination of a country's latest EDP. As will be deeper investigated later in the paper, this could have substantial implications for countries such as Italy which, in line with the new regulation, should cut their debt to GDP ratio by roughly 3.5% annually in the first years of implementation.

Finally, the compact includes a provision requiring those Eurozone countries in breach of the debt criterion to submit ex ante reports about future public debt issuance plans to the Commission ant the Council, so as to increase the degree of coordination of debt financing within the Eurozone as well as providing better insight on Member States' debt management strategies.

2.3 Strengths, deficiencies and implications of the Fiscal Compact

In their article " A Fiscal Compact for a stronger Economic and Monetary Union" published in the ECB Monthly Bulletin of March 2012, the authors identify a great number of improvements which, according to them, effectively address the shortcomings of the reinforced SGP both in the preventive arm and the corrective arm framework.

First, as for the preventive arm, the intergovernmental treaty moves key elements of the SGP from the EU secondary law level into the constitutions of contracting Member States. This aspect is considered to positively contribute to a firmer national implementation of fiscal discipline.

Moreover, the authors claim, that by forcing Eurozone countries to a much quicker convergence towards their country-specific MTOs, especially in the aftermath of the sovereign debt crisis triggered by the financial markets' lack of trust in some Eurozone countries' ability to conduct sustainable fiscal policies and stay solvent, the fiscal compact

helps Member States to regain the lost trust and restores the credibility of their fiscal policies.

Additionally, the compact's automatically triggered correction mechanism to be introduced into national legislations and being activated when a country is expected to be deviating from its budgetary MTO, even if legitimized by the escape clause, fully and permanently corrects the impact on public debt of deviations from MTOs as observed in the past. It practically makes the possibilities for governments to delay fiscal consolidation to later periods equal to zero, and may therefore be defined as a "debt brake" preventing the contracting parties' public debt from becoming unsustainable.

As stated by the ECB's analysts, in the framework of the corrective arm of the reinforced SGP, the extension through the fiscal compact of the reverse qualified majority voting mechanism, already introduced for Commission's recommendations and proposals to the Council by the six-pack, to all procedural steps involved in an EDP further increases the fiscal framework's corrective automaticity for Eurozone countries breaching the deficit criterion, which is considered as a step in the right direction as it most likely reduces the space for political discretion and makes the correct application of rules and sanctions more probable. This is considered to repair to significant shortcomings which were still to be observed after the implementation of the six-pack.

However, to this extent, the authors of the article also pinpoint what they argue to be one of the strongest weaknesses of the fiscal compact, that is, the absence of the introduction of a RQMV mechanism in case of a Eurozone country's breach of the debt criterion to automatically implement the thereto related procedural steps. Oppositely, in such case, the procedure is still the one outlined by article 126 of the Treaty of Maastricht and the resulting decisions have to be ratified through qualified majority voting.

One more significant enhancement brought about by the fiscal compact are the more independent and rigorous assessments of the Commission resulting from the upgrade of the Commissioner for Economic and Financial Affairs to Vice-President of the Commission and Commissioner for the Euro, providing his role with a greater degree of freedom and autonomy in its surveillance operations.

As portrayed by the paragraphs above, the ECB considers the fiscal compact as a "welcome step towards a stronger rule-based fiscal governance framework", that with its set of

measures should, if rigorously enforced, effectively put an end to unsustainable fiscal policies, thus correctly complementing the rules of the SGP.

However, according to the ECB's analysts, even though many of the remaining shortcomings are effectively addressed by the compact, its final purposefulness and credibility are still dependent on the strict surveillance of fiscal policy by the Commission and a limited use of political discretion by the council.

Moreover, by adding a further layer of rules to the already reinforced SGP the fiscal compact increases the overall complexity of the fiscal framework which could, in practice, put at risk its effective enforcement.

Finally the authors of the article, claim that more significant steps aimed at improving the EU fiscal framework, especially the Eurozone's one, will have to follow in order to remove the remaining weaknesses. In this sense, they make the proposal of providing European institutions with the necessary power to directly step in a Member State's political decision-making process to take the necessary fiscal policy decisions when, despite the enforcement of all the previously mentioned measures, a country's public finances continue to harmfully run aground. In other words, the ECB's analysts propose a sort of European compulsory administration for chronically non-compliant countries.

It is worth observing, and rather puzzling, how the article doesn't analyse at all the effect that the entry into force of the fiscal compact may have on output, output gap and inflation in the short term, especially given the macroeconomic circumstances in which it has been developed and is planned to be entering into force, which were characterised by the not full recovery of most of the Member States' economies from the very recent financial crisis and the thereto related periods of recession. Indeed, those Member States who were forced by the pressure exercised by both the EU, under strong political pressure of Northern-European countries like Germany, and financial markets to dramatically tighten their fiscal policy, such as Italy and Spain, were already struggling to take their economies back on track. Predictably, the adoption of the mix of austerity policies imposed by EU agreements and intergovernmental pacts resulted in the return of these countries back to recession for the second time since the 2008/09 period, the so called double-dip recession. According to

OECD data[1], at the end of 2012 the Italian GDP had contracted by 2,4% after only two years of moderate recovery from the great recession of 2008 and 2009, whereas Spanish output had contracted by 1.6% after only one year of approximately inexistent growth in 2011. Additionally, both countries were already suffering from substantially high levels of unemployment of about 10.7% in Italy and a dramatic 25% in Spain.

In their paper "The European Fiscal Compact: A Counterfactual Assessment" published on the Journal of Economic Integration Jérome Creel, Francesco Saraceno and Paul Hubert claim that the new regulation, introduced through the new fiscal framework, "would certainly lead to lower debt levels, hence to larger fiscal margins for manoeuvre in the future but (…), it would be very costly to implement as the requirement to enforce a substantial consolidation in the short run (…) would worsen the output gap and the inflation rate". More precisely, the work of the authors includes a major assessment of the recently introduced fiscal and economic governance rules, from the European Semester to the Fiscal Compact, and finally proposes some alternative solutions to the deficit bias issue.

As far as the fiscal compact is concerned the authors focus on what they judge as its two main pillars, the balanced structural budget rule, imposing an upper cyclically adjusted deficit boundary of 0.5% of GDP, and the new debt rule stating that countries exceeding the reference debt value of 60% should reduce the exceeding debt at an annual average of one-twentieth.

As far as the first rule is concerned, the authors argue that with respect to the SGP the new structural deficit limit of 0.5% and the consequent speed of adjustment towards it, as stated in the agreement, would obviously result in the loss of country specificity for the new limit. In fact, the fiscal compact also states that Member States not in breach of the debt criterion may run structural deficits up to 1% of GDP. This may lead to an unequal and unfair assessment of a country's budgetary position by the Commission, as countries with similar deficit levels but different overall debt to GDP ratios would be judged differently. For example, in accordance with the new balanced structural budget rule, two countries with both a 1% structural deficit to GDP ratio and no cyclical deficit, thus with their output gap equal to zero, but with a debt to GDP ratio of respectively 50% and 100% would be required

[1] Data published by the OECD in May 2014 and retrievable at: http://www.oecd.org/eco/outlook/italy-economic-forecast-summary.htm ; http://www.oecd.org/eco/outlook/spain-economic-forecast-summary.htm

to make different discretionary efforts, despite their situation in terms of current flows is perfectly identical. Indeed, while the Member State with the 50% debt to GDP ratio wouldn't be required to take any action, the country in breach of the debt criterion would be required to implement strong contractionary fiscal policy measures. The authors consider this an additional burden to be added to such country's higher interest payments implied by the higher debt to GDP ratio. Thus, countries like the one above would be penalized twice, on the one hand by the higher cost of capital set by financial markets and on the other hand by the requirements of the new fiscal framework.

As to the second rule, the new debt rule, the three economists claim that it doesn't remove the main shortcomings of the former and reinforced SGP. Similarly to the balanced structural budget rule, the debt rule requiring countries with a debt to GDP ration in excess of the reference value to cut the exceeding part of their debt at an average of one-twentieth per year is not country-specific. To this extent, the authors observe that the public debt target value is the same for all countries, despite their difference in levels of private debt and other relevant factors. Moreover, as in the SGP, a slower pace of economic growth cannot be labelled as "severe downturn" allowing for a suspension of the framework's provisions. Nonetheless, a more moderate level of growth might have a crucial impact on a government's fiscal effort required to match the debt reduction. In fact, according to the example brought about by the authors, if we assume a real annual interest rate at 2% and an initial debt to GDP ratio of 100% the public budget surplus required to match the imposed debt reduction of 5%, increases from 2% to 3% if the growth rate declines from 2% to 1%. And, just to state the obvious, dramatic cuts in government expenditure or increases in taxation nearly always result in lower GDP levels. Therefore, especially when GDP growth rates are already low, achieving deficit surpluses is particularly difficult and overall debt to GDP ratio cut downs are rarely successful. In fact, as will observe more deeply at the end of this section, most of those Member States which made huge fiscal adjustment efforts, in accordance to the agreement's new regulations, ended up with higher debt to GDP ratios, as a direct consequence of dramatically shrinking GDP levels, and slightly improved deficit figures, but only at the expense of severe and painful recessions.

Finally, the authors express strong criticism against the preamble of the whole Treaty on Stability, Coordination and Governance which states that "the 25 ratifying Member States

must comply with the obligation to transpose the balanced budget rule into their national legal systems through binding, permanent and preferably constitutional provisions."[2]

According to the authors, such obligation would have a restrictive impact on the independence of Member States and would represent a substantial step towards the bureaucratization and de-politicization of fiscal policy. In other words, fiscal policy choices, which should be performed by democratically elected political bodies and reflect the population's political preferences, are conversely made by non-elected institutions. This fact, besides amplifying the already present restrictive bias, also shifts the political priority from the macroeconomic balance to the public finance balance, once more conferring to instruments, such as fiscal policy, the role of ultimate objectives.

This is the rationale behind the treaty, directives and the many regulations which have been recently introduced in EMU and, in spite of them, fiscal profligacy has not been fully removed, the above mentioned target values or the adjustment path towards them have not been achieved by nearly all Member States and, most important, macroeconomic imbalances as well as asymmetric demand shocks generated by the austerity policies seem to have characterized the economic scenario in EMU up to the very present.

2.4 The Two-Pack

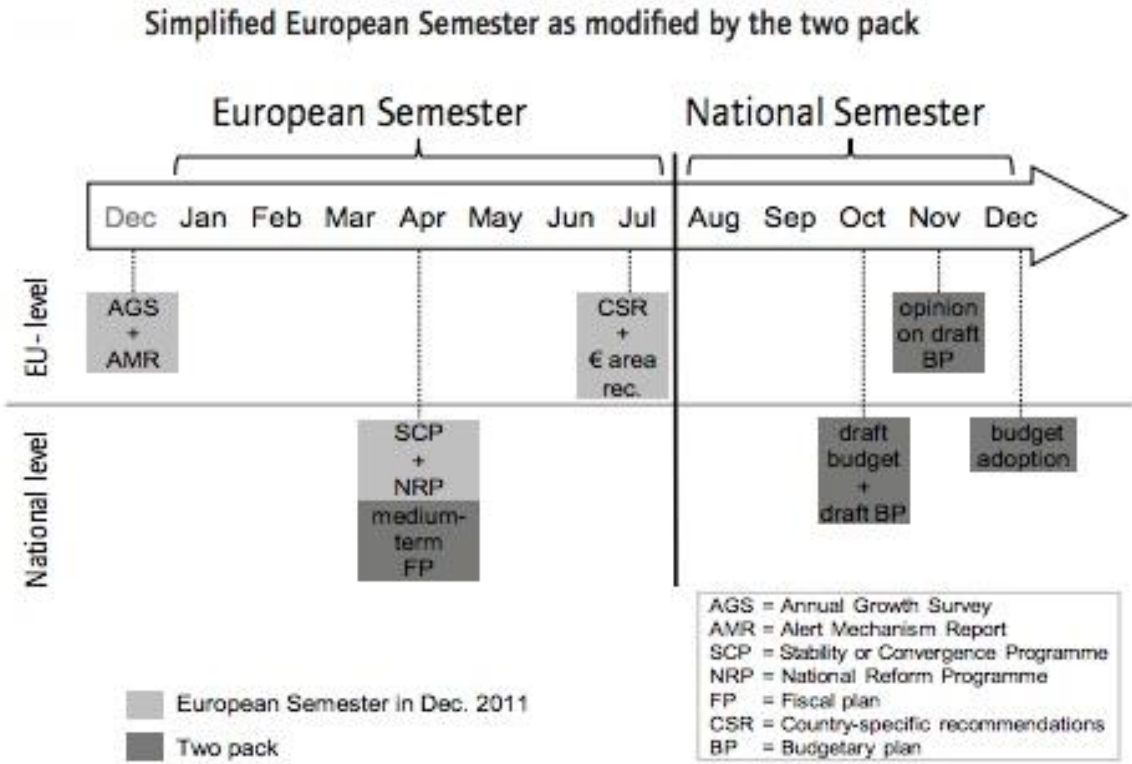
The latest, and for now the last, set of regulations regarding the Eurozone's fiscal framework was discussed and finally entered into force in May 2013, as the outcome of previous reforms wasn't deemed as sufficient to effectively enhance fiscal austerity in the euro area and, most of all, because it lacked specific regulations for those countries receiving financial assistance through the ESM and EFSF and those exiting such financial assistance programs.

In fact, the new set of regulations at stake, the so called "two-pack" consists of two new rules respectively concerning the completion of the European Semester as well as the introduction of a closer monitoring mechanism for countries facing EDPs and specific regulation for Member States receiving financial assistance.

[2] Preamble of the Treaty on Stability, Governance and Coordination cited in "The European Fiscal Compact: A Counterfactual Assessment", by Jérome Creel, Francesco Saraceno and Paul Hubert. Published in the Journal of Economic Integration, Vol. 27 No.4, December 2012.

As already pointed out above, the first rule (regulation 473/2013) introduced by the two-pack is aimed at improving the effectiveness of the European Semester by introducing some new features and deadlines in the attempt to enhance the degree of surveillance and coordination among Member States' economic policies, especially when it comes to fiscal ones. The Semester can be defined as "the first phase of the EU's annual cycle of economic policy guidance and surveillance"[3], aimed at ensuring a proper implementation of the EU's economic regulations.

More precisely, during the Semester the Commission as well as the Council "analyse the fiscal and structural reform policies of every Member State, provide recommendations, and monitor their implementation"[4], while during the second phase of the cycle, called the National Semester, governments are supposed to implement, through their national parliaments, those policies which have been reviewed at the EU level.



The two pack on economic governance: an initial analysis. Source: European Trade Union Institute

[3] Definition provided by the EU Comission and retrievable at:
http://ec.europa.eu/economy_finance/economic_governance/the_european_semester/index_en.htm

[4] As described by the European Commission at:
http://ec.europa.eu/economy_finance/economic_governance/the_european_semester/index_en.htm

The European Semester, as modified by the two-pack, requires Member States' governments to publish a medium term fiscal plan completing their stability programmes and to provide a draft of their budget laws and of the budgetary plan for the subsequent year, to the Commission and the ECOFIN, which check the consistency of the contents of such documents with the recommendations and opinions previously issued. The pack also states that, all documents' economic forecasts should be provided by independent bodies. In cases of suspected particularly serious non-compliance of a country's budgetary plan with the above cited recommendations (issued in June/July) , the Commission is given the power to demand a revised version to be submitted within three weeks or it is enabled to express a detailed opinion. Finally, only after such round trips and the approval by EU institutions, Member States are required to approve their budget laws before 31 December, which have obviously to be consistent with the approved version and the Commission's opinion.

Additionally, in its second part, the first regulation of the two-pack completes the EDP procedure, by imposing closer monitoring and tighter reporting obligations on Member States in excess deficit. To this extent, the most significant novelty appears to be the requirement for Member States in EDP, to carry out extraordinary independent audits of their public budgets and provide any kind of information demanded, if the Commission requests so.

Finally, the Commission is allowed to step in at an earlier stage than allowed up to now, if it observes the existence of a risk that a correction of the deficit will not occur within the planned time span.

The second rule (regulation 472/2013) introduced by the two-pack, the "regulation on strengthened surveillance", is mainly aimed at reinforcing the surveillance on Eurozone Member States, which are already experiencing or are threatened by serious troubles related to their financial stability. Its main goals are to avoid contagion of such financial instability across Member States, to prevent already seriously troubled governments to delay their request for financial assistance until their financial position has worsened as much as to require greater financial aid at the moment of bail-out and finally to attach economic policy obligations outside the EU fiscal regulation framework, such as mandatory structural reforms, to financial assistance programmes. This sort of emergency procedure, mainly consisting of enhanced surveillance and a mandatory macroeconomic adjustment programme aimed at "re-establishing a sound and sustainable economic and financial

situation and restoring the Member State's capacity to finance itself fully on the financial markets"[5], predictably results in a strong reduction of a Member State's sovereignty. Contemporarily, so as to avoid a double effort related to reporting requirements, all other surveillance mechanisms are transitorily frozen. Moreover, the financially assisted country will be held under "post-programme surveillance"[6] until it has repaid at least 75% of the amount received.

In addition to the two main regulations some substantial points have been added to the two-pack in order to ensure a fair amount of transparency of the mentioned procedures, to prevent that constraints embedded in the macroeconomic adjustment programmes will impede economic growth, and finally that social and labour rights are respected.

To the extent of transparency, the competent committee of the European Parliament is given the right to invite top EU bureaucrats for what is called an economic dialogue on the matters at stake. Moreover, for issues related to Member States currently under financial assistance and, thus, undertaking a macroeconomic adjustment programme, such invitation is allowed to be extended to all members of the so called "troika", that is, the EU Commission, the European Central Bank and the International Monetary Fund. Additionally, most of the documents related with the procedures foreseen by the two-pack, such as the reasons behind the Commission's request to a Member State to revise its budgetary plan, have to be made public.

As for the measures assuring that economic growth is not disregarded, nothing really worth mentioning other than the introduction of the obligation for Member States to assess in their budgetary plan the expected impact of budgetary measures on growth, and the obligation for the Commission to pay particular attention on how to eliminate the trade-off between productive public investments and the effective enforcement of the SGP, has been added to the two-pack.

Finally, the pack also states how social and labour rights are respected, in accordance with the Treaty of Maastricht and the EU Charter of Fundamental Rights, by the fact that social objectives must still be at the base of any EU policy and, in the framework of the pack that the involvement of national social parts at every step of a Member State's negotiation when bargaining about the content of the macroeconomic adjustment programme to obtain

[5]Regulation 472/2013, art.7 (1)
[6] Regulation 472/2013, art.14

financial assistance, is made mandatory. In the end, also in the event of financial assistance, the macroeconomic adjustment programme and fiscal consolidation are required to still leave sufficient resources available to the delivery of fundamental policies such as healthcare and education.

Despite the many proposals, mainly advanced by left-wing EU parliamentary groups, of compensation mechanisms and measures to somehow offset the contractionary nature of the sum of all recently introduced fiscal constraints, no significant one has been finally included in the two-pack. Besides the extreme proposal represented by different sorts of debt mutualisation (e.g. Eurobonds and European Redemption Fund), suggestions such as to establish a reasonable balance between public investment and fiscal soundness objectives (e.g. golden rule of public finance) within the boundaries of the current framework have not been taken into account yet.

2.5 Austerity and the Two-Pack: A critical Assessment

In his paper "The two pack on economic governance: an initial analysis", published by the European Trade Union Institute in March 2013, Sergio De La Parra defends the two pact from the accusations of being just one more austerity oriented measure, strongly characterised by a further reduction of national sovereignty.

First, the author argues that the tightening of the national budgets' surveillance procedure and the strengthening of the EDP should be considered a "physiological asymmetry", as besides monetary policy, fiscal discipline is, according to all treaties, the only field in which the EU has binding powers.

Second, he claims that economic priorities are seasonally assessed and should be in line with those established at the beginning of the European Semester by Annual Growth Surveys (AGS), which for 2013 stated, among the others, that "Fiscal consolidation may have a negative impact on growth in the short term (…) the alternative scenario of postponing fiscal adjustment would prove much more costly", definitely clarifying on what matters the attention of EU policymakers would have been directed during the following period.

As to the suspension of national sovereignty implied by the conditionality of bail-out payments to the compliance with the agreed macroeconomic adjustment programme, following a Member State's request for financial assistance, the author states, that such

forced fiscal consolidation path would be the only way to reconcile the granting of financial assistance with the no bail-out clause of the TFEU.

Finally the author concludes that, as in the case of the rationale behind the SGP, Member States' space for manoeuvre is directly proportional to the soundness and health of their public finances.

2.6 Brief considerations on the effectiveness of fiscal reforms

At the time of writing (September 2014), all of the previously discussed fiscal regulations, aimed at stabilizing EU government budgets and debt to GDP ratios as well as macroeconomic imbalances, have entered into force and have started to display their first outcomes.

GDP, government deficit/surplus and debt in the EU (in national currencies)

		2010	2011	2012	2013
Spain					
GDP mp	(million euro)	1 045 620	1 046 327	1 029 279	1 022 988
Government deficit (-) / surplus (+)	(million euro)	-100 508	-100 072	-109 460	-72 577
	(% of GDP)	-9.6	-9.6	-10.6	-7.1
Government expenditure	(% of GDP)	46.3	45.7	47.8	44.8
Government revenue	(% of GDP)	36.7	36.2	37.2	37.8
Government debt	(million euro)	644 692	737 406	884 731	960 676
	(% of GDP)	61.7	70.5	86.0	93.9
Italy					
GDP mp	(million euro)	1 551 886	1 579 946	1 566 912	1 560 024
Government deficit (-) / surplus (+)	(million euro)	-69 919	-59 112	-47 356	-47 345
	(% of GDP)	-4.5	-3.7	-3.0	-3.0
Government expenditure	(% of GDP)	50.5	49.7	50.6	50.6
Government revenue	(% of GDP)	46.1	46.1	47.7	47.7
Government debt	(million euro)	1 851 256	1 907 564	1 989 473	2 069 216
	(% of GDP)	119.3	120.7	127.0	132.6
France					
GDP mp	(million euro)	1 936 720	2 001 398	2 032 296	2 059 852
Government deficit (-) / surplus (+)	(million euro)	-135 744	-103 093	-98 747	-87 566
	(% of GDP)	-7.0	-5.2	-4.9	-4.3
Government expenditure	(% of GDP)	56.6	55.9	56.7	57.1
Government revenue	(% of GDP)	49.5	50.7	51.8	52.8
Government debt	(million euro)	1 601 966	1 724 917	1 841 027	1 925 292
	(% of GDP)	82.7	86.2	90.6	93.5

Figure 2: The development of debt-related figures in three main Eurozone countries[7]

Austerity policies in EMU had the ambitious purpose of restoring the Union's financial stability by cutting the widespread deficit bias present among Eurozone governments and by reducing the overall debt burden. Additionally, as stated in most of the treaties and

[7] Eurostat news release, issued in April 2014 and retrievable at: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-23042014-AP/EN/2-23042014-AP-EN.PDF

intergovernmental agreements introduced throughout the past years, this should have happened, at least within certain boundaries, without completely disregarding economic growth and by guaranteeing each Member State's capability to still provide its citizens with fundamental services such as education and healthcare.

Thus, based on the current development of key macroeconomic indicators the first conclusions about their effectiveness in pursuing the established objectives can be drawn.

As is possible to observe, the development of debt-related figures in important Eurozone countries like Spain, France and Italy (Figure 2) all display the same tendency, that is, slightly improving budget deficit to GDP figures and overall debt to GDP ratios that have dramatically increased over the past three years. Specifically, if attention is paid to the Italian and Spanish cases, the debt to GDP ratio has risen by respectively 13% and 32%, reaching a peak of 132.6% and 93.9% at the end of 2013. Nevertheless, besides Italy, none of the countries in Figure 2 lies within the 3% upper limit imposed by the SGP, not even talking about Fiscal Compact criteria. At least up to now, as previously for the SGP, the Fiscal Compact is another agreement which sets very strict rules that none of the three main Eurozone economies behind Germany, is intentioned to comply with. But, most important, the ever increasing overall debt to GDP ratios of France, Italy and Spain despite their fiscal consolidation efforts lead us to an obvious consideration: Austerity policies, especially because implemented during an uncertain business cycle, have led to output levels as low as to make the undertaken budget deficit reductions vane. The fact is that, despite years of austerity, the Eurozone's debt level is still growing and reached a new high of 93.9%[8] of GDP in the first quarter of 2014 (latest observation). As previously stated by Saraceno and Créel, apparently the instrument, austerity through fiscal consolidation, has turned into the goal and the actual objectives are being missed. This is particularly clear when observing that, along with increasing debt levels, those countries forced to budget consolidation have been pushed into severe recessions or stagnations. Indeed in the past two years, Italy and Spain experienced significant contractions of their GDP, while France's economy was practically stagnating with growth levels for the years 2012 and 2013 of respectively 0.0% and 0.3%. Additionally in each of these countries unemployment rates have touched new peaks. The output gap generated by austerity policies has obviously resulted in decreasing inflation

[8] Eurostat news release, issued in July 2014 and retrievable at: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22072014-AP/EN/2-22072014-AP-EN.PDF

rates, which have led to an expected Eurozone's aggregate headline inflation rate of close to zero for 2014. Contemporarily, EMU's GPD growth has been stagnating during the first two quarters of the current year (Q_1:0.2%; Q_2:0%)[9] as a result of a German slowdown. This combination of growing debt, stagnation and an inflation rate dangerously close to zero poses a significant threat to the sustainability of public debt of many Member States and, thus, to financial stability. In other words, the policy mix imposed at the EU level, limited to austerity policies and strict fiscal regulations alone, has not produced the desired effects. Moreover, it has been responsible for amplifying economic inequalities between Eurozone countries, such as the difference in unemployment rates and GDP per capita, and for undermining some governments' capability to provide fundamental services to their citizens. The vision is widespread that, to sustainably and effectively perform fiscal consolidation policies and a significant reduction in the aggregate debt burden, if not with undesired debt mutualisation tools, EMU's fiscal framework should be complemented with any kind of compensatory international money transfer instrument. Such asymmetric shock absorption mechanisms would make fiscal consolidation financially sustainable even during uncertain, if not already contractionary, business cycles.

[9] Eurostat news release, issued in September 2014 and retrievable at:
http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-05092014-AP/EN/2-05092014-AP-EN.PDF

An Evaluation of Alternatives

3. Different Schools of Thought and The Fiscal Union

In this section the different options available to the Eurozone in order to combine fiscal consolidation policies and an effective asymmetric shock absorption mechanism will be analysed. In particular, the cost and benefits resulting from the creation o a fiscal union in EMU will be closely evaluated[10]. As this seems an ambitious and, for some countries, an undesired solution, a set of alternatives will finally be described.

3.1 Fiscal Federalism, History and a Fiscal Union in EMU

As seen in the previous sections of this paper the allocation of fiscal rights and responsibilities plays a fundamental role in a monetary union, mostly because fiscal policy is the only macroeconomic adjustment tool left to the discretion of national governments. However, due to spillover effects of various kind, if fiscal rights are not employed appropriately by one country in EMU, other Member States are likely to be called to share the responsibilities. To solve this problem, rather than concentrating alone on which budgetary discipline measures to impose on Member States, fiscal federalism focuses on where fiscal decision-making powers are best allocated, to possibly avoid such externalities to arise. With respect to fiscal policy measures and reforms analysed up to now, the policy mix proposed by fiscal federalism, besides internalising the spillover effects, also implies a viable solution to the problem of macroeconomic imbalances.

In EMU fiscal federalism is generally associated with the idea of centralization, to some degree, of fiscal policy at the supranational level, obviously implying a further loss of sovereignty for Member States. Specifically, fiscal federalists advocate for the redesign of fiscal architecture in the Eurozone in order to allow for a rich European budget centrally administrated by the Commission, to be ready to kick in when asymmetric shocks hit the Member States. The actual budget consists of only about 1% of the national incomes of the

[10] The nature of the evaluation will by qualitative, as a quantitative approach to the potential effect of such complicated policies would certainly lead to inaccurate results.

Union’s Member States. The belief in the necessity for a richer budget is based on the assumption that, lacking the Eurozone of some typical features of Optimal Currency Areas such as international money transfers and perfect cross border labour mobility, a common fiscal policy and budget, would most likely reduce such shortcoming.

However a closer look to the concept of fiscal federalism, entailing the one of a fiscal union, is required to understand whether this can be considered as an effective and viable option for the Eurozone. As stated by M. Bordo, L. Jonung and A. Markiewicz in their working paper “A Fiscal Union for the Euro: Some Lessons from History” (2013), there is no single definition for fiscal federalism, but four typical elements which are deemed to characterize the “ideal type”[11] of it have been identified. According to Sorens (2008) those are (i)the autonomy of regional governments to decide taxes and expenditures according to their voters preferences, (ii) strong budget constraints such as a credible no-bailout clause, (iii) the presence of a common market characterized by free trade and mobility in order to ensure the scope for competition among regional governments, and (iv) the fact that the system of fiscal federalism should be made formal by a set of binding rules. The authors of the paper add what they consider another fundamental element of fiscal federalism, that is, “the common market is based on a common currency, that is, the sub-central and central fiscal authorities are members of the same monetary union”. The difficulties of the Eurozone to adapt to such a model lie in the fact that it doesn’t consist of regional governments, but of sovereign Member States, who are quite reluctant to give up their only macroeconomic stabilization instrument, even if just to a certain degree. However, the combination of centralized monetary policy and de-centralized fiscal policy, especially when their objectives are not aligned may result in consistent drawbacks due to spillover effects. Besides the Eurozone-specific and current issues implied by such institutional asset already mentioned in the paper, from a pure theoretical point of view non-cooperative fiscal and monetary policies are likely to lead to less than optimal inflation and Nash equilibrium output (Dixit and Lambertini, 2011). A wide number of studies in this area come to the conclusion that the interaction between one monetary authority and numerous fiscal ones has to be regulated by strong fiscal policy constraints, as free-riding phenomena are more likely to occur. To this extent, as previously observed, EMU has already been sufficiently regulated. Conversely, as

[11] Jason Sorens, *Fiscal Federalism: A Return to Theory and Measurement*. Published in 2008.

argued by Jonung, Markiewicz and Bordo (2013), who compared the functioning and development of the Eurozone to the one of successful fiscal federations like the USA, Germany and Canada, money transfers guaranteed by a central authority to avoid vicious circles of falling trust and increasing borrowing costs appear to be missing, even if apparently in development. However the authors observe, by analysing the creation and development of five important fiscal federations such as the USA, Canada, Argentina, Germany and Brazil, that their creation is strictly related to their path from a conglomeration of independent regional countries to the creation of single nation states. More importantly, what has been observed is that their creation weren't based on mutual economic convenience matters, but were due to pure political reasons, such as military insecurity forcing separate political entities to stick together to preserve their independence. This matter of fact clarifies that besides economic interests, the creation of a fiscal union must be backed by strong political and social will. According to Thomas M. Franck, in order to be successful the creation of a fiscal union should be triggered by what he calls the "federal spirit", that could be defined, with a sufficient degree of simplification, as "the commitment to the value of federalism and to compromise"[12] . While it is possible to state with absolute certainty that the creation of the first common European institutions as the ECSC (1951) and EEC (1957) has been triggered by the mutual commitment and political will to prevent further wars between the main continental powers, whether similar shared feelings and such incentives for further federalisation are still present nowadays is up for debate.

As to already observed experiences of fiscal federations, Bordo and co-authors make a clear distinction between well-functioning fiscal unions and unsuccessful ones, where the judgement is based on their achievements in terms of debt accumulation and inflation. The successful examples are represented by those fiscal federations, like the USA and Canada, which have permanently imposed relatively strict fiscal discipline on sub-federal entities and achieved stable levels of inflation over the long term. The unsuccessful examples are represented by those countries, like Brazil and Argentina, whose local institutions have run high public deficits, which have been financed through massive central bank debt acquisitions and high, if not uncontrolled, levels of inflation.

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[12] Michael D. Bordo, Lars Jonung and Agnieszka Markiewicz, *A Fiscal Union for the Euro: Some Lessons from History*. Published by Oxford University Press on behalf of Ifo Institute: CESifo Economic Studies, 2013.

To this extent, the lesson to be learned from well-functioning fiscal unions is that to prevent sub-central institutions , Member States in the case of EMU, to engage in irresponsible fiscal profligacy and moral hazard, the federal government should give a clear signal of commitment to pursue fiscal stability also at the cost of a sub-central government's default. This was done by the US government in 1840 when, as a consequence of a serious financial crisis and recession in 1839, many American states who had previously accumulated great amounts of debt to finance significant infrastructural investment projects, weren't able to serve it. The federal government refused to take on the states' debt and most of them defaulted and consequently had to undertake painful adjustment policies. That solution was costly, but rather effective, as from that moment on all US states started developing the fiscal sovereignty observed nowadays, which includes strict balanced budget rules.

However in 2014, with strongly globalized and interrelated financial markets this solution doesn't seem an option anymore, at least within the Eurozone. In fact the no bailout clause included in the SGP from its very beginning lost its credibility since the Greek rescue of 2010. A possible way to remove this shortcoming and restore the credibility of the no bailout clause will be analysed later in the paper. In any case, the importance of a credible no bailout rule has been illustrated.

Up to this point, as to fiscal policy and the different economic structure of sub-central entities, the European and the US institutional set up of 1840 could seem quite similar, with the only difference that overseas states were allowed to default on their debt. However, the real difference, which mainly differentiates EMU from the US of 1840 and thanks to which the application of the no bailout rule was possible, then and in later crises like the Great Depression, is that the US disposes of a conspicuous central budget which is employed in these cases to implement measures aiming at the equalization of income across states in order to stabilize the US' economy both from a macroeconomic and financial point of view.

Specifically, as during the Great Depression, in times of recession the central government increases spending or reduces taxation in the most distressed areas of the country, where citizens' welfare and standard of living have been hit the most. Historical events display that in response to exceptional conditions the central government is often strengthened by taking on an increasingly important role. It does so through fiscal policy, by issuing more debt at the national level, which also implies lower interest rate payments.

Always according to Jonung, Bordo and Markiewicz this is a key element of the success of a fiscal union and should be transferred to the Eurozone, as they claim that the creation of a euro area bond market, that is Eurobonds, “is the most appropriate way to finance interregional transfers in distressed times”. It is important to recall that the creation of a common debt market entailing a common debt instrument such as Eurobonds first requires a central government. This means that a fiscal union, implying shared debt among countries, would only work if complemented by a strong political union.

However, following the authors’ opinion, the European Sovereign debt crisis has given a significant contribution in increasing the central fiscal power of the EU, and would be paving the way for larger transfers to the Member States hardest hit by the crisis. Apparently, the EU would be following the same pattern towards the creation of a federal state as the countries mentioned above.

The authors conclude, based on the historical evidence gathered, that a number of conditions specific for the Eurozone are strictly necessary for it to develop into a fiscal union. First, and most important, is the serious commitment to a no bailout rule to be maintained credible. Second, is a sufficient degree of Member States’ tax revenue and public expenditure independence reflecting the voters preferences. Third, a well developed international money transfer mechanism to offset the effects of asymmetric shocks, possibly financed through a common bond, should be established. Fourth and last, the EU should develop the capability to learn from past mistakes and adaptively react to new economic and political circumstances.

Despite the fact that the creation of a fiscal union with the properties mentioned above probably represents a strongly desirable option and the first-best solution not only to the issue of the Eurozone’s financial stability, but also to the missing absorption mechanism of asymmetric shocks and more generally to the problems currently posed by stagnation and low inflation levels, the way towards the “United States of Europe” is far from being feasible under current circumstances.

The main obstacle to the success of the federalist project, besides the lack of support by nearly all Member States’ governments, is the insufficient democratic legitimacy of European institutions, which are mostly perceived as a ruthless and inhumane technocracy to which citizens are not willing to give up such a precious power.

3.2 Liberal Intergovernmentalism and a less demanding solution

Oppositely to the federalist approach liberal intergovernmentalism, whose roots are found in the neo-functional approach to European Integration, is a theory in the study of regional integration mainly based on the belief that national states are the central actors acting in their own and best interest in order to maximize their utility. It strongly differs from neo-functionalism, as liberal intergovernmentalism claims that national interests are issue-specific and have to be pursued at the international level through intergovernmental bargaining, rather than through delegation to a supranational authority as the EU Commission, which should be involved exclusively in the case that one nation's interest is clearly conflicting with the ones of others and governments are afraid that the resultant agreement is not going to be tolerated by other parties (Schimmelfennig, 2004). It is deemed to be a state-centric integration theory arguing that international interstate bargaining results from the interest of a country in pursuing international agreements for domestic political objectives and can thus be considered as an approach that strengthens or even "rescues the nation state" (Milward,1992). At the European level this implies that optimal decision making and compliance surveillance would possibly have to take place at the Council. This position is based on the assumption that government leaders have better knowledge about their mutual preferences than a supranational authority has. In fact the latter, mainly because of nations' self-interests, enjoys low levels of efficiency and bargaining power, whereas it is mostly useful for mutual monitoring and sanctioning (Schimmelfennig, 2004). Following the liberal intergovernmentalist approach only countries that enjoy the most of the gains from integration should and have made more efforts to accelerate the process, while other countries (e.g. United Kingdom) are seeking to slow it down. More precisely, such approach was based on the exploitation of the unanimity principle, which implied that all Member States had to agree on most matters in order for related regulations to be ratified. This provided single Member States with enormous bargaining power as they were entitled to veto rights on most decisions and therefore allowed for a greater degree of compromise. However, since the reinstatement of majority voting through the Single European Act in 1986, the liberal intergovernmentalist approach has considerably lost importance, while the rationale and the way of reasoning behind it have still a fair amount of influence nowadays.

As liberal intergovernmentalism, in their paper "European Fiscal Union: What is it? Does it work? And are there really "no alternatives?"" published by the German Institute for the Study of Labor in March 2012, Clemens Fuest and Andreas Peichl come to an exactly opposite conclusion about the creation of a fiscal union with respect to the one proposed by fiscal federalists. Alternatively the argue in favour of a financial sector reform limiting the contagion effect across Eurozone countries due to a Member States' default. First, the authors state that, being a unique definition of fiscal union missing, the latter should be characterized by at least some of the following features : (i) a set of fiscal rules, policy coordination and supervision mechanisms, (ii) a crisis resolution mechanism, (iii) joint guarantee for government debt, (iv) fiscal equalisation instruments and other international money transfer mechanisms and finally (v) a larger EU budget and European taxes.

However Peichl and Fuest strongly criticize most of the elements they consider as necessary for the set up of a fiscal union starting from the concept of debt mutualisation. Besides the typical moral hazard objection, the consideration is made that a joint guarantee for governments' debt would strongly reduce the incentives for Member States to service their debt at all. In other words, countries could stop paying their debt as others will have to step in for them by contract. As for fiscal equalisation mechanisms, the argument is raised that separating the "insurance effect" of transfers, which is fundamental for the absorption of asymmetric macroeconomic shocks, from the "income redistribution effect", which by contrast is considered illegitimate and unfair with respect to lending Member States. Additionally, the authors claim that immediate stabilization through outside financial support would probably reduce troubled governments' incentives to undertake the needed macroeconomic adjustment measures, that is, to approve structural reforms.

However, the element which raises the greatest number of questions is the larger EU budget and the direct collection of taxes by the Union. First, its success at stabilizing macroeconomic imbalances in the monetary union is strongly tight to the fact that a country's contributions to the central budget decrease when it is hit by the shock, while the EU's expenditures in the country increase. This would mean that all economically healthy Member States would be financing the country hit by the recession. The possibility of such a dynamic doesn't find the approval by many EU members and could reduce a government's incentive to efficiently seek healthy economic growth at any cost.

In any case, as recalled by the authors and already previously stated, the establishment of such a union would require to replace current EU institutions with more legitimate, probably elected ones and a consistent step towards the establishment of a federal state. As the circumstances doesn't allow for such a project to be feasible, an alternative and completely different solution, fostering the concepts of responsibility decentralisation and the stabilization of financial markets is presented. It basically relies on a drastic improvement of the current EMU setup by making the no bailout clause applicable, credible and a Member State's default on its debt sustainable for the rest of the Eurozone. The authors claim that during the latest sovereign debt crisis the no-bailout rule was violated because the weakness of EMU's financial sector would have made the absorption of a Greek or Portuguese sovereign insolvency unsustainable. In other words, as the main German and French banks were holding too much of the Greek debt and would have certainly faced bankruptcy in case of sovereign default, Greece had necessarily to be bailed out. The aim of Peichl and Fuest's solution would be to reform the financial sector, through a further strengthening of the Basel Accords on banking regulation, in order to make contagion across Member State's impossible and sovereign defaults and debt restructurings to happen smoothly. Specifically, their recipe consists in the introduction of correctly estimated risk coefficients for the different government bonds, which could not be equal to zero anymore, and consequently an increase in the quantity of equity to be provided by banks to hold such bonds, especially if issued by countries considered at risk. In this way banks would be forced to diversify their portfolio and also to invest a greater amount of money in safer securities, which would be less costly in terms of required reserves. Following the authors, this would represent a perfect solution because not only will it make possible for orderly debt restructurings to take place, but it will also lead financial markets to set better incentives for governments to limit debt accumulation.

However, as good as this solution might be presented by its supporters it clearly has major flaws which make it undesirable at the very least. First, it completely ignores the issue of the lacking shock absorption mechanism which, this paper claims, is at the base of the current situation of stagnation and deflationary tendencies across the Eurozone. Conversely, by making the holding of bonds of distressed countries even less attractive than it actually would be without the expansionary monetary policies of the ECB, such a regulation which further increases the debt cost of capital for those countries like Italy, Spain and France

which are more or less struggling to achieve the necessary fiscal consolidation without completely disrupting their economies, would result in a deeper recession for Italy a moderate one for France and a slower recovery for Spain. In other words, it would push the Eurozone's aggregate GDP growth down into the negative area and ultimately help deflation to consolidate.

Second, another issue which is deemed to be a major cause of inexistent growth and recession in many Eurozone countries is the so called "credit crunch", that is, banks not lending money to the economy but rather investing it in risk free government bonds or depositing it overnight at the ECB.

The increased regulatory capital requirements for the holding of any government bond implied by the policy mix proposed above, would result in a reduced real money stock and thus make the phenomenon even worse than it actually is.

Therefore it is possible to finally come to the conclusion that the alternative to a fiscal union in EMU proposed by Clemens Fuest and Andreas Peichl cannot be really considered as an option.

3.3 The Golden Rule of Public Finance, a viable second-best proposal?

Being the implementation of the first-best solution identified by this paper, that is, the establishment of a European Fiscal Union including the fundamental element of a fiscal equalisation mechanism to absorb asymmetric shocks, opposed by a vast number of Member States and being the previously analysed proposal of a strengthened and stricter financial sector not a viable option, a second-best proposal for the stabilization of public finances and reduction of macroeconomic imbalances in EMU is required and could be represented by the introduction of the so called "Golden Rule of Public Finance" as a substitute of the stricter and widely non-respected existing pacts, recently proposed by the former Italian Prime Minister Mario Monti and whose potential effect has been evaluated by Creel, Saraceno and Hubert (2012). The golden rule states that "over the cycle, government borrowing should not exceed net government capital formation; hence, current

expenditures should be financed by current receipts"[13]. In simpler words, according to such rule, current government spending must be entirely covered by tax revenues, while the issuance of new public debt is allowed only to finance public investments, which are expected to generate positive cash flows in the future. The rationale behind the "golden rule" is that the cost of public capital formation should be spread across the generations that will actually enjoy the arising welfare benefits, such as to prevent their uneven distribution between elderly and younger members of society. It is widely considered that the introduction of such regulation would contribute to reduce the incrementing negative bias against public investment caused by the implementation of the recent austerity policies. In fact, a tight relationship between fiscal consolidation efforts and the cut of both private and public capital expenditures has been proved to exist during the past decades. Thus, an increase in public investment should result in a consequent and proportionate surge in private investment and wage levels. Another obvious advantage of the adoption of the "golden rule" is that it would create a strong incentive for governments to move part of their spending from unproductive current expenditure to profitable long term investment expenditure, including the one for the improvement of key infrastructures and human capital, a combination that is deemed to favour innovation. According to Creel (2003), public investment is considered to boost economic growth mostly through two different channels, which are (i) the improvement of total factor productivity, through the provision of public goods like transports infrastructure and (ii) an increase in "overall welfare" in the cases in which public investment is employed to protect the environment or improve resource distribution's equity.

Nonetheless, how already pointed out previously in this paper, the goal is the one to best combine fiscal consolidation and economic growth, in order to sustainably and progressively cut down EMU Member State's average overall debt burden to provide financial stability. This requires one more step, a slight correction, for the "golden rule" to be consistent with such objective. Indeed, the impact of the introduction of the rule alone, by leaving the cyclically adjusted deficit to GDP ceiling of 3% unchanged would certainly result as

[13] "Ranking Fiscal Policy Rules: The Golden Rule of Public Finance vs. The Stability and Growth Pact", Jérome Creel, May 2003.

unsustainable, as "there would be no intrinsic forces stopping interests payments and public debts, expressed in terms of GDP, from growing"[14].

This is why, according to Creel, a rule that excludes public investment from being considered when computing the deficit to GDP ratio should be combined with regulation imposing a balanced cyclically adjusted deficit criterion, that is, to set the upper limit to zero. Such a combination would make public investment possible by contemporarily ensuring sound public finances. Creel (2003) calls it the "modified golden rule". Moreover, a strict definition of public investment clearly stating what to be considered as "productive public expenditure" should be provided by the EU, and governments should be allowed to only exclude spending consistent with this definition.

The solution represented by the introduction of a "modified golden rule" appears as a more than viable option to resolve both the issue of sound public finances and the one of macroeconomic imbalances. In fact, not only does it allow for automatic stabilizers to fully come into play in case of adverse economic conditions, but also leaves governments' enough space of manoeuvre, as they're free to decide about the size of public investments, to implement countercyclical fiscal policies when a country is hit by an asymmetric shock. Moreover, by boosting potential output, such a regulation is deemed to result in higher levels of economic growth with respect to current ones and to consequently stabilize EMU's average debt to GDP ratio. Finally, conversely to the first-best solution represented by the creation of a fiscal union, the "Modified Golden Rule of Public Finance" doesn't imply any form of debt mutualisation, meaning that no further political integration at the Eurozone level would be needed for the rule to be implemented in the very short term.

[14] "Ranking Fiscal Policy Rules: The Golden Rule of Public Finance vs. The Stability and Growth Pact", Jérome Creel, May 2003.

4. Conclusions

The most recent treaties and intergovernmental agreements, including the Fiscal Compact and the Two-pack, have been introduced at the apex of the European sovereign debt crisis, at a moment in which certain Eurozone countries normally considered as “too big to fail” were seriously facing the risk of defaulting on their debt. The mismanagement of the Greek and Portuguese bailouts and the consciousness that the ECB would have strictly followed its statute, which doesn’t allow it to increase the money supply by purchasing bonds of troubled Member States, had led the investors’ confidence crisis to spread across the Eurozone and interest rates on public government bonds had reached a nearly unsustainable level. The decision by the EU to start strengthening its fiscal framework was taken both to literally force fiscal profligate governments to drastically reduce their public deficits, and mainly to relieve the tensions on financial markets by restoring the Eurozone’s credibility. However, if such measures combined with the immense liquidity provided by the ECB have managed to effectively address the latter issue, the former appears to stay unresolved. Specifically, the progressive strengthening of criteria, aimed at the achievement of major debt cut downs, which were often not respected even in their weaker form and the lack of a brighter and far-sighted vision about how to sustainably reduce public debt in countries whose governments were still facing the drawbacks of a recent and significant recession, have apparently led to the opposite outcome. Additionally, besides the increase in the Eurozone’s average debt to GDP ratio, the employment of austerity policies alone has resulted in stagnation and the risk of deflation in the Eurozone, while economic inequalities among Member States are as high as never before.

The most important and clear point made by the analysis of EMU’s fiscal policy and framework performed throughout this paper is that the current course of action and the existing regulations must be modified. Specifically, it concludes that for EMU’s fiscal consolidation policies to be sustainable, a framework including an asymmetric shock absorption mechanism must be put in place. The fundamental rationale behind this statement is that, according to the paper’s analysis, debt reductions are effective and sustainable in the long run only when combined with stable economic growth.

To this extent, two alternative solutions for the Eurozone are proposed. The first-best solution is represented by the creation of a European Fiscal Union consisting of, among the

others, fiscal equalisation tools and other automatic international money transfer instruments to kick in when Member States are hit by asymmetric shocks. This would allow countries engaged in fiscal consolidation and structural reforms efforts that contemporarily face a recession, to keep pursuing their budgetary and reform goals while the Union takes care of funding countercyclical fiscal policies and automatic stabilizers can be allowed to fully come into play.

However, even if the belief that Member States' governments and institutions should seriously commit to take the process of European integration one step further is strong, the creation of a European Fiscal Union implying the "United States of Europe" with a central and elected government, appears as a politically too ambitious project to be implemented in the short term. Nonetheless, it is crucial to state that the fiscal union stands out as the ideal solution and as the natural consequence to the creation of the monetary union.

Finally, as current circumstances require an immediate and effective regulatory reform, a second-best solution to be implemented in the short term is proposed, that is, a shift from the current version of the SGP strengthened by the Fiscal Compact and the Two-pack to a pact based on the "Modified Golden Rule of Public Finance".

Such rule excludes public investment from the computation of a country's deficit to GDP ratio, while at the same time imposing a balanced cyclically adjusted budget. Its adoption is strongly recommended as it allows governments to absorb asymmetric shocks through countercyclical fiscal policy, without diverting from the path of fiscal rectitude.

The path towards the creation of a European Fiscal Union and the frequently evoked "United States of Europe" is not only long, but also undermined by the Member States' governments tendency to blindly pursue what they consider to be their countries' best interests, or worse, to exploit their approach to European policies to gain voters' consensus.

However, as proved by current circumstances, the creation and development of the Economic and Monetary Union has led to such a strong degree of correlation between Member States' economies that its completion with a fiscal and political union is required for it to produce its optimal social and economic outcome.

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