Dipartimento di Economia e Finanza

Cattedra di European Economic History and Policies

Crisis and reform of the European fiscal policy coordination

Relatore

Prof. Carlo Viviani

Candidato

Luca Vanzini

Matr. 153961

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«Our constitution is called a democracy because power is in the hands not of a minority but of the whole people»

The Peloponnesian War, Thucydides

These words opened the first draft of the preamble of the European Constitution released on May 23rd 2003 and they well embody the spirit of the time [1]. Trust, consensus and hope were the feelings of the Europeans toward the integration process. Indeed, since its dawn, the European Union has been meant and seen as a way to achieve peace, growth and democracy after the tragedy of World War II.

Nevertheless in the past few years many things changed. As the crisis hit the whole continent, member states rediscovered their selfishness, their differences and were ultimately unable to promptly react. This inevitably led to extensive reforms of the European Institutions and to the creation of new ones. Obviously reactions were quite diverging.

In a simple and reductive way, on one side some advocate Europe needs crises to foster its process of integration, on the other one some openly attack the "Europe of the banks" and in the middle there is a continuum of intermediate positions. Anyway, the trust, the consensus and the hope of just few years before are no more.

How was it possible? How did it happen? Which are these controversial measures? These are the main questions that must be answered today. For these reasons it is necessary to deeply analyse the reform of the European economic governance and in particular to put under scrutiny the reform of the fiscal coordination.

1 European Convention, 2003

How and why Europe arrived at the reform

Before 1951: First steps and EPU

In a journey in the reform of the economic governance of the European Union - and more precisely of its fiscal policy coordination - the first step to undertake is to analyse its history. The issue of coordinatio, indeed, was present since the integration process had just begun and was limited to few similar countries in Western Europe. Moreover, it can also be easily argued that the present situation is just the result of previous actions (and inactions) of that period. Hence, it is crucial to see how fiscal coordination evolved over the past 60 years. It is then useful, for clarity's sake, to divide this long period into several intervals marked by the main events of the history of European integration.

The first of such turning points is the European Payment Union in 1951, which for the first time tried to solve Europe current account problems through European cooperation. Namely, it is possible to go back till 1947 to find the first problems of fiscal coordination and the first attempt to solve them at the continental level. Indeed, in the first two years after World War II, the destroyed Western European countries invested heavily in reconstruction [2]. However, that meant huge imports of capital goods from the USA, as national industries were little more than debris [3]. Indeed, not to mention Allied carpet bombing, German troops looted all the machinery they could bring back home during their retreat, but Germany too, the capital good heartland of Europe, was divided, looted and planned to become a pastoral heaven [4]. Therefore, the only possible source of machinery was beyond the ocean and required dollars.

2 Eichengreen, 2008
3 Eichengreen, 2008
4 Eichengreen, 2008

This quickly led to a situation like Spanish one today; huge imports were not matched with sufficient export and the current account imbalance depleted all foreign reserves [5]. Furthermore, as borrowing abroad was infeasible and exports themselves required preliminary imports, the situation seemed without solution [6]. Indeed, European Governments could discourage investment, harming future growth, or reduce private consumption, threatening social peace [7]. Moreover, the situation was such that prices were kept under control to avoid excess liquidity to be wasted in luxury imports putting additional pressure on foreign reserves [8]. Namely, the problem of fiscal imbalances was pivotal, but there was no consensus on how to adjust the budgets since that would have required increasing taxes and reducing expenditures [9].

In a similar scenario the Marshall Plan was created. With 13 billion dollars over four years it widely relaxed the European constraints, but also provided a first coordination of the fiscal policies [10]. Indeed, as it was mainly meant to be a weapon against the Communists, it sponsored the integration process to create the "United States of Europe", an united front against Soviet Union and the spread of Communism [11].

Following this line it hence fostered the creation of a Conference for European Economic Cooperation, soon renamed Organization for European Economic Cooperation (OEEC) [12]. This was a first attempt to overcome the previous complex system of bilateral agreements and create a multilateral organization. Indeed, as currency were not freely convertible, the only possible way for intra-European trade was a this system where every country had to fix prices and quantities for any product with any other single country [13].

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13 Eichengreen, 2008

However, as imbalances started to rise, this arrangement showed its weaknesses [14]. Temporary deficits towards one partner were allowed up to a ceiling and covered by surpluses, assuming there would have been a reversal that never arrived [15]. Indeed, almost immediately countries started to pile up deficits and surplus towards their partners, because of inflation differences, but also because of trade patterns [16]. The Netherlands, for example, accumulated deficit with Belgium and surplus with Denmark, but couldn't pay the former with the latter [17]. The credit crunch became hence the main issue in European trade, which had just recovered to 60% of its pre-war level, but seemed to be doomed to fall down again[18].

The only possible solution was a central clearing house. This was so proposed by the OEEC via its French representative Hervé Alphand together with the U.S. Economic Cooperation Administration's Planning Group [19]. Surplus with one country could be hence used to pay deficit with another one, but their sum should always had to be positive [20]. That was clearly not a current account convertibility, like the tremendous one England had just passed through, but it was an outstanding step further [21]. The First Agreement on Multilateral Monetary Compensation was hence born in November 1947 between France, Italy and the Benelux, although still not enough [22]. Indeed, the lack of financing for temporary deficits, extensive domestic imbalances, wrong exchange rates and the exclusion of England led to a quick rearrangement [23].

This second attempt of fiscal coordination was again set up through the OEEC under

14 Eichengreen, 2008
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U.S. Impetus and was named Agreement for Intra-European Payments and Compensations [24]. Notably, it included also the United Kingdom, which so joined the previous countries from October 1948 [25]. Nevertheless, the share of liabilities cancelled multilaterally was still too small and once more no credits were provided as everybody was hoarding resources to buy dollars [26]. Clearly, also this second agreement was insufficient, and ultimately led to coordinated devaluations and increasing imbalances. Also the US-backed use of Marshall Plan "drawing right" ultimately failed due to free riding [27].

A new round of negotiations started so among European countries with the Finabel Plan of February 1950, but already in March the project was dismissed because of diverging opinions on the inclusion of Western Germany between France and the Netherlands [28]. Indeed, in this period, coordination was performed usually as round tables and talks among the Western European Governments, with the support of U.S. and OEEC. Negotiations originated from one country's initiative and involved then others. There was still no coordination praxis and the whole affair followed the old rules of international diplomacy.

The failure of this method urged then the U.S. direct intervention [29]. Indeed since 1949 they'd been lobbying for an European Payment Union (EPU) with 350 million dollars of credit coming from the Marshall Plan, but with little results [30]. Hence, Paul Hoffman, the chief Marshall Plan administrator, removed all the supranational elements to convince France and England which were forced to agree [31]. Namely, the cost in U.S. goodwill and the acceptance of the remaining countries made a refusal too expensive for both countries [32]. Moreover, the EPU was more powerful since it had wider membership and financing [33].

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33 Eichengreen, 2008

However the EPU was also more effective as it was managed somehow like the modern excess deficit procedure after Maastricht; independent experts were nominated in the EPU Managing Board tasked to report at the Council of the OEEC [34]. As soon as deficits knocked down their ceilings, the Board "met to advise the Council and recommend the adoption of corrective policies" [35], while retaining the power of granting additional funds in exceptional circumstances [36]. Nevertheless, the praxis evolved in preventive talks and compulsory adjustment-targeted policies enactment, backed by U.S. influence [37]. Moreover, to sweeten the pill to surplus countries, the EPU enforced a new round of liberalization through the OEEC's Code of Liberalization where the Member states agreed to end reciprocal discrimination and decrease by 50% their trade barriers [38]. It is hence possible to argue that the EPU, thanks to U.S. intervention, was the first step towards a more centralised and Europe-wide coordination of fiscal policies. Moreover, it can also be seen how many elements from this first institution have later been taken again in the following ones.

The EPU indeed took a more and more active role, somehow similar to that of the present-day European Commission. Already in 1950, few months after its establishment, it played its first main role when "Germany's current account swung into deficit and the country exhausted its EPU quota" [39]. Indeed, as Italy, Denmark and the Netherlands relied on German export market, fear of new recession rose again [40]. The EPU hence directly intervened with a delegation including Swedish economist Per Jacobbson and British civil servant Alain Cairncross [41]. Their analysis found that German problems were matter of time, nor of price control, so issued a 120 million dollars credit conditional to balanced-

34 Eichengreen, 2008
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39 Eichengreen, 2008
40 Eichengreen, 2008
41 Eichengreen, 2008

budget policies, similar to what happened during 2011 summer between ECB on one side and Italy with Spain on the other [42]. Germany so committed itself to keep the exchange rate fixed, refrain from borrowing and raise taxes to limit consumption and investment, while also raising interest rates and reserve requirements in the banks for the very same purpose[43].

Nevertheless, adjustments were long to become effective, so in March 1951 Germany had to restrict trade, but again this happened in a European centralised way [44]. Indeed the OEEC obtained a temporary status for these norms and nominated a team of independent experts who invigilated over the license awarding process [45]. Thanks to the OEEC and EPU involvement, Germany was so able to quickly revert to surpluses without negative externalities over other countries [46]. Indeed “the EPU reassured firms and households that no devaluation was in the offing, limiting panic purchases of imports to avoid subsequent price raises and helping to sustain investment. Germany's foreign customers and suppliers, who had delayed making payment for their purchases and had demanded advanced payment for their sales, reverted to normal timing, moderating the pressure on the country's international accounts” [47]. Similarly also the Netherlands passed through the same crisis and solutions and, by the end of 1951, became too “a persistent creditor in the EPU” [48].

Nevertheless full account convertibility was still far to come; in the end it was re-established only in 1958 [49]. However it was immediately evident the new role of EPU as a supranational body coordinating European answer to trade liberalization problems [50]. Indeed, this new “transnational board of financial technocrats who reported not to national

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42 Eichengreen, 2008
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50 Eichengreen, 2008

governments, but to the OEEC" [51] set the new standards for the process of European integration and coordination.

1951-1971: ECSC, EEC & Euratom

In fact, the following year, six European countries (Belgium, France, Italy, Luxembourg, the Netherlands and West Germany) founded the European Coal and Steel Community (ECSC) on these groundings [52]. Namely, a supranational High Authority would govern the ECSC, while "a Special Council of Ministers, a Common Assembly of seventy-eight advisers from the six participant countries and a High Court of seven jurists, at least one from each member state" [53] would keep it under scrutiny. As the first real supranational organization in Europe, it led the shift from previous diplomatic coordination to institutional one.

The High Authority was effectively the real predecessor of the European Commission and similarly was a nine members executive body [54]. The larger countries, France, Italy and Germany, had two seats each, while the three smaller ones, Luxembourg, Belgium and the Netherlands, one each [55]. These nine then elected among themselves the President of the High Authority [56]. Moreover, the High Authority had then three legal instruments to coordinate member States: legally binding Decisions, Recommendations with binding aim and free implementation and, finally, Opinions without legal force [57]. With these tools and the assistance of the Common Assembly (predecessor of the European Parliament), the High Authority managed to coordinate the reallocation of unemployed coal and steel

51 Eichengreen, 2008
52 Eichengreen, 2008
53 Eichengreen, 2008
54 Wikipedia, November 5th 2011
55 Wikipedia, November 5th 2011
56 Wikipedia, November 5th 2011
57 Wikipedia, November 5th 2011

workers, the betterment of their life conditions and the introduction of the first pan-European tax [58].

This could happen as members of national Parliaments were appointed each year to serve in the Common Assembly, effectively working as hyphen between national bodies and supranational one [59]. Moreover, also the Special Council of Ministers played a pivotal role as it was in charge of harmonising the work of the High Authority with that of national governments [60]. The Council, had also to actively participate in the Commission activities with both non binding (steel and coal sectors) and binding (any other sector) opinions [61]. Furthermore it introduced the concept of turning Presidency as each member State held it for three months in an alphabetical order progression [62]. Finally, the Court of Justice took a similarly active role enforcing the earlier acquis communitaire with the help of two Advocates General [63].

Nevertheless, its scope was still limited and its coordination was bounded to the steel and coal sectors, somehow touching also close ones like energy and industrial workers [64]. It then came natural in 1957 with the Treaties of Rome to extend such coordination also in other sectors [65]. Were so born the Euratom and the European Economic Community (EEC), which shared with the ECSC the Common Assembly, now called Parliamentary Assembly, and the Court of Justice, now labelled as European Court of Justice [66]. In particular, between the two, the EEC was set up to establish a custom union with a common external tariff among Europe and hence began soon the most important of the three communities [67]. Moreover, it also led the enlargement process and the creation of the Common Agricoltural

58 Wikipedia, June 7th 2012
59 Wikipedia, June 7th 2012
60 Wikipedia, June 7th 2012
61 Wikipedia, June 7th 2012
62 Wikipedia, June 7th 2012
63 Wikipedia, June 7th 2012
64 Wikipedia, June 7th 2012
65 Wikipedia, April 8th 2012
66 Wikipedia, April 8th 2012
67 Wikipedia, June 16th 2012

Policy [68]. On the other side, the Euratom was built limited to the only nuclear power sector. It had indeed to create an European market for nuclear energy, boost its production and incentive its sale outside the community [69]. Nevertheless, although limited in its scope, it must be highlighted how it remained fairly unchanged over the years, especially concerning the role of the European Parliament [70]. Indeed, anti-nuclear feeling of the electorate made fear a reversal of fortune or even dismissal of the program, so it was decided to take it away from the European Parliament competence [71]. Moreover it can be remembered how the Euratom is now financing the ITER project to evolve from nuclear fission to nuclear fusion energy [72].

Anyway, the year 1958 saw also the birth of another important supranational institution, the Committee of Permanent Representatives (COREPER) [73]. Still today, this is a main coordinating body constituted by the head or deputy head of mission from each member state and it is tasked with the preparation of Council's agenda and procedures [74]. It plays also another crucial role overseeing and coordinating more than 250 preliminary committees preparing issues for both COREPER and the Council [75]. During these activities, its fiscal policies tasks are split among its two committees; the first one is made up by the deputy head and deals with economic issues, while in the second one the heads work on financial issues [76]. These committees are dramatically important as during their weekly sessions they formally draft the Council's agenda, but de facto already take decisions [77]. Indeed, they divide the topics to be voted in A points and B points, where only

68 Wikipedia, June 16th 2012
69 Wikipedia, May 2nd 2012
70 Wikipedia, May 2nd 2012
71 Wikipedia, May 2nd 2012
72 Wikipedia, May 2nd 2012
73 Wikipedia, March 12th 2011
74 Wikipedia, March 12th 2011
75 Wikipedia, March 12th 2011
76 Wikipedia, March 12th 2011
77 Wikipedia, March 12th 2011

the second ones are to be discussed by the Council [78]. However, most of the time the Council tasks the committees to present directly either A points or false B points, namely relevant issues already settled but formally discussed to appease the general public [79]. It can then be stated that the COREPER with its weekly meetings, especially of Committee II on financial issues, brings even further the coordination to an institutional setting. Coordination on fiscal policies is no more left to member States' own initiative, but is scheduled according to precise rules evolving in a clear and shared praxis.

After these great steps forward and the transition to an institutional coordination, the next stage was naturally to strengthen the existing bodies. This indeed was the main aim of the Merger Treaty signed in April 1965, although it came into force only in July 1967 [80]. As the name lets imagine, it merged the existing three Communities (EEC, ECSC and Euratom) that before just shared the Parliamentary Assembly and the European Court of Justice [81]. With this agreement, finally also their Councils and Commissions were merged, a fact considered by many as the actual beginning of the European Union as we know it [82]. In particular, this first Commission of the now merged European Communities was chaired by Jean Rey, a Belgian Liberal politician whose to reinforce the European bodies and deepen the integration process managed to give the Commission own revenues and to create the Economic and Monetary Union of the European Union (EMU) in 1969 [83]. Indeed, although already in 1955 a European Monetary Agreement (EMA) was signed by EPU countries to "provide one another with expanded amounts of emergency balance-of-payments assistance" [84], the EMU was a far more ambitious program. It was namely meant as a three stage program to reach economic and monetary convergence in ten years, but the

78 Wikipedia, March 12th 2011
79 Wikipedia, March 12th 2011
80 Wikipedia, January 10th 2012
81 Wikipedia, January 10th 2012
82 Wikipedia, January 10th 2012
83 Wikipedia, March 18th 2012
84 Eichengreen, 2008

sudden collapse of Bretton Woods in 1971 brought it to a complete new scenario [85].

The answer was hence the so-called snake in the tunnel, which soon started to experience the same weaknesses of its predecessor [86]. Namely, it was an intergovernmental agreement to limit the intra-European exchange rate fluctuations to 4,5% rather than the 9% allowed by the Smithsonian Agreement [87]. Nevertheless, although originally meant as a system of fixed but adjustable exchange rates without any dominating currency, it evolved in an European D-Mark area as soon as the dollar began to freely float, breaking what left from the fixed exchange rate era [88]. In particular, the countries failed to coordinate their fiscal and monetary policies as they wanted to avoid austerity measures [89]. Clearly, that meant a harsh stop for the coordination process in Europe that lasted till the end of the 70s.

1978-1992: The EMS

Indeed by April 1978 the process gained new life with French President Giscard and German Chancellor Schmidt [90]. They wanted to create a European Monetary System (EMS), but Bundesbank officials feared it would have brought inflation to Germany [91]. The EMS initiative hence included the German worries for discipline in the shape of "trigger mechanism" and binding interventions [92]. Moreover, the EMS included the creation of the first European currency, the European Currency Unit, although it was only an accounting unit made as a basket of currencies [93]. Notably, the European Currency Unit was the centre of the contemporaneously established Exchange Rate Mechanism, the key component of the European Monetary System, effectively becoming what the dollar was initially under

85 Eichengreen, 2008
86 Eichengreen, 2008
87 Wikipedia, May 26th 2012
88 Eichengreen, 2008
89 Eichengreen, 2008
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91 Eichengreen, 2008
92 Eichengreen, 2008
93 Eichengreen, 2008

the Bretton Wood system [94]. Beyond this, although most of the measures were of monetary nature, fiscal policies were also included, mainly as austerity measures for devaluing countries [95].

Indeed, to keep their obligations with the Exchange Rate Mechanism countries were often forced to implement restrictive fiscal policies through the established system of institutional coordination, while the alternative was only a set of subsequent devaluations [96]. Nevertheless, many countries chose the latter option and the system showed even more quickly its tendency to become a D-mark area up to its final break down in 1992 and the beginning of a new phase with the Maastricht Treaty [97]. France in particular failed to recognise the binding interdependence between European countries in the ERM sector [98]. Hence, when the new leftist government led by Mitterand launched its ambitious "program commun", problems quickly emerged [99]. The expansionary fiscal policy boosted GDP growth rate, but scared investors just a little bit less than the nationalizations and the communist ministers [100]. That led to growing interest rates and depletion of foreign reserves [101]. The solution obviously came with austerity measures, supported by exchange rates realignment as traditional policy instruments were no longer available in an European setting [102].

Finally, the last document dealing with financial coordination in this period is the Delors report in 1990. The relevance of the document is such that the Delors report has been called the founding document of the European Economic and Monetary Union as it laid down the three stages to reach the adoption of a single currency [103]. Indeed, while

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102Eichengreen, 2008
103Eichengreen, 2008

abstaining from proposing a federated Europe, it called for a quick economic and monetary convergence to quickly issue the new currency and so divided the incoming decade in three periods [104]. A first stage would have seen the complete liberalisation of capital markets across Europe, a second one the creation of the European Central Bank and of the Eurosystem, while the third one the definitive fixing of exchange rates [105]. Moreover, among the many issues covered, the Delors report also speaks in favour of compulsory deficit ceilings [106]. Those were hence given to the ECOFIN and the Parliament to be established and checked in a mutual surveillance system aimed at coping with German fears [107]. Similarly Germany obtained, despite the opposition of Delors himself, the obligation for predetermined tracking on fiscal policy before joining the monetary union[108].

These last years showed clearly the limitations imposed to single countries by the integration process, however these are one of the most important shortcomings of this period. Although the chaos, mistakes and stops in these years, European countries were finally forced to cooperate to achieve their goals. Indeed, as the integration process was meant to make war unthinkable and infeasible in Europe, their so close interdependence is one of the main achievements of the EU. Nevertheless it must also be stressed how this first stage encompassed the important shift to an institutional coordination of fiscal policies, a characteristic that would become more and more prominent [109].

1992-2005: Towards the Euro and its first steps

After these events, the following phase of fiscal integration was opened by spectacular break down of the first European Monetary System under the speculative pressure of

104Eichengreen, 2008
105Wikipedia, June 22nd 2012
106Eichengreen, 2008
107Eichengreen, 2008
108Eichengreen, 2008
109Eichengreen, 2008

financiers like George Soros [110]. Exploiting mismanaged fiscal and monetary policies they were able to make huge profits betting against overvalued currencies which failed to adjust in the previous years for a lack of fiscal coordination. However the collapse of the system was astonishingly coupled with little effects on macroeconomic variables [111]. There was no steep rise in unemployment or inflation and, in general, the situation didn't worsen [112]. This led to the conclusion that the path was correct, but needed more efforts. In this climate the Maastricht Treaty survived. The Treaty was indeed signed February 1992, just few months before of the crisis, and was meant to give further energy to the integration process [113]. However, the rejection of the Danish voters lead exactly to the above mentioned events, namely professional investors speculated against a weak and unsure Europe [114]. It hence emerged all its insufficiency, later patched with other agreements, but, as these were all built on it, it is worthy to first analyse it.

The Maastricht Treaty was indeed the most important step towards a further fiscal coordination since many years. Indeed, not only it stated in articles 3a and 103 the commitment to the "adoption of an economic policy which is based on the close coordination of the Member States' economic policies" [115], but also included its famous Maastricht criteria. These admission criteria became in the following years a heated topic for their usefulness and feasibility, although they remained the fundamental and untouchable ground for any further reform. Meant to prevent all over Europe Government bailouts and inflation, now the major concern of the Community, they set for the first time clear targets and procedures with apparently little left to diplomacy. It is hence correct to first briefly summarize then and later move on the other issues. The first of these criteria

110Eichengreen, 2008
111Eichengreen, 2008
112Eichengreen, 2008
113Eichengreen, 2008
114Eichengreen, 2008
115The Maastricht Treaty, 1992

states that inflation rates in each country cannot be higher than 1,5 over the average of the three lowest ones [116]. The following two ones regard Government debt and deficit which must stay below 60% of the GDP the first and 3% the second [117]. The fourth one applies to exchange rate that must be ruled by the ERM II and not have changed in the previous two years [118]. Finally the fifth looks at the nominal long-term interest rate that must can be just up to 2% higher that that of the three lowest inflation countries [119]. To ensure the commitment to such hard criteria the Delors Commission put a clear incentive for EU member States; indeed in case of failure they would have remained outside the Euro, something at that time simply unthinkable.

Nevertheless the Maastricht Treaty required also an invigilator with more concrete power than mere incentives. This active role was hence given to the Commission, to the Council of Europe (also called Council) and to the European Council [120]. Namely, the first one had to propose recommendations, on whose the second one had to draft by qualified majority voting the broad guidelines of the economic policies [121]. This draft would then pass to the European Council to find a conclusion on it [122]. This conclusion would again pass through a vote by the Council to write the final recommendation [123]. Furthermore, the Council had also to assess the general situation "on the basis of reports submitted by the Commission" [124] to which member States are obliged to send their economic plans. Similarly they also jointly act in single cases to suggest the proper actions [125]. Moreover, the Treaty sets also another important tool in the coordination of fiscal policies as it

116Eichengreen, 2008
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118Eichengreen, 2008
119Eichengreen, 2008
120The Maastricht Treaty, 1992
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125The Maastricht Treaty, 1992

explicitly forbids any help for a distressed Government [126]. Finally, article 104c deals with an embryo of excessive deficit procedure [127]. In addition to these tasks given to already existing bodies, the Treaty also sets up new Committees for specific purposes [128]. In particular, the Monetary Committee and the Economic and Financial Committee were given the task to constantly monitor the financial situation and policies of Member States together with the newly established European Monetary Institute (EMI), the predecessor of nowadays European Central Bank (ECB) [129].

Furthermore, it must be remembered how all these decisions were taken into the framework set by the Delors report and in particular within the second and third phases [130]. Namely, the first stage lasted from July 1990 till the end of 1993, presiding over the complete capital market liberalisation and over the first coordination to achieve price stability [131]. On the contrary, after Maastricht Treaty signing, the second phase focused more on the coordination of monetary policies and on the preliminary tasks to achieve a common currency in the third stage through economic and institutional convergence [132]. Finally, the third stage of common monetary policy under the European Central Bank began on 1st of January 1999, when on December 31st 1998 the definitive exchange rate had been established [133].

Anyway, despite all the mechanism bureaucracy there described, a large amount of discretion remained. Indeed, in the following years there have been many examples. Among these, Italy was allowed to enter according to a tendency towards a lower debt over GDP, while Greece was allowed to enter even though it had faked its balance sheet with

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126The Maastricht Treaty, 1992
127The Maastricht Treaty, 1992
128The Maastricht Treaty, 1992
129The Maastricht Treaty, 1992
130Wikipedia, June 22nd 2012
131Wikipedia, June 22nd 2012
132Wikipedia, June 22nd 2012
133Wikipedia, June 22nd 2012

the help of Goldman Sachs, a fact now well known to the general public. However, this didn't happen suddenly. Indeed, as the 1992 devaluation crisis had proven, there was a need for strengthening the Treaty and this was encompassed in three other steps taken by the European Union, steps that today are known for having been again insufficient. These were the Broad Economic Policy Guidelines (BEPG) in 1993, the Stability and Growth Pact in 1997 and, partially, the Amsterdam Treaty in 1997. Moreover, in this period there has also been a first attempt to give the EU its own Constitution (2004), blocked by the double "no" of French and Danish referenda.

The first step to analyse is hence the institution of BEPG, already briefly mentioned in the previous paragraph. Indeed, "although economic guidelines have existed in various guises since the pioneering work of the Monetary Committee in the late 1950s, the Maastricht Treaty of 1992 gave them a more prominent role in the EU's system of economic governance. Since their launch in 1993, the BEPGs have gradually developed into an expansive instrument of economic policy co-ordination, covering macroeconomic issues like budgetary and wage developments and structural issues like labour-market reform and enhancing the knowledge-based economy" [134]. Enshrined in article 99 of the Maastricht Treaty, they "take the form of guidelines to Member States and the Community, which are adopted by the Council of Ministers for Economic and Financial Affairs (ECOFIN) and monitored through a system of multilateral surveillance involving the Commission and ECOFIN" [135] briefly described above. More in detail, they are a very useful instrument for fiscal policy coordination because, although they "ultimately rely on soft sanctions and non-coercitive methods" [136], they are Treaty-based. This hence leads to a more clear system of responsibilities and enforcement on which the BEPG gain their

134Deroose, Hodson & Kuhlmann, 2008
135Deroose et al., 2008
136Deroose et al., 2008

legitimacy and effectiveness [137]. Indeed, as their drafting involves many actors, they aim at stimulating three effects of peer pressure [138]. Firstly they should trigger moral force at committee, ministerial and governmental levels; furthermore they aim at promoting public debate on the dealt issues and finally, in extreme circumstances, they invite at reconsidering actors' priorities [139].

Nevertheless they found a less fertile soil than expected, especially in relation to the attention paid to them by politicians, laymen and scholars too [140]. Anyway, they introduced two important debates at the European level. The first one involves the Maastricht criteria as they "linked the avoidance of excessive deficits to a broader debate on the stability of budgetary policies over the medium term and the sustainability of public finances over the long-term" [141]. Similarly they also introduced the concept of quality in public finances, rather than being limited to mere quantity [142]. In addition, the second debate focused on deficit rules as the BEPG attacked Ireland in February 2001 when it had a budget surplus due to a boom, but its cyclically-adjusted fiscal position was deteriorating [143]. They so showed their usefulness for the Community, but, because of the above mentioned problems, they also needed a restyle. Hence in 2005 they were too affected by the Lisbon strategy relaunch, that will be discussed in the following section as it involved also the other steps now under scrutiny. In particular it involved also the Stability and Growth Pact.

Therefore the second step to analyse is the Stability and Growth Pact. Well know, widely criticised and base for the future amendments, it was originally proposed by Theo Waigel, German finance minister to tighten Maastricht criteria with Deutschbank's discipline. Nevertheless, this first draft was highly criticised and was relaxed into a

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restatement of the Maastricht financial criteria on debt and deficit. Its main outcome is the creation of two arms of action, a preventive one and a corrective one. The former is discussed in the Council Regulation N° 1466/97, one of the two out of which the Stability and Growth Pact is made. In particular, this part aims at avoiding the rise of excessive deficits strengthening the surveillance of budgetary positions and economic policies, also coordinating the latter ones [144]. Under this first half, each member state of the Eurozone must submit early in the year a Stability Program "which provides an essential basis for price stability and for strong sustainable growth conducive to employment creation" [145]. It should namely include the forecast of budget situation on the medium-term (3 years), together with the policy actions to be taken to reach an at least close to balance budget [146]. Moreover it must also include the forecast for the main macroeconomic variables and an assessment of their influence on the budget [147]. Similarly, member states non-participating to the Eurozone must present an alike Convergence Program [148]. The Commission then values each report and presents its own assessment to the ECOFIN which then delivers by qualified majority its opinion [149]. On the other side, the corrective arm instead proceeds by increasing levels of peer pressure and sanctions. All this is discussed in the Council Regulation N° 1467/97 aimed at "speeding up and clarifying the implementation of the excessive deficit procedure" [150]. The regulation indeed starts defining what can be considered an excessive deficit, under different circumstances, and then describe the procedure. This starts with a report issued by the Commission, followed in maximum two weeks by an opinion of Economic and Financial Committee [151]. On top of this opinion, the Commission builds its own together with its recommendations to be submitted to the

144Council Regulation (EC) N° 1466/97, 1997
145Council Regulation (EC) N° 1466/97, 1997
146Council Regulation (EC) N° 1466/97, 1997
147Council Regulation (EC) N° 1466/97, 1997
148Council Regulation (EC) N° 1466/97, 1997
149Council Regulation (EC) N° 1466/97, 1997
150Council Regulation (EC) N° 1467/97, 1997
151Council Regulation (EC) N° 1467/97, 1997

Council [152]. At this point the final decision is given to the Council, which will vote on the presumed excessive deficit in maximum three months [153]. In the case the vote is affirmative, the Council should then present also some recommendations to the Member State under scrutiny which has four months to implement them and one year to return within the criteria [154]. In the event, the infringing state does not revert its behaviour, the Regulation sets also fines in the form of compulsory deposits at the Commission taken from the EU transfers [155].

Nevertheless and despite all this stringent bureaucracy, what can seem a well-built structure, soon revealed its weaknesses. Indeed, in good times there were no incentives to pile up reserves for bad ones, as Ireland did in 2001. Moreover the fiscal mix of taxes and expenditures was totally left to national governments, despite the BEPG's attempt to highlight the problem. This hence resulted in two negative outcomes; governments were indeed following pro-cyclical policies feeding booms and deepening recessions. Similarly tax competition on capital begun with some countries like Ireland again having tax rates twenty percentage points lower than other main countries like France, Italy or Germany. Similarly, as sanctions were left to a ECOFIN decision, they were ultimately influenced by power relations between the countries. Indeed in 2003 both France and Germany, the two largest countries, managed to avoid sections despite their excessive deficits [156].

However, before these problems finally emerged, a two other steps had been taken by the EU. Indeed in October 1997, just few months after the Stability and Growth Pact, also the Amsterdam Treaty was signed [157]. This agreement touches many topics, like the foreign common policy and the European citizenship, but it also partially affects fiscal

152Council Regulation (EC) N° 1467/97, 1997
153Council Regulation (EC) N° 1467/97, 1997
154Council Regulation (EC) N° 1467/97, 1997
155Council Regulation (EC) N° 1467/97, 1997
156Eichengreen, 2008
157Eichengreen, 2008

coordination. In particular it stated the rules for a closer cooperation among Member States saying that it must be an action of last resort after failure of a general agreement and that it must be coherent with the Union itself [158]. This was then applied to fiscal policies in the March 2012 with the European Fiscal Compact described in the following chapters. After these three successful steps, the last one was then the aborted European Constitution in 2004 [159]. Although, it was ultimately rejected by the French and Danish referenda it is worthy to briefly recap what would have been its effect on fiscal policy coordination. Indeed, on this experience subsequent proposals were built. It firstly restates the will to cooperate, but the Council now takes a more pre-eminent role elaborating plans for the whole Union together with the Commission [160]. Moreover it establish that no EU guarantee nor help by the ECB for Governments incurring financial problems [161]. Similarly it reinforce the Stability and Growth Pact in both its preventive and corrective arm [162].

Nevertheless the European Constitution was not the only failure of those years. Indeed, in March 2000 the European Council signed the Lisbon agenda for the decade 2000-2010. This aimed at making "Europe, by 2010, the most competitive and the most dynamic knowledge-based economy in the world" [163] and hence called for appropriate macroeconomic policies and structural reforms [164]. This was clearly a step forward for the EU since it took a quality point of view on the fiscal policies, rather than just looking at their quantity. In particular it stressed the importance of research, capital accumulation and education [165], but by 2010 few of these goals were achieved as admitted by then Swedish Prime Minister Reinfeldt [166]. Again Europe seemed to stop its integration process, but again

158The Treaty of Amsterdam, 1997
159Eichengreen, 2008
160Treaty establishing a Constitution for Europe, 2004
161Treaty establishing a Constitution for Europe, 2004
162Treaty establishing a Constitution for Europe, 2004
163European Council, 2000
164European Council, 2000
165European Council, 2000
166"Sweden admits Lisbon Agenda 'failure'", 2009

this took new life in 2005 with the reform of Stability and Growth Pact in 2005.

2005: Reforming the Stability and Growth Pact

Indeed, as already said above, both France and Germany run excessive deficits in the early 2000s and were finally warned by the Commission in the period 2003-2004 [167]. Nevertheless, this didn't result in an excessive deficit procedure. On the contrary it ended up as a reform of the Stability and Growth Pact itself [168]. In fact, smaller countries, like Portugal in 2001, underwent such procedure, although fines never fired, but in this case things were different for several reasons [169]. France and Germany were among the strongest promoters of the Pact, but they were also among the most powerful nations of the EU and lacked proper incentives [170]. First of all, they had large influence (informal power) and controlled a large amount of votes in the Council (de jure power); secondly their electorate and politicians were less concerned of the opinion of the rest of the Union and finally they were less bound to the Euro for the magnitude and architecture of their own national economies [171]. The two countries hence, strong of their superior bargaining power, lobbied for a reform of the Stability and Growth Pact to weaken it and given them more freedom.

This reform was then approved by the European Council of March 2005 on the basis of a previous ECOFIN report. It firstly restates the importance of the two financial threshold of 60% for the debt and 3% for the yearly deficit; however, it contextualise them within the Lisbon Agenda [172]. Indeed, due to the new scale and heterogeneity of the European Union and after 5 years of EMU [173], the European Council calls for "an enriched common

167Eichengreen, 2008
168Eichengreen, 2008
169Eichengreen, 2008
170Wikipedia, May 11th 2012
171Wikipedia, May 11th 2012
172European Council, 2005
173European Council, 2005

framework with a stronger emphasis on the economic rationale of its rules [...] to better cater for differences in economic situations across the EU" [174]. Similarly, to protect itself against critics, it stated that "the aim is not to increase the rigidity or flexibility of current rules but rather to make them more effective" [175]. The European Council then lists five areas of improvement for the Stability and Growth Pact: "enhance the economic rationale of the budgetary rules to improve their credibility and ownership, improve "ownership" by national policy makers, use more effectively periods when economies are growing above trend for budgetary consolidation in order to avoid pro-cyclical policies, take better account in Council recommendations of periods when economies are growing below trend, give sufficient attention in the surveillance of budgetary positions to debt and sustainability" [176].

On these premises, the reform is hence built. In first place, Member States are given more freedom of action as they can now choose "the policies of their choice within the limits set by the Treaties" [177] while the Commission and the Council must respect this decision [178]. After this, the European Council vaguely calls for responsibility, timeliness and commitment to the Stability and Growth Pact among the different actors involved [179]. It similarly calls for more communication and peer pressure [180]. It is after these indefinite statements that the real reform takes place. Indeed, it calls for removal of EU disincentives and implementation of positive incentives to support the Stability and Growth Pact [181]. At the same time, also expenditure rules are dismissed as valuable per se, but rather should be discussed only when relevant [182]. It moreover hopes for continuity among subsequent

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national Governments, more involvement of National Parliaments, more reliable macroeconomic forecasts and better statistics [183].

It then moves towards the preventive arm that proved weak in the 2001 Irish case. Therefore, it immediately affirms the "broad consensus that periods of growth above trend should be used for budgetary consolidation in order to avoid pro-cyclical policies" [184]. It then deals with the medium-term objective (MTO) of close to balance or in surplus (CTBOIS). It so states that "in light of the increased economic and budgetary heterogeneity in the EU of 25 Member States, the Council agrees that the MTO should be differentiated for individual Member States to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, also in the face of prospective demographic changes" [185]. It next derives from this proposition a triple aim for the EU, effectively accepting the issues of France and Germany [186]. It namely states that, together with sustainability and the 3% ceiling, enough room for budgetary manoeuvre must be left especially for issues of public intervention [187]. Moreover it establishes different MTOs for the different countries, leading to a raw two-speeds Europe; indeed the fastest growing and lowest debt countries are allowed to run a yearly 1% deficit in cyclically adjusted terms, while the laggards must be in balance or surplus [188].

Afterwards, the European Council deals with the corrective arm of the Stability and Growth Pact. In this case, it again firstly restates its usefulness, but again also highlights its problems [189]. It "underlines that the purpose of the excessive deficit procedure is to assist rather than to punish, and therefore to provide incentives for Member States to pursue budgetary discipline, through enhanced surveillance, peer support and peer pressure".

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189European Council, 2005

Moreover, it establishes that “policy errors should be clearly distinguished from forecast errors” [190], effectively weakening the power of the corrective arm, although sanctions remains available “if nevertheless a Member State fails to comply with the recommendations addressed to it under the excessive deficit procedure” [191]. Furthermore it establishes for the Commission the duty to assess whether the deficit exceeds that Government investment expenditure and whether there are other significant factors behind this outcome [192]. Inevitably all this weakened the Stability and Growth Pact and in few years, with the financial crisis, all the problems emerged again abruptly.

190European Council, 2005
191European Council, 2005
192European Council, 2005

The Crisis

The crisis indeed exacerbated all the problems in the European Union, in particular hitting the sovereign debt. However, this happened only in a second stage and it is so useful to briefly sum up the whole story.

For this purpose however it is necessary to go a little back in time in 1973. Indeed, this year is the milestone separating in Western Economic history the extensive growth period from the following intensive growth period [193]. Namely, in 1973 the first Oil Crisis occurred disrupting the previous path of growth; profits decreased and the tendency of the rate of profit to fall exacerbated [194]. Capital became hence abundant as there was no profitable use of it in the real economy [195]. These free capital looking for an adequate return moved then to the financial sector, that exactly in those years begun to grow [196]. The financial sector played so a key role in the world economy as it kept the rate of profit high, well above that of the real economy, postponing the crisis and accomplishing to its task of "elasticity" or counter-crisis tendency against the tendency of the rate of profit to fall [197]. In the following twenty years, indeed, finance and debt progressively grew together under the stimulus of neoliberism, the so-called Reaganomics, made of deregulation and wild markets [198]. Even large traditional companies like General Electrics converted to the new religion, with half of their profits coming from the financial sector [199]. However, clearly this process could not hold on infinitely as the rate of profit was constantly falling in the real sector and finance does not create wealth per se [200]. So, likewise what happened in

193Eichengreen, 2008
194Giacché, 2012
195Grossmann, 1929
196Giacché, 2012
197Grossmann, 1929
198Giacché, 2012
199Giacché, 2012
200Grossmann, 1929

1929, the crisis exploded.

Nevertheless, contrariwise to what the common sense thinks, it started in the real sector, not in the financial one [201]. Indeed, already before 2006 the housing sector in the USA was suffering for an excess supply [202]. Namely, in the previous six years an housing bubble grew fed up by the low interest rate of the Federal Reserve (the US Central Bank). Prices of the houses sky-rocketed, doubling in six years and seemed to be going to grow forever [203]. Obviously banks quickly entered the market financing any kind of loan and then selling them on the market as structured products. It seemed a risk-less game as prices were rising and banks could always recover on the house itself if the owner was going bankrupt. Hence also poor or risky households could now enter a loan backed by the ever rising value of their houses, creating the so-called sub-primes like the Ninja loans (standing for "No income, no job, no asset") [204]. It seemed like the houses were an endless and ever growing bank account with which anybody could finance anything taking more and more mortgages in an infinite feed-back effect between loans and prices [205]. However things couldn't go this way much longer. Indeed, to match this hugely inflated demand and gain from rising prices, the building sector begun to produce more than it was possible to sell. This, combined with an exhausted demand, broke down the game.

Prices of the houses started to fall already in 2006 and soon households discovered they owed more than the value of their home [206]. Not even the injection of more sub-primes in the market was able to keep the prices up [207]. However, what could have been just a sectoral crisis soon exploded in a full-blown world financial crisis. Indeed, profit-hungry banks from all over the world, no more able to find adequate returns in the real sector,

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revolved to this building bubble in the previous years and filled their balance sheets of those mortgage-related instruments [208]. Nevertheless, this was just the fuse. Namely, it exposed the huge debt-to-equity ratio through which these financial institutions were able to artificially boost their returns [209]. This meant that in extreme, but not uncommon, cases like that of Lehman Brothers, with an official 31 debt-to-equity ratio, a 4% decrease in the asset prices would completely wipe out the whole capital of the company. The crisis hence dramatically accelerated as it begun on the market a massive sale of any asset at any price to pay back these huge loans, depressing even further the prices of these very same assets[210]. At this point the previous abundance of capital, in reality nothing else than debts, reverted into a financial famine, the credit crunch [211]. It is hence possible to say that the financial crisis is not the cause of the world crisis, but rather both its symptom and drug [212].

It is exactly at this point that national Governments enter the game. Attacked in the previous twenty years of being the problem rather than the solution, they soon discovered they were the only able to save these financial giants [213]. Even staunch neoliberist quickly turned their mind back to Keynes or even Marx, although it soon proved to be just a flirt. Among them there was even Hank Paulson, former CEO of Goldman Sachs and at that time Secretary of the Treasure. Indeed, after his last famous words “the markets will take care of themselves” [214] and the sudden collapse of Lehman Brothers, he intervened in less than 24 hours to save AIG, a bailout of 182 billion dollars [215]. Similarly, all Governments prepared help plans to bailout creaky banks transforming private debt into public debt [216]. At this point the financial crisis of private debt becomes a sovereign debt crisis.

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Ireland, Spain, England, France and the whole European Union enter indeed a massive program to keep alive their banks. In particular, the first two, up to that moment pointed as examples of fiscal probity, bled themselves dry. Ireland passed in one year from a 2,9% surplus to a 32% deficit while the debt sky-rocketed from 25% to 80% of the GDP just to save two banks [217]. Similarly Spain followed the same path while rescuing its numerous medium-size savings banks [218]. At the same time, national economies slowed down implying more expenses (automatic stabilisers) and less revenues (taxes) for national Governments [219]. This obviously resulted in an unbearable sovereign debt that banks soon attacked, the same banks previously saved with that same debt [220]. This was the beginning of the European crisis in 2009.

Nevertheless there are other elements in the story, the Stability and Growth Pact and the current account imbalances. The Stability and Growth Pact indeed focuses only on public debt, but does not consider the private one or the total debt of a nation. Hence, many Governments managed to hide their fiscal problems in the years before the crisis transforming public debt in private debt. A perfect and worrying example of this is the United Kingdom where the Governments of Thatcher and Blair cut most of the public spending since the 80s. In such a way, previous public expenditure became private one in a so called "private keynesianism". The result was a relatively small public debt and a much larger public one. In 2008, before the crisis, public debt was just 47% of the GDP, well below Stability and Growth Pact parameters, but the total debt of the country was an astounding 469% [221]. On this same ground also lied Spain (342%), France (308%) and Italy (298%) just to remain in the EU [222]. Also Greece went into troubles for the narrow-

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mindedness of the Stability and Growth Pact, but for different reasons. Indeed, the previous conservative Government led by Karamanlis managed to fake its balance sheets continuously thanks to a Goldman Sachs swap allowed and undetected because the Stability and Growth Pact focuses only on the size of the box rather than on its contents [223]. However Greece was an isolated case since all the other countries followed in the previous years very stringent policies and some even managed to reduce their public debt [224]. The real problem indeed was the huge excess capacity built on a vanished debt-based demand[225]. This in turn called for public intervention that drained public finances, already creaky for the lower revenues, and finally let emerge the current account imbalances [226].

These indeed are the cornerstone of problem. Namely the birth of the Euro had two great outcomes, low interest rates all over Europe and the impossibility of competitive devaluations [227]. This in turn made borrowing very cheap and fostered specialisation among countries [228]. In this way Germany strengthened its manufacturing vocation piling up exports and balance of payments surpluses, while the other countries focused more on the service sector piling up imports and balance of payments deficits as most of the services cannot be exported and are meant for the internal market [229]. De facto Europe split in two set of countries, the deindustrialising periphery with chronic deficits and the neo-mercantile core growing on exports and exporting capital towards the periphery [230]. Portugal, Ireland, Italy, Greece and Spain, the so-called PIIGS, all belongs to the periphery and the 2009 crisis with its credit crunch did nothing more than uncover their deficits and deindustrialisation [231].

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It is hence possible to say that what European Governments faced in 2009 was not a mere crisis of their sovereign debt. It was something more, deeply rooted in the integration process itself and due to lacks of real fiscal coordination. The narrow-mindedness of the Stability and Growth Pact and its shortcomings put at stake the results achieved in the previous sixty years and called hence for a reform of the European fiscal policies.

Why do Europe need a fiscal policy coordination?

The European Union has always paid attention to its fiscal policies, more and more as the integration process was going further. However somebody can ask why all this effort was done. It is hence useful to briefly recap the problems of cohabitation in a currency union and the relevance of the topic for everybody's life.

Among the several issues, that one mostly considered by European institutions involves spillovers, in particular on inflation and cost of debt. Among the two kinds, the second may be the most obvious and direct. Indeed, a lavish fiscal policy by one member State clearly leads financial markets to question the long-term sustainability of its debt and hence to ask higher interest rates to pay back the higher risk. However, since the lavish country is part of a larger union, the EU, financial markets may ask higher interest rates also to the fellow member States. Indeed, as these may be forced to bailout the lavish member once bankrupt, they will effectively burden their own public accounts with more debt and so decrease their own sustainability. Namely, it is possible to say that the decreased sustainability of one's debt will increase everybody's interest rates and thus, in a second step, also put pressure on the formally independent ECB to set rates according to debt repayment and no more inflation. Obviously this would be detrimental for the whole union. Similarly, also the second kind of spillovers is negative and, maybe, puts even more pressure on the ECB. Indeed, a lavish fiscal policy may also boost the output gap and blow up inflation in the country. Keeping apart other effects of inflation differentials, this can, at first, stimulate inflation also in other countries of the union, but especially, in second place, it will change the average inflation of the union itself and its variation among single countries. This will mean higher difficulties for the ECB which will have to set a one-fits-

all interest rate. Indeed, as each economy needs its interest rate and differences get larger, the single one set by ECB will be likely too high for some countries and too low for others, damaging the normal economic cycle.

Nevertheless, spillovers are just part of the story. Indeed, a common currency represents for each participating country the loss of its monetary sovereignty. Namely, Governments can no more use their exchange rates to boost their economies and, basically, cut wages [232]. This means that balance of payments deficits will quickly appear in the countries with higher costs, while those with the lower ones will pile up surpluses. It is hence clear that the only way to recover from a deficit position becomes a painful internal devaluation, something that clearly countries want to avoid [233]. There is hence also another the rationale to coordinate fiscal policies, competitiveness and thus macroeconomic imbalances. In details, this can be addressed mainly in two ways, control over inflation and control over the debt.

The first argument is straightforward. As inflation behaves differently in the currency union costs begin to vary creating a differential and eroding relative competitiveness . However this can no more be absorbed and adjusted by an accordingly devaluing exchange rate and hence deficits will accumulate. Firms and households will indeed find cheaper to buy products from abroad, while national products will find less buyers abroad. Consequently the internal manufacturing sector will proportionally decrease to the advantage of untradable services. Nevertheless, it is well known that an area or a country cannot consume more wealth than what it produces for much long and so a crisis is the natural outcome with its painful consequences. Hence, Governments must be stick to the common inflation rate in order to avoid these loss of competitiveness and deficits and their painful consequences.

232Krugman, 2011
233Krugman, 2011

A similar reasoning works also with debts. Namely debts with foreign countries have a parallel effect and usually are also associated with balance of payments deficits. The latter indeed can be financed either selling national assets, either at home or abroad, or taking more and more loans, as long as deficits pile up. However, the main point with debts is that, to pay them back with the interests, a country has again to consume less than what it produces and send the difference abroad. A balanced or in surplus budget hence avoids the future crisis as it can provide help to the endangered private sector and as it represents a lower dependency on capital markets for the Government in a moment when deficits get larger. At this point, it is particularly interesting to notice how the problem due to lost monetary sovereignty arises in both cases, inflation and debt, with the necessary compression of the internal demand, namely with a reduction of the standards of living. It is hence clear that, to avoid such a reduction, the only solution is a constant discipline in the fiscal policy.

Having so described the approach adopted by the European Union so far, it is then time to explain also the other factors involved. Among these secondary issues, a first one involves tax differentials. Indeed, as countries apply different tax regimes, firms working in the cheapest ones can produce at lower costs and hence be more competitive [234]. Similarly it works also with wages and workers rights, whose reduction gives firms an unfair advantage [235]. Moreover the same choices of public spending can affect the outcome. There is hence room for a further integration of fiscal policies to prevent imbalances, although this implies interpreting them in a broader sense than just the size of deficit and debt.

Anyway there is also another important factor in the equation, namely the above mentioned capital markets. Indeed they play a crucial role as they control the money

234Giacché, 2012
235Giacché, 2012

supply for Governments, firms and households. In particular, they can demand different returns in the different areas of the currency union according to the factors mentioned above. While higher inflation and balance of payments deficits would mean less creditworthy borrowers, other countries would exploit their better “fundamentals” and obtain lower interest rates. However, this cannot do more than exacerbate already existing trends of macroeconomic imbalances and low debt sustainability. Hence there is also a finance rationale for the control over fiscal policies, as it was imprinted in the Maastricht criteria concerning long-term interest rates.

Finally there is a political factor for fiscal policies coordination. Indeed, as Governments share all the same currency there are many spillovers and externalities, other than inflation and interest rates. A Government hence may not fully internalise the effect of its fiscal policies and engage in negative practises. Most notably, a country can run massive deficits boosting the interest rates of the whole union, as already said above. Contrariwise, all Governments may abstain from expansionary fiscal policies, hoping to free ride on the first mover in a chicken game. This, of course, results in a sub-optimal situation.

This and all the previous issues shows clearly that a monetary union needs a highly integrated fiscal policy. Indeed, this necessity grows as more the countries in the currency union are integrated through trade, labour market and business cycles. It is so clear that an area so interconnected like the EU cannot avoid the topic and, contrariwise, must dedicate to it all its efforts. It can even be claimed that what done till now is not enough, but anyway it cannot be denied its urgency and relevance. Therefore, after discussing the rationales behind all the story, it is finally time to see how the European Union managed to reform the coordination of its fiscal policy under the crisis.

The reform day by day

2007: The calm before the tempest

The events and rationales described in the previous two chapters hence urged the European Union to reform its then fiscal policy coordination when the crisis emerged. Nevertheless, the EU reacted slowly; in 2007, while the crisis was blowing up in the USA, the European Heads of State and Government felt safe and stable and didn't forecast what was happing [236] [237] [238]. They initially called for compliance with the revised Stability and Growth Pact, looking in particular to the MTOs and structural reforms [239]. More in detail, even before the crisis actually hit the continent, they focused on long-term sustainability of public finances through cuts of pension and health care systems, reduction of debt and increase in productivity and employment rates [240]. They also mentioned the quality of public finance as it needed “to be improved by raising efficiency and effectiveness of spending, by restructuring public expenditure in support of measures that promote productivity and innovation and by strengthening human capital with a view to raising the long-term growth potential of the economy” [241]. Nevertheless these were felt as non-urgent needs as “Europe [was] currently enjoying an economic upswing and reforms [were] starting to translate into growth and jobs” [242]. Similarly to what stated in March, also the following meeting in June and December claimed that the “macroeconomic fundamentals in the EU [were] strong and that sustained economic growth [was] expected” [243]. In particular that was justified by the assumed fact that the “Lisbon Treaty [provided] the

236European Council, 2007a
237European Council, 2007b
238European Council, 2007c
239European Council, 2007a
240European Council, 2007a
241European Council, 2007a
242European Council, 2007a
243European Council, 2007c

Union with a stable and lasting institutional framework" [244] without the need of expected change in the foreseeable future [245]. Furthermore, just to show the belief of a stable stronghold Europe in the midst of someone else crisis, it must be highlighted how the Reflection Group created to establish the new strategy for the period 2020-2030 was explicitly forbidden to discuss institutional or financial issues [246].

2008: The tempest

The attitude remained the same also for most 2008, in what seemed an approach aimed at waiting for the evolution of the crisis hoping it would not cross the Atlantic. Indeed the European Council met a first time in Spring 2008 and claimed with the maximum strength that the "fundamentals of the European Union economy [remained] sound" [247] already in the first row of its conclusions. At the same time, it underlined the relevance of the National Reform Programmes and of the Integrated Guidelines for Growth and Jobs to avoid excessive exchange rate moves [248]. It subsequently finished calling both member States and the Council to approve them, reaffirming their validity notwithstanding the intervened events [249]. After this, again the same belief was stated by the European Council in the following meeting during Summer 2008; for the EU Head of State and Government there was no need to change as the financial situation, although fragile, was recovering [250].

However, notwithstanding the previous confidence in a quick solution, the Autumn meeting took instead a different approach. Namely, the collapse of Lehman Brothers and the Icelandic bankruptcy showed that the crisis was evolving far beyond what initially

244European Council, 2007c
245European Council, 2007c
246European Council, 2007b
247European Council, 2008a
248European Council, 2008a
249European Council, 2008a
250European Council, 2008b

thought and was clearly not recovering. Facing these difficulties, the European Council stated in this meeting for the first time the principle that the Stability and Growth Pact could be infringed to protect the financial system, namely the banks and the other financial institutions [251]. Liquidity of the system became hence a primary target of the Union which totally committed itself to this end through all its institutions [252]. In this optic, the European Council contemporaneously welcomed also the coordinated action plan of the Eurozone member States and the following measures taken by the other non-Euro member States [253]. Similarly it welcomed too the creation of an informal alert mechanism which was meant to prevent further deterioration of the situation. However, notwithstanding these measures and the new course of action, the European Council did not change the mandate of the just appointed Reflection Group [254]. In brackets, it is also interesting to note how, among the Group members, there was also Mario Monti, later called by the Italian President of the Republic to lead the country outside the crisis following Mr. Berlusconi dismissals [255].

With this a new path was entered and the European Union became more active. In fact, more energetic actions were later taken in the following December meeting, in particular a 200 billion Euros re-launch plan for European economy [256]. Nevertheless this plan was again relatively small, although accounting to 1,5% of the EU GDP. Indeed, to give a benchmark, China invested during the same year 500 billion Euros with its own stimulus pack, while the soon to exacerbate Greek debt was then 263,3 billion Euros. This shows clearly how Europe continued to adopt a "wait-and-see" policy, acting only when forced and never of its own initiative. Indeed, the December meeting called also for a coordinated action both at European and especially at international level, trying to shift part of the

251European Council, 2008d
252European Council, 2008d
253European Council, 2008d
254European Council, 2008d
255European Council, 2008d
256European Council, 2008e

political and economic burden to partner countries [257]. Anyhow, the final document stated again the total commitment to protect the financial markets, specifying that member States would had to provide funds to banks without delay and that they would had to increase public spending while reducing capital taxes, thus effectively breaking the Stability and Growth Pact with the endorsement of the EU itself [258].

It is hence relevant to notice how a first informal reform of the fiscal policy coordination was performed in an unorthodox way, through the Conclusions of the two last European Council of 2008. Indeed, the Stability and Growth Pact, just reformed and invoked up to little before, was effectively put aside, at least temporarily, and wild public spending begun, as shown in the previous chapter. In particular large budget deficit were deemed necessary for the first time after many years of condemn. However, the relaxation of Stability and Growth Pact was still not enough as the aggravation of the crisis showed.

2009: Stimulus packages and Irish troubles

The year 2009 indeed opened with a new Spring meeting that, first of all, approved a new 200 billion Euros stimulus pack, summing up with the previous one to 400 billion Euros in just four months [259]. Nevertheless European Heads of State and Government recognised that the performed recapitalisation of the banking system could not be enough and hence invited to further actions [260]. These actions resulted later in the public acquisition of the so-called “toxic” assets, “financial assets whose value has fallen significantly and for which there is no longer a functioning market” [261], to relieve banks' balance sheets, although this happened at the expenses of public balances. For similar reasons the

257European Council, 2008e
258European Council, 2008e
259European Council, 2009a
260European Council, 2009a
261Wikipedia, March 11th 2012

European Council called also for more powers to the International Monetary Fund and, apparently contradicting what stated in the previous two meetings, called for a quick return to the Stability and Growth Pact criteria [262]. In particular, this last point was treated in details in the related Key Issue Paper [263]. This acknowledged that the Stability and Growth Pact had to be infringed to save banks, but also claimed that emergency had already finished and so EU had to revert back to Stability and Growth Pact compliance by 2010 or 2011 maximum according to each country fundamentals [264]. In this regard, the Key Issue Paper expressed its confidence that Europe would have managed to avoid the problem to spread, although it admitted that the financial system recapitalisation would have not paid back to the Governments [265]. It hence highlighted the need of further budget measures, in particular cuts, and explained how the crisis was actually the perfect moment to implement flexicurity and other structural reforms [266].

This Key Issue Paper hence further clarified the evolution of the fiscal policy coordination in the EU. While before, in the two previous meetings, it was generally stated the total commitment to financial stability endorsing the infringement of the Stability and Growth Pact, here the Stability and Growth Pact is re-established together with the total commitment [267]. Hence, according to the new doctrine, the budget criteria would have had to be met while at the same time expanding public expenditure in the financial sector. As the Key Issue Paper itself suggested, this could have been done only through cuts on other invoices of the public expenditure (health care, education) and through the so-called "structural reforms" (pension system, work protection) [268].

On the same position the European Council remained also in the June meeting, stressing

262European Council, 2009a
263Economic and Financial Affairs Council [ECOFIN], 2009
264ECOFIN, 2009
265ECOFIN, 2009
266ECOFIN, 2009
267ECOFIN, 2009
268ECOFIN, 2009

again the relevance of fiscal consolidation. However, it also introduced a new important principle in fiscal policy coordination, taking the chance from the then-current Irish crisis. It namely established that the EU would have abstained from any interference in taxation policy and would have not changed its competence on the issue [269]. This in particular ruled out from the coordination topic the national tax policies, allowing countries to continue their taxing competition. In the specific case, Ireland, although in crisis and taking financial aid from other countries, was allowed to not raise its 12,5% tax on capital, around 20 percentage points lower than those of other main countries in the EU. From this point onward hence Europe ruled out any hypothesis of a coordinated tax increase on capital to finance its budget and avoid fiscal dumping. Fiscal consolidation hence became a matter of cuts on public expenditure and taxes on natural people.

The same approach was then further restated in the September informal meeting. In particular the EU Heads of State and Government highlighted once more the need for fiscal consolidation, while also introducing a 5% of GDP stimulus pack for 2009-2010 and expressing the need for a G20 coordination [270]. Similarly they dealt with structural reforms calling for promotion of labour mobility [271]. On the other hand, the following meeting did not deal with the issue as it was focused on approving the Lisbon Treaty [272]. Finally, the last meeting of the year in December strengthened the initial position. The Stability and Growth Pact became a pillar of the EU and the consolidation, achieved as stated before, had to proceed well beyond the previous benchmark of 0,5% of GDP per year [273]. Nevertheless, the European Council agreed to unwind financial sector aids to help the fiscal consolidation, although the withdrawal would have to be done carefully to prevent

269European Council, 2009b
270European Council, 2009c
271European Council, 2009c
272European Council, 2009d
273European Council, 2009e

negative shortcomings [274]. This last meeting of 2009 was hence significant as it urged a higher convergence pace towards fiscal consolidation, even beyond what initially stated in the Stability and Growth Pact, signing the new priority of the EU.

2010: European Semester, Task Force Report and Greek tragedies

Nevertheless the newly-discovered interventionism quickly faded away. The EU soon reverted to its "wait-and-see" policy as it though to be safe while Greece was falling into the abyss. In particular, although even important efforts were made before, no real action was taken in the first two meeting of the year regarding the deteriorating Greek crisis [275] [276]. On the contrary, even limited direct intervention were denied [277]. Nevertheless, the contemporary European Council of March was finally forced to admit problems in the balance of payments and planned talks in June on the issue [278]. This resulted in the critical European Council of June 2010 which set three important reforms. First of all, evolution and level of debt surged to equal importance with deficit in budgetary surveillance, thus enlarging the original scope of the Stability and Growth Pact [279]. Secondly, it was agreed to strengthen both the preventive and the corrective arms of the same, whose insufficiency was officially deemed the cause of the high deficits and debts [280]. On third step, all member States were compelled to be inside the Stability and Growth Pact [281]. Finally the European Semester was established as a mean to control public budgets and finances [282].

In particular, the latter was the most important among these four decisions. The European semester is indeed an EU level policy coordination tool to implement effectively

274European Council, 2009e
275European Council, 2010a
276Head of State or Government of the Euro Area, 2010
277Head of State or Government of the Euro Area, 2010
278European Council, 2010b
279European Council, 2010c
280European Council, 2010c
281European Council, 2010c
282European Council, 2010c

the Stability and Growth Pact and the structural reforms called in the previous meetings. It is furthermore part of a larger scheme as it is complementary to the Euro Plus Pact [283]. More in details, the European Semester works on the budget of the following year respect to the one when it is performed and its activities can be divided in two phases; the first one up to the Spring meeting of the European Council, when material is produced by EU institutions, and the second one from then till the early summer, when the issue is on material produced by the member States. Everything is done in a six month period overall, hence the name. More in details, the process starts in January when the Commission issues its Annual Growth Survey "which sets out EU priorities for the coming year to boost growth and job creation" [284], on top of which the European Heads of State and Government issues in March the EU Guidelines for national policies [285]. The Member States have hence one month to implement these documents in their national plans "for sound public finances (Stability or Convergence Programmes) and reforms and measures to make progress towards smart, sustainable and inclusive growth (National Reform Programmes)" [286]. The plans are then handed in by April to the Commission which then revise them and provides recommendations for each single case [287]. This later revision is then in June discussed by the ECOFIN and endorsed by the European Council, while between the end of June and the beginning of July the ECOFIN finally approves it concluding the European Semester. All this process is indeed ultimately aimed at allowing Member to include EU recommendations in their national plan at an early stage of their development, achieving hence a better coordination of budgetary, macroeconomic and structural policies [288]. Hence the European Semester represented a great step forward in a closer fiscal policy coordination inside the EU, although limited in its contents by the previous exclusion of

283European Council, 2010c
284European Commission, 2010
285European Commission, 2010
286European Commission, 2010
287European Commission, 2010
288European Commission, 2010

taxation policy.

It was therefore natural that the following meeting of the European Council in September 2010 declared its satisfaction for the progress made [289]. However new problems arose before the October meeting, which was again forced to take new actions. In particular, the latter expressed the need for both higher fiscal discipline and a permanent crisis mechanism, while at the same time endorsing the Task Force Report [290]. The Report introduced many issues later implemented through several reforms. First of all it dealt with the preventive arm of the Stability and Growth Pact, suggesting that, in case of infringement, the Council should issue a compulsory recommendation within one month alongside with a deadline for its implementation by the infringing member State [291]. At the same stage it also proposed to introduce an interest-bearing deposit whether the infringing country had not corrected its behaviour in 5 months, reduced to 3 in case of serious violations [292]. Regarding then the corrective arm of the Stability and Growth Pact, the Task Force supported the introduction of an immediate non-interest-bearing deposit, compulsory if already under sanction from the corrective arm or merely possible otherwise [293]. Moreover it also advised a system of automatic fines to be activated in case the infringing member State would not take actions effective enough [294]. Furthermore it also proposed a change in the voting procedure about sanctions in the Council itself, supporting a reverse qualified majority voting [295]. While up to that moment fines were proposed by the Commission and later approved by majority voting by the Council, the new system presented was designed such that the Commission decided on the sanctions and the Council could only repeal them with a qualified majority. This was meant to increase the

289European Council, 2010d
290European Council, 2010e
291Task Force on Economic Governance, 2010
292Task Force on Economic Governance, 2010
293Task Force on Economic Governance, 2010
294Task Force on Economic Governance, 2010
295Task Force on Economic Governance, 2010

enforceability of the sanctions greatly reducing the possibility to repeal them through political agreements among countries; indeed the new rule provided that a small minority was enough to enact the sanction. Finally the Task Force proposed to expand the Stability and Growth Pact beyond Governments' budgets into macroeconomic flows. In particular it supported the introduction of an alert mechanism for macroeconomic imbalances and of an excessive imbalance procedure based upon the previous excessive deficit procedure [296]. All these proposals were then enacted in the following months through several decision of the European Council, making this Task Force one of the most influential think-tank in Europe. Nevertheless, it is relevant to notice how much the situation changed as the Task Force went clearly against its original mandate which explicitly precluded institutional and financial issues.

Indeed, such was the change and the relevance now attributed to the topic that already in the December meeting the European Council passed the creation of the European Stability Mechanism (ESM) [297]. This fund was meant to provide financial resources to countries unable to normally finance themselves on the market. In doing this it would have first cohabited with and then replaced from July 2013 the two previous financial instruments of the EU, the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) [298]. The ESM was moreover embedded in the Treaties themselves with a reform of the Article 136 of the TFEU, which also specified that ESM intervention would have been granted only in cases of threat to the whole Union and under strict conditionality [299].

296Task Force on Economic Governance, 2010
297European Council, 2010f
298European Council, 2010f
299European Council, 2010f

2011: Tightening up

The following year hence begun under good omens, with the backing of the Task Force Report and of the newly established ESM. Indeed, the first meeting in February declared its satisfaction with the so-far evolution of the crisis in both Ireland and Greece and took no further actions [300]. Similarly also the following meeting expressed the same position regarding the two countries in crisis as austerity measures were deemed to be working effectively [301]. Nevertheless this time the European Council took also important decisions. It indeed established the size of the ESM, namely 500 billion Euros at full capacity, and explicitly restated that financial aid would have been available only if the Euro itself would have been at stake [302]. In particular, the interventions would have taken place as loans or acquisitions on the primary market under strict conditions for the borrower, among which there would have been also a reference to market interest rates, as the ESM would finance itself on the market [303]. Moreover, the same meeting also approved the Pact for the Euro, another cornerstone of the reforms [304].

Indeed, the Pact for the Euro adopted a set guidelines to strengthen the economic policy coordination of the EU [305]. In particular, among these there were four main points. First of all, to reduce balance of payments deficits, wages would have to be adjusted according to relative competitiveness [306]. In details, the Unit Cost of Labour would be taken into account across the Union as a whole, single countries and single sectors, thus endorsing the labour cost deflation as main tool to exit imbalances instead of fiscal policy tools [307]. The second issue raised regards the sustainability of public finances over the long run, calling for

300European Council, 2011a
301Head of State or Government of the Euro Area, 2011a
302Head of State or Government of the Euro Area, 2011a
303Head of State or Government of the Euro Area, 2011a
304Head of State or Government of the Euro Area, 2011a
305Head of State or Government of the Euro Area, 2011a
306Head of State or Government of the Euro Area, 2011a
307Head of State or Government of the Euro Area, 2011a

adjustments to pensions, health care and social benefits [308]. In particular, these should adapt to a longer lifespan and hence foster a longer working life [309]. The third point then claimed again the commitment towards the Stability and Growth Pact, although specifying that the methods to achieve it remained national prerogatives, partially disregarding what said in previous meetings and above [310]. Finally, in the last step, a concrete yearly commitment towards reforms was declared and decided to be embedded in the "National Reform Programmes and Stability Programmes submitted each year" [311].

However, in addition to the Pact for the Euro the meeting of March 2011 passed also another important bill as it decided the features of the ESM [312]. This would be based on the structure of the previous EFSF and would encompass a certain amount of private sector involvement [313]. Indeed, the ESM will partially finance itself on the market and hence will price its loans taking into account market rates [314]. Moreover, ESM assistance was established to be conditional to economic and fiscal adjustments and to an analysis of the debt sustainability, but also that it would depend on the unanimity of the Eurogroup [315]. Finally, "to facilitate this process, standardized and identical collective action clauses (CACs) [were] included" [316] so that creditors would be able, like in UK and US, to "to pass a qualified majority decision agreeing a legally binding change to the terms of payment (standstill, extension of the maturity, interest-rate cut and/or haircut) in the event that the debtor is unable to pay" [317].

These two acts, the Pact for the Euro and the General Features of the ESM, are hence important for the fiscal policy coordination for two main points. The first one indeed

308Head of State or Government of the Euro Area, 2011a
309Head of State or Government of the Euro Area, 2011a
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311Head of State or Government of the Euro Area, 2011a
312Head of State or Government of the Euro Area, 2011a
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317Head of State or Government of the Euro Area, 2011a

defines what are the areas of intervention, going against what previously said about national prerogatives. Namely, if taxation remained independent and uncoordinated, the direct State intervention in economy through the welfare state became regulated and the field of a downward competition due to capital mobility and capital arbitrage preventing single country tax raises. In this view it can so be better understood the focus on the reduction of pensions, health care and social benefits called so strongly by the European Union. Similarly, the second point provided a threat to do so as financial aid will be conditional to the implementation of such reforms. Hence, countries, unable to finance themselves through capital taxes and unable to get financial transfers from the Union, will be forced to run downward.

The same orientation was again restated in the meeting at the end of March. Again balanced and sustainable budgets are called as main objective of the EU and labour reforms were pointed as main source to achieve them [318]. However, in the framework of the European Semester, there was a steep acceleration in the proposed consolidation plan as now the previous yearly benchmark of 0,5% of GDP was no more considered a sufficient reduction towards balanced budget and hence the EU called for a faster convergence towards balanced or in surplus budgets [319]. In addition to this reinforcement of what already stated on balanced budgets, this meeting passed also two important acts, the Six Pack and the Euro Plus Pact.

The Six Pack is a group of five regulations and one directive that would have been finally approved by the European Parliament later the same year in October and hence represent a piece of EU secondary law. Their main goal is to strengthen and widen the Stability and Growth Pact in several aspects, taking into account the earlier Task Force report. Indeed, already in the preventive arm there are many changes, even beyond what

318European Council, 2011b
319European Council, 2011b

have been suggested originally. Namely, expenditure growth is compelled to be lower than MTO GDP growth to reduce the presence in the economy of the Government whose revenues must be fully devoted to debt repayment [320]. Moreover, fines as interest-bearing deposits are already put in place at the preventive arm level to an amount of 0,2% of GDP[321]. Similarly, also on the corrective side there is a strengthening of previous positions. Emphasis is now put on both debt and deficit, when the former must be reduced every year by one twentieth of the part exceeding 60% of the GDP [322]. Moreover, also fines are increased, following what suggested in the Task Force report [323]. There are however other issues that do not simply strengthen the Stability and Growth Pact, but also widen its scope. Namely, budget will now be designed on the basis of multi-annual fiscal plans to comply with the MTO [324]. Similarly this and the Stability and Growth Pact will be translated into national constitutions as the strongest way to enforce compulsory balanced or in surplus budgets [325]. Furthermore, the excessive deficit procedure will now be sided by an excessive imbalance procedure modelled on the former to attack balance of payments deficits [326] [327].

Similarly the other act, the Euro Plus Pact, follows the same ideology. Labour cost is again quoted as main source of fiscal problems and so it can be now, after many repetitions, be considered a matter of fiscal policy [328]. In particular it is explicitly stated that the labour costs, namely wages (direct, indirect and deferred), must be reduced [329]. In this optic, pensions, health care and social benefits are again put under inquiry and their

320Regulation (EU) N°1175/2011 of the European Parliament and of the Council, 2011
321Regulation (EU) N°1173/2011 of the European Parliament and of the Council, 2011
322Regulation (EU) N°1177/2011 of the European Parliament and of the Council, 2011
323Regulation (EU) N°1173/2011 of the European Parliament and of the Council, 2011
324Council Directive 2011/85/EU, 2011
325Council Directive 2011/85/EU, 2011
326Regulation (EU) N°1176/2011 of the European Parliament and of the Council, 2011
327Regulation (EU) N°1174/2011 of the European Parliament and of the Council, 2011
328Euro Plus Pact, 2011
329Euro Plus Pact, 2011

reduction for sustainability reasons is called another time [330]. Moreover, receiving what stated in the Six Pack, also the Euro Plus Pact establishes that EU fiscal rules must enter national Constitutions [331]. However, confirming what already stated in previous meetings, tax policies coordination is explicitly repelled, although informal non-binding discussions are allowed [332]. Finally, the Pact restates the concrete yearly commitment, already mentioned and described in previous documents [333].

These two acts represented a turning point in the fiscal policy coordination of the EU. Indeed, they widened it to the balance of payments and to the labour market, but especially they laid the fault for all these problems in the public budget, endorsing a precise view of the world. Moreover, the public budget was in turn compelled to reduce its size and width both in relative and absolute terms, claiming that privatisations and deregulation were the proper way to exit the crisis. Indeed, just few months later a Deutsche Bank report to the German Government would have endorsed massive dismissals of public wealth and wild laissez-faire in every sector [334]. Furthermore the strict EU interference with national public expenditure was in stringent contrast with the absolute freedom left to tax policy, reinforcing the above mentioned downward pressure on both capital taxes and welfare state. Finally the assumption of these rules at national level represented the beginning of a new approach by the European institutions towards countries, in what Mario Monti described as a cession of national sovereignty [335].

These two documents were so important that also the following meetings dealt with them. In particular, the June Council positively assessed both the results of the first European Semester, whose conclusion was marked exactly by that event and the

330Euro Plus Pact, 2011
331Euro Plus Pact, 2011
332Euro Plus Pact, 2011
333Euro Plus Pact, 2011
334Bräuninger & Steimer, 2011
335Romaunita, 2011

commitment to the Euro Plus Pact [336]. More in details, while dealing with the latter, the Council stated that the participating countries should prepare their next commitments taking into account a broader scope, a more concrete approach, a higher degree of ambition and a pragmatic coordination of tax policies [337]. However it must be noted that the last of these four points, although highly promising and apparently correcting EU fiscal arbitrage problems, remains rather weak as it is limited to countries signing the Euro Plus Pact, it mostly concern exchange of best practises and especially it is left to individual free will [338]. Furthermore, the July meeting of the EU Heads of State and Government called for a quick approval of the two, to gain a renewed confidence from the markets [339]. Indeed, the public debt crisis was contemporaneously worsening with Greece so much in trouble that a 109 billion Euros loan was required in conjunction with the IMF [340]. However, this was not a single case as also Portugal and Ireland needed help for their trembling situation [341]. Nevertheless, just few months later, the EU expressed its certainty that the crisis would have ended as a result of the European Semester, of the Euro Plus Pact and of the Six Pack[342]. Nevertheless, to ensure a quick recovery, they also passed a 25% reduction of the administrative burden and the Single Market Act, a twelve point plan to boost growth [343].

Anyway, also at the end of October, two other important decisions were taken. Namely, notwithstanding all the previous issues on Stability and Growth Pact criteria, the EU issued renewed guarantees to the banking sector, in particular on the new bonds [344]. Italy alone guaranteed 100 billion Euros of Italian banks' bonds, heavily burdening its public accounts[345]. At the same time, the ESM was finally ratified by all member States and so

336European Council, 2011c
337European Council, 2011c
338European Council, 2011c
339Head of State or Government of the Euro Area, 2011b
340Head of State or Government of the Euro Area, 2011b
341Head of State or Government of the Euro Area, 2011b
342European Council, 2011d
343European Council, 2011d
344Head of State or Government of the Euro Area, 2011c
345C, 2011

was going to enter into force [346]. Similarly, starting from ESM access conditions, the EU called again for fiscal consolidation to be achieved through structural reforms [347].

Finally, in the last meeting of 2011, the EU Heads of State and Government declared their commitment towards the new fiscal rules [348]. In details, these mostly repeated again things already decided. The Stability and Growth Pact had to be brought at constitutional level, fiscal reports had to be drafted ex-ante and convergence towards the reference level had to proceed by calendar [349]. Nevertheless a new important specification regarded the annual structural deficit that now was set to be less than 0,5% of the GDP [350]. The latter decision in particular openly endorsed the adoption of cyclically adjusted budgets as well as put in jeopardy state investments in the long-period. Following these new fiscal rules, the Council restated the reform of the Excessive Deficit Procedure, whose benefits would help to create greater commitment towards fiscal discipline and hence gain more confidence from the markets [351]. Furthermore, another important issue was the request by the Commission to have intervention rights in the national draft budgetary plans [352]. Finally, the ESM was rescheduled to enter into activity since July 2012, one year in advance, and an emergency voting procedure was established [353]. This in particular will be structured as "the mutual agreement rule will be replaced by a qualified majority of 85 % in case the Commission and the ECB conclude that an urgent decision related to financial assistance is needed when the financial and economic sustainability of the Euro area is threatened" [354].

This last meeting of 2011 passed several important issues for many reasons. More in

346Euro Summit, 2011
347Euro Summit, 2011
348Head of State or Government of the Euro Area, 2011d
349Head of State or Government of the Euro Area, 2011d
350Head of State or Government of the Euro Area, 2011d
351Head of State or Government of the Euro Area, 2011d
352Head of State or Government of the Euro Area, 2011d
353Head of State or Government of the Euro Area, 2011d
354Head of State or Government of the Euro Area, 2011d

details, the new fiscal rules and especially the limit of the structural deficit put, as already said, a burden on Government intervention in the economy. Especially they limit public investments in sectors likely to fall into market failures, like infrastructures. Similarly the constitutionality of the Stability and Growth Pact will prevent ad hoc solutions of temporary higher deficits like those of the initial phases of the crisis, when billion were given as aid to the financial sector. Furthermore, the Commission proposal signs a step onward in the above mentioned cession of sovereignty of member States, moving economic programming from national Parliaments into the hands of the unelected Commission.

2012: Will compactness be enough?

Following these decisions, the first meeting of 2012 welcomed another important act, like the Euro Plus Pact or the Six Pack. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, also called Fiscal Compact, indeed systematised all the previous decisions into a single act with Constitutional force. Indeed, it explicitly called for the emendation of national Constitutions as to include all the following issues [355]. First of all, the budget will have to be compulsory balanced or in surplus and will have to be cyclically adjusted. In details, the annual structural balance will have to be at its MTO with a lower limit for the structural deficit of 0,5% of GDP [356]. However, this last measure will be partially released for countries with debt well below 60% of their GDP and with no issues of sustainability, allowing them to have a lower limit of 1% [357]. Moreover it was again restated the compulsory yearly cut by one twentieth of the debt above 60% of

355Treaty on Stability, Coordination and Governance in the Economic and Monetary Union [Fiscal Compact], 2012
356Fiscal Compact, 2012
357Fiscal Compact, 2012

the GDP, as decided in the Six Pack [358]. Furthermore it was established that a country under excessive deficit procedure will have to present a budgetary and economic partnership programme to the Council and the Commission [359]. This will include “a detailed description of the structural reforms which must be put in place and implemented to ensure an effective and durable correction of its excessive deficit” [360]. Furthermore, the content and format of the budgetary and economic partnership programme will be defined in the EU law and will have to be endorsed by the Council of the European Union and the European Commission within the Stability and Growth Pact framework [361]. Another topic of the Fiscal Compact is the compulsory report to the EU of plans regarding issuance of debt to achieve better coordination [362]. Furthermore, the reverse qualified majority voting was again restated [363]. In addition, the Treaty also established that fines will be now sided by a direct intervention of the European Court of Justice [364]. Finally, also the Euro Summit was established [365].

Anyway, it is interesting to notice how the Fiscal Compact differs from the previous agreements. Indeed, while the others were all passed through the normal procedures, the opposition of Great Britain and Czech Republic broke unanimity and made impossible to follow the same path. The Fiscal Compact had hence to be written as an intergovernmental treaty. This meant that it rests at a lower level than what originally planned. Nevertheless, as part of the so-called “closer cooperation”, it is still enforceable. In particular, the EU Court of Justice is given by the Fiscal Compact itself the authority and power to set fines and oversee its well-functioning. In addition, ESM financial aid will be granted only to adherent countries, giving a further incentive. However, it must be remembered that, for

358Fiscal Compact, 2012
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364Fiscal Compact, 2012
365Fiscal Compact, 2012

how strong and binding an international agreement can be drawn, public international law remains a precarious field, ultimately subject to mere convenience and strength.

Finally, the June meeting of 2012, the last up to now, took two important decisions. First of all it approved the transformation of the ESM into a fund able to recapitalise banks directly, effectively disrupting its original purpose [366]. In particular, the Euro Summit justified its apparent contradiction stating that this was due to its “strong commitment to do what is necessary to ensure the financial stability of the euro area, in particular by using the existing EFSF/ESM instruments in a flexible and efficient manner in order to stabilise markets” [367]. Regarding the second decision then, the European Council endorsed the report “Towards a Genuine Economic and Monetary Union” which established “four essential building blocks for the future EMU: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework and strengthened democratic legitimacy and accountability” [368]. In particular, these called for integrated supervision of the financial sector, a common authority chairing an European deposit insurance scheme and an European resolution scheme, a coordination of sovereign debt issuance and an analysis for common debt issuance [369].

Anyway, reached this point and the latest decisions, it is finally time make an assessment of what the European Union has done so far. Actions, inactions and contradictions must so be scrutinised to see their effectiveness in targeting the assumed goal, to defeat the crisis and improve coordination. However, to improve the quality of such assessment, it is also interesting to briefly recap the present situation after all these changes and then to analyse how other federal countries managed to coordinate their own fiscal policies.

366Euro Summit, 2012
367Euro Summit, 2012
368European Council, 2012
369Van Rompuy, 2012

A Final Overview of the Reform

Having illustrated above all the different steps done by the European Union it is hence time to finally consolidate the reform into a single body. This can then be divided in three parts: the reform of the fiscal policy coordination strictly speaking, the creation of the macroeconomic coordination and the institution of mechanisms to deal with crises in individual countries.

Regarding the first part there are many changes to the plain vanilla Stability and Growth Pact of the beginning. Just to start and to follow chronological order, the Six Pack introduced in this area a limit to public expenditure growth in the preventive arm of the Stability and Growth Pact. This sets out a ceiling such that public expenditure growth cannot exceed the reference MTO GDP growth rate in order to both reduce the Government involvement in the economy and to devote all revenues to debt repayment. Moreover, the Six Pack integrated this provision enforcing already at the preventive arm fines for violation in the form of a 0,2% of GDP interest-bearing deposit. Similarly, also the corrective arm was changed by the Six Pack, in this case with a higher relevance of debt. In particular, now the Member State having a debt above 60% of its GDP must reduce it by one twentieth of the exceeding part each year, a provision this restated also in the Fiscal Compact. However, these are not the only changes in the area due to the Six Pack. Indeed, this brings two other contributions; namely, it first increased the fines in the corrective arm and it secondly supported, together with the Euro Plus Pact and the Fiscal Compact, the introduction of balanced or in surplus budget requirements in national Constitutions.

Said so, the reform of fiscal policy coordination strictly speaking was affected also by

the Fiscal Compact, as it can be understood from above, although this is limited to all EU Member States but the United Kingdom and the Czech Republic. Indeed, this Treaty established the adoption of the cyclically-adjusted budget when to measure deficits or surpluses. Moreover it ruled that the annual structural balance at MTO can have a maximum structural deficit of 0,5% of GDP. However, this can be increased up to 1% in some circumstances, namely if the debt is well below 60% and there's no risk for sustainability. Furthermore, the Fiscal Compact stated that a country under excessive deficit procedure must handle to the Commission and the Council a budgetary and economic partnership programme which would act as a road map towards deficit solution. Finally, the same Treaty established also a reverse qualified majority voting system on sanctions so to make them more enforceable.

The last contribution to the first part comes then from the European Semester. Indeed, although not modifying the Stability and Growth Pact directly, it made up the framework for its effective implementation. Indeed, as a EU level policy coordination tool, it allows a proper review of national policies by the Commission so to correct any mistake. In particular, it should be noticed how it is complementary with the previously mentioned acts. Namely, it states, as already explained above, that in the first semester of the year the Commission and the national Governments must interact to set up national policies. More in details, the January Annual Growth Survey issued by the Commission becomes the basis for March EU Guidelines on top of which Member States draft their plans, namely their Government budgets, for the following year in April. Such plans are then checked and corrected by the Commission with the endorsement of the ECOFIN and of the European Council in June. At this point, it must be strongly highlighted how, firstly, all this happens before the budget is discussed in the Parliament of the Member State, secondly, how the Commission can completely rewrite the budget and, finally, how the corrections are

mandatory since their infringement would lead to a fine of 0,2% of GDP. It is hence possible to say that, with the European Semester, there is a perfect coordination on fiscal policies as the Government budget itself is corrected or written by the Commission.

Passing now to the creation of the macroeconomic coordination, it must be acknowledged that this is mostly laid down through the Six Pack. Indeed, this created a new excessive imbalance procedure modelled on the previous excessive deficit one, although with due differences. This indeed was meant to detect, prevent and correct macroeconomic imbalances within the European Semester framework. Starting hence from the basis, the Six Pack starts defining imbalances as "any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole" [370] rather than adopting a quantitative approach like that used for the excessive deficit procedure. It then established an alert mechanism to permanently monitor the situation and on whose top the Commission will have to write a "qualitative economic and financial assessment based on a scoreboard with a set of indicators the values of which are compared to their indicative thresholds" [371]. Already from these two points it appears clear that the Council and the Commission, although inspired by the previous experience, adopted a partially new approach preferring a qualitative one.

Regarding then the scoreboard mentioned before, article 4 paragraph 2 states that it "shall comprise a small number of relevant, practical, simple, measurable and available macroeconomic and macrofinancial indicators for Member States. It shall allow for the early identification of macroeconomic imbalances that emerge in the short-term and

370Regulation (EU) N°1176/2011 of the European Parliament and of the Council, 2011
371Regulation (EU) N°1176/2011 of the European Parliament and of the Council, 2011

imbalances that arise due to structural and long-term trends” [372]. In addition to this, the Six Pack charged also the Commission with the task to perform an annual in-depth review of each Member States to assess its likelihood to be affected by imbalances.

Said this, the Six Pack established also a preventive arm based on public recommendations communicated to the European Parliament and reviewed during the European Semester. However, may this not be enough, also a corrective arm is created. Namely, the procedure is opened by a statement of the Commission together with some recommendations. The Member State must hence submit its corrective plan which will be assessed within two months by the Commission which in turn can still reject it and pretend a new one in two months. Anyway, if the plan is finally approved, the Commission will overlook and the assess the outcome and eventually close the procedure. However, in case of persistent imbalance and insufficient actions, the Commission will be able to sanction the infringing country with a 0,1% of GDP interest-bearing deposit.

To complement these provisions, the Euro Plus Pact states that macroeconomic imbalances must be solved through structural reforms involving the labour cost, which must meet productivity, and the sustainability of pensions, health care and social benefits.

Said this, it is finally time to move to the third and last part, namely the institution of the mechanisms to deal with crises in individual countries. The first thing to say on the topic is that it represents a difficult field as the last meeting of the Council changed the nature of the ESM, the European Stability Mechanism. Indeed, originally, this would have replaced the former EFSF from July 2012 and would have provided assistance to distressed Member States under the conditionality of Eurogroup unanimity and of economic and fiscal adjustment. However, there is an ongoing revision of the Treaties to reform the ESM and, among the possible options under discussion, there's its transformation into a fund to save

372Regulation (EU) N°1176/2011 of the European Parliament and of the Council, 2011

banks. Clearly, due to this, there is a high degree of uncertainty on the future of this institution.

Having briefly recapped the present situation, it is then clear how there are huge differences among the three parts. The first one is the most detailed, with a quantitative approach, as years of practice evolved into a deeper knowledge of the subject. The second part, then, is less detailed, but taking from the similarities with the first it can still be pretty accurate. Finally, the third one represents a whole new sector and hence is still under construction. However, it is finally time to move on and see the other ways other countries have managed their fiscal policy coordination during the last centuries.

The ways of fiscal policy coordination are infinite

EU, you are the only one, but...

The first thing to acknowledge once comparing the European Union with other federal States is that the EU is not a federal State. Indeed, the EU is a "unique form of monetary union with no historical precedent" [373]. Hence, every analysis of this kind must take into account the differences, even large, between the supranational organization of the EU and the other experiences around the world. In particular, to remain close just to the topic of fiscal policy coordination, it is necessary to define first two concepts: monetary union and fiscal union. Indeed, while both are typically present in federal States, only the first one is actually enforced in Europe.

Regarding the concept of monetary union, it means a set of States which share the same currency. It can also be described as "complete abandonment of regional or separate national currencies and full centralisation of monetary authority into a single joint institution" [374]. Fiscal union, on the other side, relies heavily on fiscal federalism which can be described as "cooperative arrangement between the members of the fiscal union regarding the design and distribution of taxes and public expenditures" [375]. Obviously, only the first concept is embodied in the EU, which lacks the second one.

Said this and keeping in mind the necessary caution, it is now possible to proceed and analyse some of the most notable experiences of federalism in the recent history. In particular, next sections will deal one after the other with the United States of America, Canada, Germany, Argentina, Brazil and Australia.

373Bordo, Markiewicz and Jonung, 2011
374Bordo et al., 2011
375Bordo et al., 2011

The United States of America

The United States of America adopted fiscal federalism since their independence in 1776, however much of that initial period must be said [376]. In particular, the so-called Pre-Federal Period, when the Articles of Confederation were in force before the Constitution, was characterised by huge prevalence of the single States. Indeed, the Federal Government had mainly three areas of competence: international trade, international treaties and the debt contracted in the War of Independence. On the other side, single States could instead raise autonomously taxes, print their own currencies, set their expenditures and even form separate armies [377]. To make a comparison, the situation was not far different from the initial steps in modern European integration after World War II. It is hence possible to say that, at the beginning of their history, the USA were in a group of States with a monetary union, but with no fiscal union. Indeed, it can be recalled that the Federal Government became able to collect taxes only in 1913 with the 16th Constitutional Amendment [378].

Anyway, also the USA evolved between the end of the eighteenth and the first decades of nineteenth century experimenting further integration. Namely, with Hamilton's debt consolidation in 1790, it emerged how some States were able to pay back their debt, while others not [379]. Similarly it emerged how single surplus States didn't want to bail out their fellows deficit ones ultimately forcing a Federal bailout thanks to a political compromise on the location of the future federal capital [380]. More in details, this bailout presented peculiar characteristics worthy to be mentioned. First of all, it bailed out also surplus States as the whole debt issued by States became federal [381]. This was then sided by a horizontal

376Bordo et al., 2011
377Bordo et al., 2011
378Wikipedia, June 29th 2012
379Wikipedia, July 3rd, 2012
380Wikipedia, July 3rd, 2012
381Gros, July 2nd 2012

transfer system which levelled the pro-capita burden of debt for surplus States through federal credits [382]. Moreover, the bailout covered just a precise stock of debt and stated explicitly the denial of further interventions [383]. Furthermore, the bailout included also a debt restructuring to reduce the yield from 6% to 4% with a loss in net present value of 50% [384]. Finally, it must be remembered that the state debt was then 18 million dollars, while the federal one was 40 million dollars, making the bailout an important but not overwhelming burden for Washington [385].

After this event however, States started to pile up debt between 1820 and 1840 believing in the support of the federal Government once problem would have risen [386]. However, things went in a different way when Washington made clear that any central support would have been limited, letting these States to go bankrupt [387]. This became the general rule seeing limited federal intervention and even limited federal funds. Indeed, the period up to 1901 was called dual federalism as “it was characterised by little collaboration between the national and state governments” [388].

Nevertheless, this behaviour, already touched by the 1913 reform, was soon challenged by the '29 Crisis which forced a major public intervention under the federal umbrella [389]. The so-called New Deal set the pace for a progressive expansion of federal expenditure which later culminated in the Lyndon Johnson's Great Society with pervasive grant-in-aid and federal regulations [390]. This of course changed deeply the US financial system into its present form where elements of the initial State supremacy mix with more recent centralisation attempts. In particular, States are today free to set their own tax base and

382Gros, July 2nd 2012
383Gros, July 2nd 2012
384Gros, July 2nd 2012
385Gros, July 2nd 2012
386Bordo et al., 2011
387Bordo et al., 2011
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389Bordo et al., 2011
390Bordo et al., 2011

rate, but their share on total public expenditure shrunk notably [391]. Washington accounts indeed for 47% of the total, while state and local Government divide equally the remaining 53% [392]. Regarding then this expenditure, sub-national Governments are free to borrow, although nearly all of them amended its Constitution to include a balanced budget clause[393]. Said this it must be remembered that still today the USA lack a federal-state coordination mechanism for their fiscal policy, in particular regarding revenues sharing as there are no transfers for imbalances [394]. Moreover, it must also be said that, although there is no transfer, the public expenditure is divided in such a way that the bankruptcy of one State does not hit excessively the single citizen as most of the programmes, like Medicare, are on federal basis.

The US case is hence useful mostly for its similarities with the initial development of the EU. Namely, they were both born out of independent nations which later merged and progressively gave away their sovereignty. Nevertheless, the solutions finally adopted by the US are not the only ones tried by humans, especially concerning transfers.

Canada

Remaining indeed in North America, there is the alternative experience of Canada. The country was namely born merging more British Dominions (Provinces) into a federation to prevent US expansionism and also its fiscal policies were similarly specular to the US ones. Moreover, this is an interesting case because up to 1949 Canada was split in more dominions and hence for most of its history did not represent even a monetary union [395]. Nevertheless, when a monetary union was finally implemented, it embedded also a fiscal

391Bordo et al., 2011
392Bordo et al., 2011
393Bordo et al., 2011
394Bordo et al., 2011
395Wikipedia, July 1st 2012

one.

However, looking at recent history, the '80s saw the crisis of provincial debt, especially in Ontario, to which the central Government answered with a public intervention of the Central Bank itself [396]. However, the differences are not limited to the bailout support. Indeed, since the '90s Provinces, which also collect taxes, represent the absolute majority in public expenditure as local Governments are mere territorial divisions of these [397]. More in detail, the expenses are divided according to the involvement of public services or transfers, where the latter are federal matter and the former provincial [398]. This implies a certain degree of transfers between Federal and State levels which could suggest a pro-bailout approach, like what happened with Ontario.

Nevertheless in the past years something changed and today bailouts are officially banned [399]. Although this moved them closer to the US method, Canada applies also a system of coordination completely lacking in the USA, showing once more its difference[400]. It can hence be seen easily how similar initial conditions, that even may fear annexation, can evolve in diverging and equally successful solutions.

Germany

Turning now back to old Europe, the main federal Government is Germany which dates back its form to the Holy Roman Empire. The actual structure was anyway born after War World II and the defeat of Nazi-fascism. The latter had in particular applied its totalitarian views also to the German institutional framework and hence, as answer, the newly democratic Germany adopted back a federal structure which remained unchanged also

396Bordo et al., 2011
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after the annexation of East Germany [401]. In particular, it can be noticed how Germany can date its system of monetary and fiscal union to the German Empire of Bismark, which was deeply involved with the Bavarian debt management [402].

Nevertheless this system showed immediately a difficult cooperation between Berlin and the Länder (federal entities) as the "rather competitive structure of the German federation reduced the financial responsibility of the already largely transfer-dependent Länder" [403]. In particular, although Germany built its fame on rigour and severity, the no bailout clause has never been fully credible for many reasons [404]. More in detail, the fiscal performance was often less than admirable, especially in two occasions [405]. The first one occurred in 1987 when the Länder of Bremen and Saarland were bailed out with the support of the Constitutional Court, creating a powerful precedent, while the second when in 2002 the Stability and Growth Pact itself was infringed [406]. However, these facts did not urge the German Government to change its policies and since then there has been no change [407].

In addition to this already not optimal situation, between the end of June and beginning of July 2012, another piece of legislation was passed weakening even further the credibility of the internal commitment to fiscal discipline. Indeed, the Chancellor Angela Merkel passed a fiscal reform according to which Länder will not pay fines if they will infringe the Stability and Growth Pact [408]. On the contrary, it will be the Federal Government itself to bear the cost of any fine sentenced by Brussels [409]. This obviously makes even less credible the rigour of both the Länder, as they will bear no cost for their actions, and of the Federal

401Bordo et al., 2011
402Wikipedia, July 3rd 2012
403Bordo et al., 2011
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407Bordo et al., 2011
408Ambrosino, 2012
409Ambrosino, 2012

Government, as it openly endorses the violation of the Stability and Growth Pact and hence creates a justification for future bailouts.

Furthermore, another crucial issue with Germany is its fiscal federalism. Especially the fiscal equalisation among Länder makes even less credible its no bailout clause. Indeed the central Government will be less likely to abandon both those which were permanent providers of funds, because they earned it, and those which were permanent receivers, because they got used to [410]. Hence the German system suffers from this structural weakness due to excessive transfers and equalisation, although they are formally backed by Länder adoption of self-regulations concerning debt [411].

Anyway, it is interesting to notice how Germany, which repelled at EU level any transfer, applies this tool intensively at home with the precise aim to harmonise the income of all its citizens [412]. Obviously this contradiction raises questions on German position and ideology ans especially questions why the German-backed integration process is different from what is done in Berlin itself.

Argentina and Brazil

Going once more back beyond the Atlantic, it is useful to examine also Latinamerican experiences. In particular Argentina can be a first candidate for this review of federal institutions. Indeed, Buenos Aires delegated much power to its Provinces which have substantial room for their own taxation systems [413]. However, because of low incentives, there is also a constant high vertical gap backed by relevant transfers sided by an almost unrestrained independent borrowing [414].

410Bordo et al., 2011
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Nevertheless, of all Southamerican countries, the most relevant for the current investigation is Brazil. Indeed, the Federation created in 1889 after the fall of the Empire left a very large degree of autonomy to its States [415]. The agreement indeed relied on the exchange between independent fiscal policies with no transfers, to the advantage of the rich Southern States, and distorted electoral colleges, to the advantage of over-represented North [416]. In particular, the 1891 Constitution granted this autonomy in the form of taxes on exports, own army, self-decided debt and independent tax collection [417]. Especially the first and last invoices were crucial up to '29 Crisis as they represented huge proportion of the balance in many States, especially in the South [418]. Effectively, Brazil represented in those years a monetary union, but not a fiscal one.

Nevertheless, the sudden drop in raw materials after 1929 begun a wave of centralisation under the dictatorship of Vargas, to which followed a cycle of back and forth as regimes changed [419]. When finally democracy was restored with the 1988 Constitution, it was decided that a large amount of power and resources would have been delegated to States and especially municipalities, which surged to higher role [420]. Revenues were hence shared, with the unforeseen outcome to leave often too few revenues to the Federal Government itself in an unbalanced fiscal union [421]. However, this delegation was not sided by similar responsibilities from the States as the 1990s bailouts showed clearly [422]. It was hence developed an wide set of transfers which lasts till today [423].

From all this Brazilian experience, it is relevant to notice the initial republican period, as many similarities can be drawn with current Europe. In particular, parallels can be made

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with the trade-off representation-economic gains, which saw in the EU Germany playing the role of Southern Brazil and peripheral countries that of Northern. Moreover, the turning point can also be compared as both systems entered into crisis lacking a fiscal union during a severe world recession. Moving a little bit further and taking into account what said by the already quoted professor Monti, the present cession of sovereignty can vaguely remember the authoritarian Vargas' rule.

Australia

Remaining then in the Southern Hemisphere and going back once more to an Anglo-Saxon country, another interesting case involves Australia during twentieth century. The kangaroos' land indeed developed a singular institution to regulate its fiscal policies between the Federal Government and the States, the so-called Loan Council [424]. This was established in 1923 as a free agreement and only four years later it would have obtained a formal recognition with the 1927 Federal Financial Agreement [425]. More in details, the delay can be explained by the controversial issue at stake. Indeed, with the 1901 formation of the Australian Federation, States gave up duties on internal and external imports, namely their main source of financing, while retaining all the expenses [426]. Namely, this could not be a long-lasting situation and so, in exchange, they wanted to transfer the debt burden to the Federal Government [427]. Exactly to address this situation the Federal Financial Agreement was approved.

It indeed aimed at shifting the debt, while avoiding moral hazard [428]. To do so, it established that the Federal Government would have absorbed the then present stock of

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debt and would have granted the new one, while the States would have contributed to a National Debt Sinking Fund [429]. Moreover, States would have also had to abide by the newly created Australian Loan Council till 1985 [430]. In particular, this would have been composed by nine members, one per State and three for the Federal Government so that the latter would have need the support of just two States to pass its decisions [431]. Moreover, the Constitution was changed and unlimited power was given to the Federal Government to enact the Federal Financial Agreement [432].

These unlimited powers, explicitly beyond the Constitution itself, were first enacted in 1932 when New South Wales attempted to default [433]. Namely, the high interest rates of the post-1929 capital markets made servicing the debt too expensive and would have required the labour state government to rise the already high taxes and destroy the most advanced welfare state of the Commonwealth [434]. Hence, the Government decided to default. However, for the negative spillovers to whole Australia, the Federal Government intervened and put under controlled administration the whole New South Wales, ultimately overthrowing the elected Government [435].

This proved the complete commitment to fiscal discipline, even beyond democracy itself. However, starting from the 60s the fiscal policy coordination became more and more difficult as financial engineering and creative accounting made more complex to detect the real situation behind the official balance sheet [436]. For this reason, in 1985 the Council was not renewed although the Federal Government retained the power to grant State debt [437]. In particular, in the recent year of financial turmoil, Canberra used frequently this power even

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though it was always supposed to be temporary and quickly dismissed [438]. Anyway, it must be noted how today the Australian general orientation is towards a self-regulating market discipline rather than a public intervention, effectively abandoning the original belief belief behind the Loan Council [439].

Said this and finally acquired some reference categories, although with their limitations, it is hence time to move further and give judgement of the EU conduct insofar, which will be the topic of next and last chapter.

438Ergas, June 28th 2012
439Ergas, June 28th 2012

Conclusion

A general overview

At this point the whole picture is almost complete. The history, the reform and the alternatives of the current European fiscal policy coordination have been exposed in details in the previous chapters. It is hence time to judge what has been done under a critical light dealing with each point one after the other.

The first thing to say in this critical overview is that the present coordination, even and especially after the reform, is rather weak. In particular, its focus on the mere levels of fiscal variables puts into jeopardy the whole European Union. Each country is indeed free to choose its expenditures and revenues, as long as their sum fits the rules, but there's no check of what is inside these choices: in one word, for the EU, the size of the box is more important than its content. However, it is well know that this framework leads to negative outcomes. Free-riding, for example, emerged during the past years as nobody wanted to burden first its public accounts with stimulus packages that would have brought positive spillovers also to others, everybody waiting to exploit somebody else pack in a disastrous chicken game. Needless to say, this blocked effective actions for enough time to make the crisis even worse and no longer manageable. Moreover, as Governments had often to perform cuts in their balances – for example when debt servicing was too high or when a crisis drained their finances – they did not spread these cuts evenly along all the invoices of public spending; rather cuts were concentrated where negative short-term effects were the least. Hence university, research, health, environment, clean energies and infrastructural investments were all cut down irreversibly harming the long-run growth potential of the whole EU.

Nevertheless, even worse, the claimed purpose behind these limitations in public spending was largely unattended. Indeed, since the Maastricht Treaty, the final goal of these artificial ceilings has been to gain the trust of financial markets and hence obtain low interest rates for the whole EU. Clearly this was not what happened. On the contrary, Italy went under speculative attacks exactly after the Euro Plus Pact and the Six Pack were approved. Apparently this is illogical, but there are deep rationales behind it. First of all, capital markets understood that, to respect the treaties, EU Governments would have to implement indiscriminate cuts to their expenditure and hence jeopardise their economic growth and in turn also their tax revenues. Secondly, they similarly understood that the commitment to these artificial criteria was not fully credible. Indeed, the EU openly endorsed the violation of such ceilings to save banks, just to cry later for consolidation after losses have been already socialised. Just to make the most recent example, the Italian Government, faced with billions of cuts, managed to find 3,9 billion Euros to save Monte dei Paschi di Siena bank, worsening even more its debt position [440]. Finally the absence of a lender of last resort represents an additional risk for investors, since traditionally Government debt was more safe than corporate one exactly for this backing. Financial markets have hence no reason to trust this reform of the fiscal policy coordination; rather they have some reasons to fear it. It is thus clear that the reform is not only ineffective, but it is possibly also dangerous.

Furthermore there are problems even in the roots of the reform as the whole ideological framework behind is built on two precise ideas. First of all, the fault is on the State and Government is the problem, not the solution. All the decisions were taken according to this backbone, like the progressive reduction of the public sector and so forth, just to claim the opposite when the private sector was, and is still, collapsing. Nevertheless, it has been shown in the first chapter how the Governments of the EU burdened themselves of debt

440Dream Theater, 2012

and ultimately entered into crisis also to save their shaky private sectors [441]. To prove this it is easy to remember how, among the countries in crisis, Ireland and Spain had a very low public debt and even surpluses in their public accounts but they were burdened with a vary high level of private foreign debt [442]. Anyway, there is also a second idea, even more dangerous as it puts in jeopardy the communality of goals and feelings that was supposed to keep together the EU and is one of the pillar of the OCA theory. Indeed, reflecting mainly the view of Germany and some other Northern countries, the solution proposed by the EU embed the idea that all the burden of adjustment must be borne by the countries deficits, while surpluses are considered as "good". However, this belief is faulty as it does not consider a simple equality: surpluses are just the other face of deficits and you have to have one in order to have the other. In particular, the deficits of the EU peripheral countries are likely to have been worsened to the restrictive internal policy carried out by core countries themselves. It is hence not just unfair, but indeed mostly useless to asymmetrically put all the burden on deficit countries as this does not solve the problem due to the real competitive devaluation of core countries and Germany in particular. On the contrary, this can only worsen the already dramatic social dumping inside the EU.

That said, it is possible to state that the EU is currently using the wrong medicine to its problems because it uses a wrong ideological diagnosis. Namely, the actual fiscal policy coordination targets the wrong causes of the crisis, leaving the true ones untouched, and hence cannot solve European problems. Furthermore, rather than stopping the fall, the reform is likely to accelerate it, like what happened with Italy. It is hence useful, before emitting the final judgement, to briefly analyse the other effects of this reform and how they will worsen the situation.

441Giacché, 2012
442Giacché, 2012

Recessive effects

Among the several shortcomings of this reform, the first one and most serious concern is its recessive effects, as already said above. Indeed, these are particularly pernicious as they worsen the debt situation and ultimately go against the initial purpose. Namely, as the economy enters into recession, the fraction debt over GDP grows notwithstanding cuts and austerity. This can seem quite counter-intuitive but can be easily explained by the following formula.

$$\Delta\left(\frac{B}{Y}\right)_{(t-1,t)}=\left[\frac{(1+i)}{(1+g_y)}-1\right]\times\left(\frac{B_{(t-1)}}{Y_{(t-1)}}\right)+\frac{(G_t-T_t)}{Y_t}$$

In this formula, where all variables are in nominal terms, B is public debt, Y is GDP, g_y is its growth rate, i is the interest rate and (G – T) is the difference between Government expenditure and taxes. As it clearly appears, if the country enters a recession, i.e. g_y is negative, ceteribus paribus the ratio debt over GDP grows. This means that in a recession part of the cuts is just merely necessary to counteract the fall in GDP. Nevertheless, because of the high interest rates, of the high initial debt ratio and of the severe recession, it is also possible that the cuts cannot cover the fall in GDP. This is like what happened in Greece and in other countries. It is hence possible to say that austerity measures which causes recession do the exact opposite effect than reducing the debt to GDP ratio. It is therefore necessary to understand how these austerity measures of fiscal consolidation translate in a recession.

More in detail, the whole story begins with new cuts and taxes. These hits in particular the working class which constitutes most of the population and which devotes to consumption most of its salary. In particular, they bear the highest burden because the cuts both put into jeopardy their jobs (public administration, satellite industries) and because they reduce their real wages. Indeed most of the cuts hit the welfare state which represents

the so-called social wage (health care, social benefits, education,...) and the deferred wage (pensions). Obviously these cuts represents a higher burden for the working class because workers and their families are, case by case, the only beneficiaries (for example unemployment benefits) or those for which they represent the biggest contribution (the same amount represent a smaller and smaller percentage addition as the income rises). It is hence clear that the cuts hit mostly the working class. However this is not the only effect. Indeed, also taxes are mostly borne by the working class itself. This happens for two reasons. First of all, the free mobility of capitals makes impossible to unilaterally tax them or they will escape to another EU country for free. Needless to say, it was already shown how tax arbitrage is a main component of EU capital market and how many countries, which exploit it, will never permit the unanimity required for such an action. Hence it comes clear that the majority of the tax burden must come from natural people, whose freedom of movement is limited. Furthermore, in second stand and to worsen the situation, these new taxes come from consumption (VAT) rather than income so they hit more intensively those who consume a higher quantity of their income, namely the working class. Indeed, it is well known that with rising income the percentage devoted to consumption falls. It is so clear that, through both ways, the fiscal consolidation, the so-called cost of the crisis, is mostly born by the working class.

However, it is also well-known how it is exactly the working class to represent the bulk of consumption in a country. Clearly, a reduction in their real wages and hence in their consumption reduces also the total demand of a country. In turn, this leads to crisis for firms which earn less and so pay less taxes or, even worse, close down and leave unemployed their workers. Of course this puts the whole country in a vicious cycle towards an even deeper recession and an even worse debt to GDP ratio. It is so clear that the fiscal consolidation imposed by the current fiscal policy coordination framework is

counterproductive as it ultimately worsen what was supposed to heal.

However, there is also another effect to take into account. Indeed, although these measures might work if adopted by a single country (for example Germany), as already said, they cannot work for the EU as a whole. Indeed, for the above mentioned equality, they could work only because other countries were not implementing them and so piled up deficits. Contrariwise, a contemporaneous enforcement of these measures all over the EU would bring no other effect than a downward race to the bottom without any benefit. Indeed, the simultaneous compression of internal demand will cancel any export opportunity while destroying the internal market of each country. This hence means a further and deeper recession and consequently a higher debt over GDP ratio. It is so clear also this second reason why the reform of fiscal policy coordination will worsen the problem.

It has therefore been shown how from a mere economic point of view the reform of fiscal policy coordination is counterproductive and worsen the situation. However, it is well-know that Europe is not mere economics. The EU was indeed built on a broader project based on political, ethical and historical roots. Needless to say, this reform puts into jeopardy them all which hence deserve a little analysis.

Europe is fading apart

The first thing to say in this section regards the communality of goals, an already mentioned pillar of the Optimal Currency Area Theory. Indeed, as the EU adopted its ideological diagnosis, it actually found guilty of the crisis the deficit country. This justified in first round the asymmetrical measures, but in second turn it also created frictions between the citizens of the different countries. It can hence happen that, due to this

disengagement, some member States of the EU may prefer or be forced to exit it. In the first case, countries may decide that the benefits of remaining in the EU are outnumbered by the disadvantages. In particular, both deficit and surplus countries may take this decision, the former ones to avoid the additional recession for which they get no help while the latter ones to avoid helping their fellows. On the other side, countries may be even expelled because they are deemed to bring chaos in the EU or because, again, surplus member States do not want to help them. It becomes so clear that the very same reform puts the EU at stake for its asymmetry and its artificial criteria. Indeed, although maybe just one country will exit first, this will force also the others to do the same as the idea itself of Europe will show its failure with all its painful consequences.

It hence appears vane to talk about Euro-bonds and fiscal union as a further step on the same path. Indeed, as already shown, the crisis was originally due not to public debt, but to macroeconomic imbalances originating in German devaluation. The only solution to this would be indeed an authentic fiscal federalism, like the above described German one, together with an harmonisation and deeper coordination of fiscal policies regarding labour, taxes and welfare state. That is, exactly the opposite of what's happening now. Indeed, the ongoing destruction of European welfare state backed by the mantra “It's Europe to ask us for that” is only doing worse. In fact, people have already started to blame the EU for any problem and the honeymoon with the European dream has since then faded. Obviously this can lead to nothing good as these people are also EU Governments' electorate and will hence vote consequently for anti-European parties. It is so clear that the present system of fiscal policy coordination, with its focus on debt and deficit levels, is not only destroying the EU at an economic level, but also is putting into jeopardy the communality of intents and feelings which represents the very core of any integration process.

Let's change the helmsman

That said, at the end of this long analysis, it is time to make a final evaluation of the reform of fiscal policy coordination in the EU. After years of wait-and-see tactic, of delayed actions and asymmetric measures, it is pretty clear that the reform is harming the EU under every point of view. Greek situation is unbearable, Italy and many other countries are in deep recession, while interest rates do not seem to go down. At the same time, the ECB is lending billions to private banks while giving prescriptions to EU Governments and the ESM seems to have changed its function in order to help banks. Clearly debt reduction is the mirage of an oasis leading Europe even deeper in the desert.

In this scenario indeed the absurd yearly cut of one twentieth of the exceeding debt is a Damocles' sword pending over Europe's head [443]. If applied, it will namely translate into an even worse recession and an even higher debt over GDP ratio, but with current interest rates there's nothing to worry about: default will come first [444].

Going through this path the implosion of the Euro becomes a quiet inescapable certainty, whether it comes from voluntary choices or just by chain reaction [445]. Titanic Europe, this is how it will be remembered, will make appear Lehman Brothers' bankruptcy a kids' game [446]. World credit crunch, chain bankruptcies, fall of investments and world trade blockade are granted [447]. Even countries relatively untouched up to now like Japan, the UK and the USA will enter the tempest [448]. Future generations will tell stories about how Europe was a dream that soon reverted into a nightmare [449]. Recession, break-up and rebirth of the worst ghost of the past century will all be sons of these disastrous choices [450].

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Nevertheless there is still an hope to go back to the bright dream of European founding fathers. Indeed it must be remembered that, if the helmsman doesn't want to change the path and heads to the rocks, passengers have a last opportunity: to change the helmsman[451]. Europe must hence stand and reject the present system. The fiscal policy coordination as it is meant today is dangerous, unfair and counterproductive, but it is not the only possible way to do it, as it was shown. There are many ways to have a better, wider and upward bringing fiscal policy coordination in a more integrated, fair and effective Europe. However this change must be done soon, before the point of no return is crossed. It is so left to the future generations to say whether the Europeans changed the helmsman in time and permanently shifted Europe on a bright path. The hope is that the answer will be positive.

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