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Economic and Fiscal Governance in the EMU: the Road Ahead

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Abstract

On 25 March 2017, at the occasion of the 60th anniversary of the signature of the Treaties of Rome, the European leaders reiterated their commitment to completing the Economic and Monetary Union (EMU). While the recent crisis provided a decisive impetus to the enhancement of the EMU economic and fiscal governance, important shortcomings remain. Addressing them is a necessary condition to create a more stable and prosperous Union. In this chapter, we provide an overview of the current setup and of the avenues to reforming it, weighing risk reduction and risk sharing. We conclude by discussing the scope to introduce reforms in the EU.

Keywords: Economic and Monetary Union; economic governance; fiscal governance; risk sharing; risk reduction; EU institutions.

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1. Introduction

The establishment of the Economic and Monetary Union (EMU) was not able to sustain neither real nor cyclical convergence in the euro area (Diaz del Hoyo et al., 2017; Auf dem Brinke et al., 2016; Allard et al., 2013). The low cross-country labour mobility, the existing structural rigidities and the risks of sudden reversals of capital flows, in a context where the exchange rate channel is not an option and there is a single monetary policy, leave countries vulnerable to the still frequent asymmetric shocks (Pisani-Ferry, 2012; Van Beers et al., 2014). Vulnerabilities are even higher for highly indebted countries, whose fiscal policies are also severely constrained (Corsetti et al., 2016). By not having control over the currency in which they issue their debt, countries risk being priced out of the market, even when solvency is not at stake. These shocks can easily propagate across the other EMU members, in particular during downturns, as the high trade and financial integration creates cross-border demand and financial spillovers (Blanchard and Leigh, 2013). Furthermore, the sum of the individual actions may not be optimal for the euro area as a whole, leading to pro-cyclical policies at the aggregate level. This was the case during the recent crisis (Bénassy-Quéré et al., 2016), harming the economic recovery and the sustainability of the EMU.

There is thus a clear rationale for well-designed, effective economic and fiscal governance at EMU level, allowing "countries [to be] more stable and prosperous than they would be if they were not members" (Draghi, 2015). However, opinions diverge on how to achieve this, both in the academic and policy debates. While some consider that an efficient functioning of the EMU depends only on effective risk reduction, taken as a substitute for risk reduction (e.g. Gern et al., 2015), others argue that the two are in fact complements and can only be effective together.

In practice, risk sharing among euro area countries – being it private or public insurance - is currently very limited, in particular when compared to that of the United States (Milano and Reichlin, 2017; Alcidi and Thirion, 2016; European Commission, 2016; Van Beers et al., 2014). This reality is exacerbated during crisis periods when risk sharing is needed the most (Thirion, 2017).

Therefore, the potential for additional private risk-sharing is undoubtedly large, namely via the completion of the Banking Union and the Capital Markets Union (Bénassy-

Quéré et al., 2016; Gros and Belke, 2015; Véron and Wolff, 2015) and, also, via further improvements of the Single Market (Mariniello et al., 2015; Auf dem Brinke et al., 2015)[1]. In any case, the effective smoothing of sizeable shocks may still imply some form of public risk sharing (Tabellini, 2017), working also as a catalyst for further private insurance (Allard et al., 2013). The EU budget, as it currently stands, is not used for stabilisation purposes and falls short of the resources available in existing federations (Bénassy-Quéré et al., 2016).

In the remaining of this chapter, we discuss the EMU economic and fiscal governance framework and the options to reform it. We conclude by arguing that there is now a reform momentum, allowing for decisive action.

2. The starting point

The current economic and fiscal governance in the EMU is considerably different from that enshrined in the 1997 Stability and Growth Pact and the (not credible) no-bailout rule foreseen in article 125 of the Treaty on the Functioning of the European Union.[2] In the buildup of the crisis, the market discipline that should have worked in a context of rules-based, decentralised fiscal policy failed (*ex-ante)* because the no-bailout rule was not credible *ex-post* (Allard et al., 2013). In such a setting, the EMU was hit by the

[1] On the improvements of the Single Market, the President of the European Commission, Jean-Claude Juncker, advocated, in the 2017 State of the Union speech, a change in the decision procedures: "When it comes to important single market questions, I want decisions in the Council to be taken more often and more easily by qualified majority – with the equal involvement of the European Parliament. We do not need to change the Treaties for this. There are so-called "passerelle clauses" in the current Treaties which allow us to move from unanimity to qualified majority voting in certain cases – provided the European Council decides unanimously to do so. I am also strongly in favor of moving to qualified majority voting for decisions on the common consolidated corporate tax base, on VAT, on fair taxes for the digital industry and on the financial transaction tax."

[2]Article 125 of TFEU states that: "1. The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.; 2. The Council, on a proposal from the Commission and after consulting the European Parliament, may, as required, specify definitions for the application of the prohibitions referred to in Articles 123 and 124 and in this Article."

crisis with no framework to adequately manage it, which ended up providing a decisive impetus for reforms.[3]

A key reform area relates to economic and fiscal rules and policy coordination. The establishment of the European Semester gave rise to a framework for the coordination of economic and fiscal policies among EU countries. There was also a revamp of the existing fiscal rules and the creation of the Macroeconomic Imbalances Procedures, through the legislative initiatives under the so-called six-pack, two-pack and fiscal compact. Despite the improvements, the current framework is considered too complex (European Commission, 2017; Leino and Saarenheimo, 2016; Juncker et al., 2015), lacking credibility and enforceability and failing to provide sufficient *ex-ante* incentives to reforms. The lack of symmetry in the treatment of negative and positive imbalances induces pro-cyclical policies and does not allow for intra-euro area adjustments.

Another area of significant changes was crisis management. In 2012, temporary rescue funds were set up – in the context of the European Financial Stabilisation Mechanism and the European Financial Stability Facility – tasked with supporting member states with no market access. They were later transformed into a permanent intergovernmental institution - the European Stability Mechanism -, providing financial assistance to crisis countries in exchange for strict conditionality, a form of the so-called federalism by exception. The ESM Treaty also introduced Collective Action Clauses for issuances of euro area sovereign bonds that, albeit considered insufficient, aimed at a more credible no-bailout clause (Martinelli, 2016). The lending capacity (maximum of €500 billion in 2016) was critical to provide assistance to Cyprus, Portugal, Spain, Ireland and Greece (on-going) but may prove to be insufficient in the face of large future shocks. Regarding the decision process, the ESM relies on unanimity at the Eurogroup – an informal group whose members are national finance ministers, responding to their national parliaments - and requires, in some countries, direct involvement of national parliaments[4]. This

[3] For an overview of the changes introduced, please refer to European Commission (2017a) and Ioannou et al. (2016). For a discussion on the institutional setup, please see Fabbrini (2016).

[4] According to art. 4 of the ESM Treaty, "an emergency voting procedure shall be used where the Commission and the ECB both conclude that a failure to urgently adopt a decision to grant or implement financial assistance (…) would threaten the economic and financial sustainability of the euro area. The adoption of a decision by mutual agreement (…) requires a qualified majority of 85% of the votes cast.". Also, in line with art. 5, a number of decisions, such as terms of accession of a new member to the ESM, appointing the Managing Director and approving the annual accounts, are taken by qualified majority voting.

translates into late and unpredictable decisions (Tabellini, 2016), not necessarily reflecting the interest of the euro area as a whole.

In parallel, the European Central Bank announced, in 2012, the Outright Monetary Transactions (OMT) programme, to tackle denomination risks. Although never actually used, the announcement proved to be very effective in reducing sovereigns' spreads[5]. However, given the difficulties in distinguishing liquidity and solvency crisis, OMT imply that the ECB is *de facto* the lender of last resort for sovereigns, without proper democratic legitimacy. Going forward, the political dimension involved in the definition of the type of crisis a country is experiencing – as illustrated by the case of Greece – reduces the credibility of actual action by the ECB in the face of future turmoil (De Grauwe and Ji, 2016).

Finally, the enhancements to the economic and fiscal framework – mostly a set of ad-hoc responses to the on-going crisis - were coupled with the creation of common supervision and resolution rules for euro area banks (Single Supervisory Mechanism, Single Resolution Mechanism and Single Resolution Fund), in the context of the so-called Banking Union. The rules for deposit insurance were also harmonised. These steps were determinant in reducing the risks of the banking sector, with improvements of capital ratios and liquidity buffers. There are still critical steps to be taken, in terms of risk-reduction but in particular concerning risk sharing. The setting up of a European deposit insurance scheme and a common fiscal backstop for the Single Resolution Fund is essential to break the feedback loop between banks and sovereigns. Moreover, it is crucial to take action – both at national and EU level - on "non-performing loans" that weight on banks' balance sheets. The home bias embedded in banks' large exposures to home sovereign bonds also needs to be tackled, namely via the introduction of regulatory changes and the creation of a safe asset, contributing towards the credibility of the no-bailout clause.[6]

[5] For more details on the economic and financial effects of the OMT announcement, please refer to Altavilla et al. (2014).

[6] In Section 3, we refer to the different options being discussed for the creation of a safe asset, from the establishment of a borrowing capacity at supranational level to the joint issuance of mutualized debt.

Departing from the flaws and limitations of economic and fiscal governance in the EMU, we now proceed to the options to overcome them.[7]

3. The road ahead: now and then

3.1 The short-run

The decision on how to enhance the EMU fiscal and economic governance requires a careful assessment of the optimal balance between risk-sharing and risk-reduction, taking into account the desired goals. As the solution is most likely a complex one, there is the need to define a long-term plan of action. Still, there are some fine-tuning measures that have been proposed in the literature and which can improve the effectiveness of the current setup in the shorter-run.

A common criticism to the existing framework is that it is not symmetric (both across time and across countries), as it triggers actions when excessive fiscal or external deficits arise but not in the face of excessive surpluses. Also, fiscal rules have been inducing procyclical policies, by forcing countries to implement fiscal consolidation in times of crisis, with important economic and social consequences.[8] In the face of asymmetric shocks, the single monetary policy further exacerbates this procyclicality, given that a common interest rate is too high for crisis countries and too low for those experiencing expansions (Bini Smaghi, 2015). Some consider that the current fiscal and economic framework is not flexible enough, as for instance the flexibility already envisaged in the Stability and Growth Pact (SGP) – namely concerning structural reforms and investment - applies only to those countries under the so-called preventive arm, not to those under the corrective arm; others argue that the large number of flexibility clauses renders the system too complex and opaque (Claeys et al., 2016).

In this context, measures that simultaneously foster flexibility, transparency and symmetry can improve the *statu quo*. Concerning fiscal governance, Bénassy-Quéré et

[7] For a discussion on the Financial Union, see, for instance, Yiatrou (2016), Petit and Monti (2016) and European Commission (2017a).

[8] For a discussion of the procyclicality embedded into the rules and the effects of the 2011 reform, please refer to Prammer and Reiss (2016).

al. (2016) suggest the creation of adjustment accounts that would allow countries to shift incremental investment and unemployment spending from good to bad times, thus fostering counter-cyclical policies. Enderlein et al. (2016) also call for a revamped SGP, with more precise guidelines on the interpretation of the rules and where reform efforts are duly taken into account, together with the quality of public spending and the position over the business cycle. Bugaert (2016) proposes a change in the rules to better account for investment. Claeys et al. (2016) suggest the elimination of the structural balance rules and the introduction of a new public expenditure rule, arguing that while the current setup could, in theory, provide for stabilisation, the implementation flaws – in particular due to forecast errors and the difficulties in measuring structural balances – render it ineffective.

In terms of economic governance, Bini Smaghi (2015) stresses that the EMU represents a large fraction of the world economy and thus the external deficits of some euro area countries are, at least to some extent, the counterpart of the surplus of other euro area members. This implies that symmetric intra euro area adjustment is crucial. In the current framework, even considering a certain degree of *de jure* symmetry embedded into the Macroeconomic Imbalances Procedure, inducing surplus countries to adjust is certainly a challenge. But if external imbalances are coupled with internal imbalances, then it is in the country's best interest to do such adjustment (Bini Smaghi, 2015).

In any case, even with the implementation of these changes, SGP and economic governance rules remain limited in the face of severe crisis and fail to promote risk-sharing across countries. The European Commission started publishing Recommendations for the euro area as a whole in 2015, but they lack enforceability and clearly entail more in-depth changes to the institutional set-up. We deal with these longer-term challenges in the next sub-section.

A second common criticism is that the existing mechanisms are not promoting convergence. Coeuré (2017) argues that this is linked with important differences in institutional quality ("the range of social and legal frameworks that shape the conditions in which households and businesses operate"), rendering the countries more vulnerable to asymmetric shocks and reducing social cohesion. Given the role of structural

policies, in particular in the context of the EMU where other national policies are non-existent or severely hampered, some authors call for enhanced incentives for reforms, ensuring that countries effectively take *ex-ante* action. The priorities in the Country Specific Recommendations proposed by the European Commission are, in the EU programming cycle of 2014-2020, already linked with European Funds. However, this can be further enhanced by linking co-funding rates with the economic cycle (European Commission, 2017a) and by providing positive incentives targeted at best practices and effective implementation. Investment in exchange for structural reforms is an idea that was already put forward in the "contractual arrangements" initially proposed by Van Rompuy et al. (2012), with investment channelled to weaker countries willing to implement reforms (Enderlein and Pisani-Ferry, 2014).

But the notions of what are the desirable structural policies and of an effective policy design need to be improved, taking into account the appropriate sequencing, bundling and prioritization of measures and building on the extensive literature on the impact of structural reforms that was produced in recent years (see, for instance, Bouis et al., 2012; IMF, 2015; OECD, 2016). Reform plans must take into account both efficiency and equity considerations - e.g. Juncker et al. (2015) and European Commission (2017a) advocate for a stronger focus on employment and social issues - and also address the possible short-term costs and heterogeneous effects across different households and firms (for an overview, see, for instance, Auf dem Brink and Enderlein, 2017). Given that there is no one-size-fits-all, national preferences over normative issues need to be duly taken into account. This is why Coeuré (2017) calls for convergence in institutional quality rather than for convergence in institutions, putting the emphasis on results and not on the exact means to achieve them.

Finally, reform processes are by their very nature multi-annual processes, and thus incentives and surveillance mechanisms must have a longer-term perspective. This also implies that national reform efforts need to be appropriately acknowledged at the EU level, as otherwise citizens may feel that they are constantly lagging behind and that no effort would ever be enough, promoting reform fatigue and reducing support for Europe.

3.2 The long-run

A robust answer to the main challenges of the EMU, effectively delivering shared prosperity and stability across the Union, may entail longer-term, deeper reforms. Different paths have been outlined on how to achieve this.

A number of authors consider that, given the existing political constraints (Andritzky et al., 2016a; and Fuest et al., 2015) and the reduced size of externalities across countries (Eichengreen and Wyplosz, 2016), a decentralized market-based model where decisions are kept at national level is the best and only feasible way forward. Such a system, with decentralized decisions, entails decentralized responsibilities, whose credibility hinges critically on the availability of liquidity provision in exceptional situations, ensuring that the minimum functions of the government - such as social security, minimum public services and financial stability - are not at stake and, also, on an insolvency framework for sovereigns. The solutions to deliver a credible no-bailout rule are necessarily complex (Andritzky et al., 2016a; Martinelli, 2016; Gianviti at al., 2010) and imply an effective plan to deal with legacy debt (see the proposals in Paris and Wyplosz, 2014; Tumpel-Gugerell, 2014; and Corsetti et al., 2015) and to firmly break the banks-sovereigns nexus, reducing the home-bias and thus avoiding contagion (Delatte et al., 2017). This would, in turn, further enforce market discipline for sovereigns, as they would no longer be able to resort on home banks as buyers of their debt (Véron, 2017). It is thus clear that even when keeping coordination to a minimum, some form of fiscal union is always needed, with actions at the EU level.

Some authors agree with this minimal view on risk–sharing, but consider that enhanced fiscal cooperation is a necessary condition for the EMU to function properly. Sapir and Wolff (2015) argue that “fiscal federalism by exception” creates the appropriate setup to ensure fiscal sustainability at the national level, also allowing to duly taking into account the euro area fiscal stance. The authors suggest the creation of a Eurosystem of fiscal policy and a Eurosystem of competitiveness councils, responsible for fiscal policy and competitiveness issues at euro area level, with powers to force national parliaments to change their policies, in the face of large national or euro area shocks.

One may argue that those losses of sovereignty are only politically acceptable if coupled with joint responsibilities and that broader risk-sharing mechanisms are a complement to those entailing risk reduction, in particular in the face of severe shocks where local

actions may not suffice. It is in this context that the creation of a euro area stabilisation function has been widely discussed, allowing countries to deal with asymmetric shocks (cross-country stabilisation) and/or with common shocks affecting the entire euro area (inter-temporal stabilisation).

There are several options for the stabilisation mechanism such as a rainy day fund, where disbursements in bad times are linked with the provisioning of funds in good times (possibly having also a borrowing capacity); an EMU-wide basic unemployment scheme or a reinsurance unemployment mechanism, replacing or adding to the national schemes (and thus requiring convergence of labour markets[9]); an investment protection scheme, guaranteeing that national investment projects in areas such as infrastructure or skills are not reduced during downturns; and a fully-fledged euro area budget, considerably enlarging the current own resources and promoting stabilisation spending.[10] In all cases, the crucial feature is that funds are earmarked for counter-cyclical policies (e.g. unemployment benefits) and target long-term growth (e.g. investment in infrastructures, training and education).

One of the main concerns with the implementation of a euro area stabilisation function is moral hazard, as countries may have fewer incentives to avoid or solve crisis when such mechanisms are in place. Tackling these concerns is crucial to ensure the political feasibility of the proposal.

Strict conditionality upon access, meaning that countries need to comply *ex-ante* with certain criteria in terms of institutional quality – in addition to the compliance with existing economic and fiscal rules (European Commission, 2017a) - reduces moral hazard by reducing the scope for asymmetric shocks to be generated endogenously from policy choices (Bénassy-Quéré et al., 2016). However, some authors question the effective compliance with these rules, in light of past experiences (Leino and Saarenheimo, 2016).

The introduction of clawback clauses can also be effective in reducing moral hazard and avoiding redistribution (Claeyes et al., 2014; Bénassy-Quéré and Keogh, 2015). However, this comes at the cost of lowering the stabilisation capacity, inducing

[9] For a discussion see Claeyes et al., 2014.

[10] For an overview and discussion of the different proposals please refer to Rubio (2015), Thirion (2017), Allard et al. (2013), European Commission (2017a,b).

procyclical contributions (Dolls et al., 2014) and eliminating the advantages of risk sharing across countries, by transforming the funds into implicit debt (Rubio, 2016).

In any case, as shown by Allard et al. (2013) and Dullien (2013), all euro area countries would receive transfers from a stabilisation mechanism at some point in time, with their relative magnitude depending on the exact features of the implemented scheme. This allows redistribution concerns to be addressed from the onset. Also, as noted by Rubio (2016), redistribution – which, as a principle, is in any case already embedded in the EU budget - may not necessarily reflect moral hazard as, for instance, smaller countries are more vulnerable to shocks for the same level of institutional quality. Tabellini (2017) adds that the possible asymmetric benefits (as there may be more substantial benefits for weaker and indebted countries) are also coupled with asymmetric losses of sovereignty. More broadly, these differentiated benefits are already present in other EU dimensions, such as the Single Market. Therefore, benefits cannot be solely measured by net contributions and payments to the stabilisation mechanism, as there are significant gains to all members from a better functioning EMU.

Besides, there is broad consensus on the use of the stabilisation mechanism only to smooth large shocks, i.e. only under exceptional circumstances (see, for instance, Gros, 2014; Rubio, 2016), reducing the likelihood of moral hazard. These severe shocks are the situations with which national policies cannot cope with, where externalities are larger and where monetary policy is more likely to be exhausted, warranting action at the supranational level.

The effectiveness of stabilisation hinges on an appropriate trigger that activates the mechanism. Enderlein et al. (2012) suggest national output gap vis-à-vis the euro area, a relative measure for the case of asymmetric shocks; Dulbeque (2013) and Furceri and Zdziencka (2013) propose national output gaps (an absolute measure) as the criteria for common shocks. However, the output gap is subject to measurement errors and delays, possibly rendering unemployment figures as a better option (Thirion, 2017). Still, as one can argue that unemployment also reflects structural differences among countries, an alternative is to rely on a measure of short-run unemployment, less endogenous to national policy options and more closely related to the economic cycle.

On top of the selection of the relevant indicator, an additional issue relates to the definition of what is an exceptional circumstance and what is the appropriate time frame to measure it – one may consider only large drops from one period to the other or also include smaller losses that cumulate over time (Rubio, 2016). Finally, once an exceptional circumstance is identified, it is necessary to take timely action. Delays in implementation may render intentions very different from results (Cimadomo, 2012).

In terms of financing, there are different options being discussed. Relying on national contributions, based on VAT or GDP, has the disadvantage of maintaining the net return logic, whereby countries assess how much they are contributing and how much they are receiving at what are usually short-time frames, thus harming the political sustainability of the system. Another possibility is to rely on a direct tax capacity, for instance related to corporate taxation, environmental taxation or financial transactions taxes.[11] As noted by Tabelinni (2017) and Ubide (2015), there is no need for a very large tax capacity; what is important is ensuring that it is kept for a long time. If extra funds are needed, the fund has the credibility to borrow against the future revenue stream, something that cannot be achieved at national level, particularly in the context of already very high public debts. A borrowing capacity has the added advantage of creating a safe asset, although in this set up it may fall short of market needs.

The discussion on the creation of a safe asset is closely linked to that of joint debt issuance, the so-called Eurobonds, which featured highly in the debate during the peak of the crisis (see, for instance, Claessens et al., 2012). As discussed by Thirion (2017), one of the advantages would indeed be the creation of a safe and liquid asset, allowing for a better transmission of monetary policy via the reduction of banks' home bias. But the overall benefits are much broader, such as grasping economies of scale, reducing financing costs and securing access to markets, thus weakening the case for a centralised stabilisation function for asymmetric shocks (Rubio, 2016).

Economic consideration aside, joint debt issuance is challenging from a political point of view. It entails transfers among countries, as some see their costs being reduced due to the credibility of the others; and there may be further transfers *ex-post*, in case of default. Limiting moral hazard is thus of particular relevance. A proposal by Enderlein et al. (2012) entails restricting the access to the jointly issued bonds so that countries

[11] For a discussion on own resources, please refer to European Commission (2017b) and Monti (2016).

remain partially responsible for their debt. If sustainability is at stake, the limit is relaxed but at the cost of increasing losses of sovereignty (Enderlein and Haas, 2015). Brunnermeier et al. (2011) and Beck et al. (2011) propose tranching debt issuance, dividing it into senior and junior tranches. De Grauwe and Moesen (2009) suggest a framework where access to the market is guaranteed via the joint issuance of Eurobonds but prices are those faced at the national level, keeping the incentives for countries to pursue sound economic and fiscal policies. Delpla and von Weizäcker (2010) advocate that only the first 60% of debt should be jointly issued, rendering its actual implementation difficult due to the legacy of the crisis. In all settings, Eurobonds are only politically feasible if countries deal with the high levels of cumulated debt.[12]

4. A glimpse at institutional implications

The current institutional framework is mostly the result of ad-hoc responses to the economic and financial crisis (Fabbrini 2016), pushing the limits of intergovernamentalism and lacking basic legal structure (Fabbrini, 2013 and Kilpatrick, 2016). Institutional changes are therefore warranted, in particular if countries agree on further risk-sharing.

One option entails the creation of a supranational Treasury (European Commission, 2017a), possibly encompassing the European Stability Mechanism – which would become the European Monetary Fund in case there is an agreement to issue debt – and taking on the responsibilities envisaged in the new agreed framework. The Treasury would be headed by a European or euro area finance minister, having a double hat as president of the Eurogroup and as a member of the European Commission (Enderlein and Haas, 2015; Enderlein et al., 2016). A key task of the minister would be to ensure that the interests of the euro area as a whole are duly taken into account, on top of the legitimate national interests. A difficult balance needs to be sought when sustainability at national level and euro area interests (e.g. reaching a positive fiscal stance) are at odds.

[12] As discussed before, see the proposals in Paris and Wyplosz (2014); Tumpel-Gugerell (2014) and Corsetti et al. (2015).

Also, the Treasury – or the recently created European Fiscal Board - would be in charge of the assessment and the promotion of fiscal sustainability during normal times (for instance managing the use of the national adjustment accounts proposed by Bénassy-Quéré et al., 2016), in a context of strong and independent fiscal and economic surveillance at national level. Additionally, it would be responsible for defining exceptional times, following clear and commonly agreed rules. This would trigger the stabilisation tool, under *ex-ante* conditionality, or – depending on the model adopted - would, for instance, allow for the limits for joint debt issuance to be relaxed, with progressive losses of sovereignty. In limit situations, there would be the possibility to veto national budgets. Even with risk-sharing, and in particular taking into account legacy issues, a debt restructuring mechanism for sovereigns would need to be established.

Operationally, and irrespectively of other institutional changes, the decision mechanism by a formal Eurogroup needs improvement, with the elimination of the current asymmetric influence of national parliaments and relying on qualified majority voting. To better account for the social dimension, Katrougalos (2017) calls for the establishment of a Eurogroup in Labour and Social Affairs ministers' formation.

Overall, improvements of democratic legitimacy are paramount. The European Parliament (EP) - possibly in euro area formation, including representatives from national parliaments and/or including members of trans-European lists - should take added responsibilities on the scrutiny of the implementation of the governance framework and the definition of policy priorities. It should also reinforce the oversight of the European Council, the Eurogroup and the European Central Bank (Enderlein et al., 2016; Alcidi et al., 2014; Kreilinger, 2013).[13] The introduction of a lead candidate (*Spitzenkandidaten*) in the elections for the European Parliament, whereby European political groups nominate candidates for the position of President of the European Commission, can foster electoral participation but the impact in the 2014 elections was limited (Alcidi et al., 2014). Gattermann et al. (2016) argue that information is crucial to

[13] These measures improve input-legitimacy. As argued by Alcidi et al. (2014), output legitimacy can be fostered "by strengthening the ability of EMU to reduce the emergence of negative externalities and to mitigate their impact, through market and fiscal risk-sharing mechanisms". This would thus be the result of the enhancements introduced to the framework itself.

change this, given its role in shaping voters' support for the candidates. In any case, the lead candidate may raise issues of further politicisation of the European Commission.

The full implementation of these institutional reforms requires treaty changes and faces significant legal challenges (Leino-Sandberg, 2016; Fabbrini, 2017a; Piris, 2012). While Fabbrini (2017b) points to *Brexit* as an opportunity for broader constitutional reform, Beukers and Fasone (2016) add that on top of the current EU legal framework, national constitutions may also require amendments. The interplay and coherence between EU and EMU institutions and frameworks need to be carefully considered[14], also in the broader context of a multi-speed and variable geometry Europe (Fabbrini, 2017).[15]

5. Scope for reform?

The momentum for re-thinking the EMU is building-up as confidence in the EU is restored (Lamy et al., 2017). Support for the euro is at a record high, reaching 73% in euro area countries (Standard Eurobarometer 87). Though the UK's June 2016 decision to leave the EU was seen as a major drawback, with fears that others would follow, it actually provided a boost for support for the European project. De Vries and Hoffman (2017) argue that it "sparked off more positive feelings about the EU as a whole". Support for being a member of the EU increased five percentage points from March to August 2016 (Hoffman and de Vries, 2016), with increased support for Europe even in the UK (Lamy et al., 2017).

A closer look at this evidence makes it clear that while most citizens do support their country's membership in the EU - and even support further integration - they are not

[14] On this distinction, the President of the European Commission, Jean-Claude Juncker, stated in his 2017 State of the Union Speech that "If we want the euro to unite rather than divide our continent, then it should be more than the currency of a select group of countries. The euro is meant to be the single currency of the European Union as a whole. All but two of our Member States are required and entitled to join the euro once they fulfill the conditions. Member States that want to join the euro must be able to do so. This is why I am proposing to create a Euro-accession Instrument, offering technical and even financial assistance."

[15] Katrouglous (2017) warns against the risk of creating a "club Europe" instead of a "Europe of choices". He advocates for no "escape from existing obligations" but also no "flexible solidarity".

satisfied with the current policy direction (de Vries and Hoffman, 2017) and differ on their judgment of major economic changes (Lamy et al., 2017). Two-thirds of the Europeans do call for reforms but cannot reach an agreement on the way forward (de Vries and Hoffman, 2016).

Tackling this lack of consensus is of paramount importance to proceed and, for this to be possible, information is essential. Europeans are not informed about the EU (Auf dem Brinke et al., 2016) and many empirical applications show the role of information on building support (e.g. de Vries and Hoffman, 2016, Gouveia, 2017). The media certainly have a role to play but, given the distrust in traditional media[16], one needs to devise alternative communication strategies, acknowledging the fact that the framing of the debate matters for public perceptions (Dolls and Wehrhöfer, forthcoming).[17]

Another critical step is the fostering of national ownership. As stated by the President of the European Commission, Jean-Claude Juncker, in his 2017 State of the Union Speech "Unemployment is at a nine-year low. Almost 8 million jobs have been created during this mandate so far. (…) The Commission cannot take the credit for this alone. Though I am sure that had 8 million jobs been lost, we would have taken the blame". This divide between perceived EU and national interests and goals, sometimes conveyed by national politicians themselves and by media coverage on the EU which focuses almost exclusively on the national dimension, is harmful to the sustainability of the EU project. The problem is only aggravated by the rise of populism. While the recent fears of populism in Europe did not materialise (Böttcher and Wruuck, 2017), the increasing influence of populist parties is a longer-term trend.[18] Even if not winning elections, populism has an important impact on politics, leading to lengthier processes, changing the debate style and content and, in some cases, reducing the scope for reforms, in particular those that entail short-term costs (Bertelsmann Stiftung, 2017).

[16] In the Special Eurobarometer 461, only 34% of the respondents state that they trust the media.

[17] The authors conduct online experiments eliciting attitudes of German voters towards two key reform proposals: an EMU-wide unemployment insurance and a sovereign insolvency mechanism. By providing randomized "argument treatments", they show that subjects' attitudes are elastic. In particular, providing arguments related to moral hazard, permanent transfers, rising risk premia and self-fulfilling prophecies increases rejection (or decreases approval).

[18] Mounk and Foa (2016) argue that "[the growing] disaffection with the democratic form of government is accompanied by a wider skepticism toward liberal institutions. Citizens are growing more disaffected with established political parties, representative institutions, and minority rights. Tellingly, they are also increasingly open to authoritarian interpretations of democracy."

Therefore, social issues need to take a more central stage in EU policies.[19] Unemployment is still the top concern at the national level (Standard Eurobarometer 87). Poverty and social exclusion continue to be an important issue in Europe, with many countries lagging behind pre-crisis opportunity levels (Schraad-Tischler and Schiller, 2017). In addition to growing inequalities across the very rich and the others, there is evidence of growing inequalities across generations.[20] The link between, on the one hand, populism and fears of globalisation and, on the other hand, reduced support for the EU (Dustmann et al., 2017; de Vries and Hoffman, 2016) reinforces the need to tackle inequalities. Acknowledging that globalisation does not work for all (see, for instance, OECD, 2016) and acting accordingly would provide a boost in support for the EU and the needed reforms (de Vries and Hoffmann, 2016). There are certainly on-going initiatives that go into the right direction – such as the European Pillar of Social Rights or the Youth Guarantee – but there is scope for further improvements, including by deepening cooperation in the field of taxation and by further potentiating investment.

6. Conclusion

The European Commission's White paper on the future of Europe, published in March 2017, and the Reflection paper on the deepening of the Economic and Monetary Union that followed (May 2017), paved the way for a broad-based discussion on the EMU economic and fiscal governance framework.

In this chapter, we departed from the current setup, with its merits and shortcomings, to then discuss the way forward. There are many proposals on how to enhance the existing framework. Some focus on market, rules-based solutions, others entail more risk-

[19] For an overview of the governance of social issues, please refer to de la Porte and Heins (2016).

[20] This is an overall tendency across advanced economics. Dobbs et al (2016), argue that "between 65 and 70 percent of households in 25 advanced economies, the equivalent of 540 million to 580 million people, were in segments of the income distribution whose real market incomes—their wages and income from capital—were flat or had fallen in 2014 compared with 2005. This compared with less than 2 percent, or fewer than ten million people, who experienced this phenomenon between 1993 and 2005. Government transfers and lower tax rates reduced the effect on disposable incomes: 20 to 25 percent of households were in segments of the income distribution whose disposable income was flat or down between 2005 and 2014, compared with less than 2 percent in 1993–2005."

sharing among euro area members. Common to all approaches is the need to reform the current system, which is not delivering the full potential of the EMU.

Some would argue that, at the current juncture, there is no scope for such reform in the EU. The recent decades show that, time and again, the European project was able to substantially progress forward. This was the case with the creation of the Single Market, the Schengen Agreement or the single currency. More recently, the steps toward the Banking Union were a prime illustration of the ability to reach an agreement and give up national sovereignty, in an area as sensitive as the financial system. There was a "major institutional quantum leap" in recent years, "which probably very few would have anticipated when the Maastricht Treaty was signed" (Dorrucci et al., 2015).

All in all, the discussion on the future of the Economic and Monetary Union cannot be disentangled from the broader discussion on the future of the European Union, including in areas such as security, migration and the Single Market. Only an encompassing view can deliver shared-prosperity and stability across the Union.

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