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A fiscal union for the EMU?

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Abstract

The dominant narrative presents the Economic and Monetary Union as an incomplete structure which, to operate stably, needs to be supplemented by a deeper fiscal integration. We study the general features of the recent proposals for a fiscal stabilisation mechanism, intended to smooth the effects of asymmetric shocks on Member States, from a multi-disciplinary viewpoint, combining economic, legal and political analyses. While possible to construct within the current Treaties, we find the proposals economically and politically fragile, and likely to be unenforceable. Our gravest concern however relates to the envisaged broad macroeconomic conditionality, which is largely unconnected to the stability aims of the mechanism but has potential to undermine the democratic legitimacy of some of the Member States' most foundational societal choices.

Key words: Economic and Monetary Union, Fiscal federalism, Fiscal stabilization, EU political integration.

JEL codes: H11, H87 and K19

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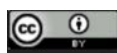
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1. Introduction

"There is, perhaps, nothing more likely to disturb the tranquillity of nations than their being bound to mutual contributions for any common object that does not yield an equal and coincident benefit. For it is an observation, as true as it is trite, that there is nothing men differ so readily about as the payment of money."

(Hamilton, Federalist Papers No. 7, dated November 15, 1787)

The dominant narrative of the architectural gaps of the Economic and Monetary Union ("EMU"), born out of the traumatic experiences of the euro debt crisis, goes roughly as follows: EMU was created as an incomplete structure. Deprived of independent monetary policy, and absent the stabilising effect of a true federal budget, Member States were left vulnerable to asymmetric shocks, leading to economic and financial instability. A key remedy for this shortcoming is deeper fiscal integration within the Eurozone, entailing mechanisms of fiscal risk sharing between Member States and – as a prerequisite for such risk sharing – stronger controls over Member States' fiscal and macroeconomic policies. These two dimensions of fiscal integration – risk sharing and stronger controls – form the pillars of a grand North-South bargain, a well-established understanding that underpins EMU deepening and, it is hoped, will lead to a politically palatable package for all. In recent years, a wide variety of broadly defined initiatives have been put forward to deepen fiscal risk sharing in EMU, and many of them have already been exposed to political discussion. To this point, no initiative has made it to the legislative stage.

In the traditional federal model, fiscal integration takes place through the federal level assuming direct responsibility over the provision of certain public services, such as defence, social security or unemployment benefits, and in exchange receiving commensurate federal sources of revenue. The guiding logic of such a process is the efficient provision of public services, not macroeconomic stabilisation as such. Although a larger role of the federal level can entail greater countercyclical properties, these are side effects and not the *raison d'être* for the federal role.

Proposals for deeper EMU fiscal integration have generally not followed this traditional federal logic. Instead, they have been designed as fit-for-purpose to tackle the macroeconomic stabilisation problem. These proposals seek to compensate for the lack of a true federal budget by creating of a system of fiscal cross-subsidies among Member States for the express purpose of stabilising asymmetric shocks. We refer to such systems as fiscal stabilisation mechanisms.¹ In several authoritative proposals, the fiscal stabilisation mechanism has acquired an additional motivation, one quite distinct

¹ . Van Rompuy, J.M. Barroso, J.-C. Juncker and M. Draghi, "Towards a Genuine Economic and Monetary Union" (2012) EUCO 120/12 ("Four Presidents' Report"); Commission, "Reflection Paper on the Deepening of the Economic and Monetary Union" COM(2017) 291, ("Commission Reflection Paper"), https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf [Accessed 7 September 2017].

from the aim of smoothing economic cycles. In these proposals, it has been suggested that the mechanism be used as a source of leverage for the EU to steer Member States towards sound fiscal policies and desirable economic and social structures. This leverage would be embedded in the mechanism in the form of conditionality: Member States' eligibility to benefit from the system would be conditional on observance of the EU fiscal rules and economic policy recommendations.

While the issue of fiscal integration has received attention from economists, political scientists and legal scholars, the three disciplines have been largely toiling away in their respective fields with limited cross-fertilisation between them. It is the economists that have mostly been responsible for any concrete proposals and, true to the tradition of the discipline, they tend to follow a mechanism-design approach. They postulate certain laws of motion, calibrate the parameters using past data, use the resulting mechanism to simulate a counterfactual, and often find significant welfare-enhancing effects. Almost invariably, the proposals are justified solely on the basis of theoretical analysis, with little or no supporting empirical evidence or examination of historical precedents. Sometimes the disregard of history is explicit: the Tommaso Padoa Schioppa Group proudly proclaimed that following a *sui generis* EMU, "a *sui generis* fiscal federalism in the euro area is needed".² Other proposals may describe arrangements in existing federations but fail to follow through by contrasting the actual designs with international experience.³ It is as if the *sui generis* nature of EMU is seen as liberating the authors of a proposal from the burden of learning from history.⁴ Further, there is typically very little discussion about the potential constraints set by the political and legal context within which the scheme would need to be adopted and, more importantly, eventually operated. Yet, the novelty of the proposals, and the lack of real-world precedents to demonstrate their practicability, underscores the need for careful, multidisciplinary feasibility analysis. These proposals invariably, though often unwittingly, build on political and legal assumptions that are critical to their intended operation and should hence be carefully studied by political scientists and lawyers. So far, such analysis has not been carried out.

In the field of political science, a key research subject has been the interplay of legitimacy and fiscal solidarity on the path towards a federal EU, the ultimate goal set already by the Schuman Declaration.⁵ A fiscal union, and the transfers it entails, would need to be legitimised in the eyes of the European

² *Notre Europe*, "Completing the Euro. A road map towards fiscal union in Europe - Report of the 'Tommaso Padoa-Schioppa Group'" (2012), <http://www.notre-europe.eu/media/completingtheeuroreportpadoa-schioppagroup-nejune2012.pdf?pdf=ok> [Accessed 7 September 2017].

³ See e.g. C. Allard *et al.*, "Toward a Fiscal Union for the Euro Area", *IMF Staff Discussion Note SDN/13/09* (2013), <https://www.imf.org/external/pubs/ft/sdn/2013/sdn1309.pdf> [Accessed 7 September 2017].

⁴ While it is broadly agreed that the EU is not a federation, there is wide disagreement on what it exactly is. On this see e.g. R. Schütze "On 'Federal' Ground: The European Union as an (Inter)national Phenomenon" (2009) 46 *C.M.L. Rev.* 1069; R. Schütze "From Rome to Lisbon: 'Executive Federalism' Federalism in the (New) European Union" (2010) 47 *C.M.L. Rev.* 1385;

⁵ The Schuman Declaration (9 May 1950), https://europa.eu/european-union/about-eu/symbols/europe-day/schuman-declaration_en [Accessed 7 September 2017].

people. The ways to achieve this are constrained by the absence of a “thick [European] political system”⁶ that in most federations is the basis for the solidarity that legitimises the transfers taking place through federal government. Key steps in European integration have generally found their legitimacy elsewhere, and an enduring source of legitimacy has been the nobility of the European cause, the creation of “an ever closer union among the peoples of Europe”.⁷ Such *raison d’être* of the Union is to be advanced through concrete steps of integration. In this thinking, steps towards deeper fiscal integration have an intrinsic value, independent of their purely utilitarian merits. Yet, the mobilising force of this kind of “telos legitimacy” (or political messianism, as Weiler has called it⁸) seems to be in inevitable decline, as the horrors of the wars keep fading in the collective memories of the European peoples. Perhaps in recognition of this, the language used to promote a fiscal union eschews Schuman’s emotional rhetoric and instead relies upon prosaic arguments related to cyclical stabilisation. It is hoped that the fiscal union would legitimise itself through the beneficial effects it brings to the people. This would secure its broad acceptance and prevent it from becoming a constant source of disagreement, a disturbance to the “tranquillity of nations”.

For lawyers, relevant dimensions of the fiscal union include the availability of the legal base and the compatibility with EU Treaties, in particular the no-bail out clause (art.125 TFEU), but it also raises fundamental issues of national constitutional law.⁹ Since the Treaty limits to risk sharing in the EMU are acknowledged, and the required broad public support for Treaty reform is known not to exist, the role of lawyers has often turned into managing the compatibility issue, to explore the maximal limits of what could be built within the present Treaties.¹⁰ The fiscal stabilisation function however also involves a number of other institutional and legal considerations. The 2012 Blueprint raised the question of the possible need to *inter alia*: introduce a new explicit legal basis for this purpose; create a dedicated budgetary and own resources procedure; create a new taxation power for the EU or enable it to raise revenue by indebting itself on the market; and provide for an EMU Treasury within the Commission. Finally, the fiscal stabilisation function also involves questions of participation for non-euro states. While these matters can be considered second order questions to those involving the economic usefulness of a stabilisation mechanism, they involve fundamental considerations relating to its design, governance, acceptance and operation, and as such cannot be ignored.

⁶ F. de Witte, “The role of transnational solidarity in mediating conflicts of justice in Europe” (2012) 18 E.L.J. 694.

⁷ Preamble, TFEU.

⁸ J.H.H. Weiler, “In the Face of Crisis: Input Legitimacy, Output Legitimacy and the Political Messianism of European Integration” (2012) 34 Journal of European Integration 825, 828.

⁹ E.g. A. Hinarejos, *The Euro Area Crisis in Constitutional Perspective* (Oxford: Oxford Studies in European Law, 2015), pp.166–177; K. Tuori and K. Tuori, *The Eurozone Crisis. A Constitutional Analysis* (Cambridge: Cambridge University Press, 2014), pp.119–180.

¹⁰ See e.g. R. Repasi, “Legal options for an additional EMU fiscal capacity” (2013), [http://www.europarl.europa.eu/RegData/etudes/note/join/2013/474397/IPOL-AFCO_NT\(2013\)474397_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/note/join/2013/474397/IPOL-AFCO_NT(2013)474397_EN.pdf) commissioned by the European Parliament’s Committee on Constitutional Affairs (AFCO), and “Legal options and limits for the establishment of a European Unemployment Benefit Scheme” (2016), ec.europa.eu/social/BlobServlet?docId=16886&langId=en commissioned by the Directorate-General Employment of the European Commission [Both Accessed 7 September 2017].

In this paper, we start by outlining some recent policy proposals for risk sharing in EMU and their key features, and continue by contrasting them with the prevailing arrangements found in mature federations. We note that, while in most federations the federal budget plays some role in smoothing state-specific shocks, this role is relatively small and operates through mechanisms that are different from those proposed for the euro area. We then turn to analysing the risk-sharing proposals from economic, legal and political viewpoints. Our analysis suggests that, first, even if operated as intended, the proposed mechanisms would contribute less to economic stability than suggested. Second, the mechanisms would likely be difficult to operate as intended. They would be prone to produce outcomes that seem unintuitive and unjust, and would risk turning into a political zero-sum game and a source of division and discord rather than unity. Finally, we find fundamental problems in the idea of making access to the mechanism conditional upon compliance under the economic governance framework.

We share the view that EMU is, in a certain sense, incomplete, but we do not think that a fiscal union would necessarily make it more complete. The fundamental incongruity of the EMU is not the one between the common monetary policy and national fiscal policies, but that between the common monetary policy and the fragmented European political landscape. This incongruity can only be resolved through much deeper political integration, a long-term prospect, at best. Until then, the point of incongruity can be merely relocated but not eliminated. A deeper fiscal union could bring fiscal policies in better alignment with the common monetary policy, but this would be at the cost of widening the disparity between fiscal integration and, on the other side, the reality of limited degree of structural, social and political integration, all critical for proper functioning and legitimacy of a fiscal union. Our argument is that the challenges presented by the new situation would be different from those faced by EMU today but not necessarily any easier to deal with.

2. Fiscal stabilisation mechanism – recent proposals and their key features

The element of the fiscal union presently attracting the greatest attention is, what has subsequently become known as, a fiscal stabilisation mechanism. A fiscal stabilisation mechanism, as proposed, would create counter-cyclical fiscal transfers between euro area countries, thereby compensating for the absence of independent monetary policy and a sizeable federal budget as stabilisation tools.¹¹ Such proposals have been part of every authoritative EU document on EMU deepening, starting from the Commission's Blueprint in 2012, continuing in the Four Presidents' Report in the same year,

¹¹ A. Hinarejos, "Fiscal Federalism in the European Union: Evolution and future choices for EMU" (2014) C.M.L. Rev. 1621; J. Pisani-Ferry, E. Vihriälä, and G.B. Wolff, "Options for a Euro-area fiscal capacity", *Bruegel Policy Contribution, No 2013/01* (2013), http://bruegel.org/wp-content/uploads/imported/publications/pc_2013_02.pdf [Accessed 7 September 2017]; *Repasi* (2013).

again in the Five Presidents' report in 2015 and the Commission's Reflection Paper published in May 2017 and its Roadmap published in December 2017.¹²

These are all high-level policy documents, with little detail on the mechanics of the envisaged mechanisms. However, at a fairly high level of abstraction, the basic idea has remained unchanged since the Commission's Blueprint. According to the Blueprint, a "fiscal capacity with a stabilisation function" would "require [from the Member States] monetary net payments that are negative in good times and positive in bad times".¹³ In its simplest form, the fiscal stabilisation mechanism would collect funds from Member States in relative economic boom and redistribute them directly to those in relative recession. In this basic form, the fiscal capacity would be merely a clearing house for Member States' cross subsidies, with no accumulated financial capacity of its own. The same concept was later recycled in the Five Presidents' Report.¹⁴ Both the Five Presidents' Report and the Commission's Reflection Paper stress that the stabilisation function should not duplicate the role of the European Stability Mechanism ("ESM").¹⁵ We take this as meaning that the mechanism would not enter into crisis financing but only provide support for countries that maintain access to financial markets.

The Commission Reflection Paper proposes a slightly modified model of a "rainy day fund" – the term borrowed from the systems established by many US states – which is also promoted by the IMF.¹⁶ A rainy day fund would add to the simplest clearing-house function the possibility to accumulate a positive balance in good times, which would then result in a larger capacity and more meaningful support in bad times. The IMF study calculates that annual contributions to the fund of around 2 percent of GDP could provide stabilisation equivalent to that found within the German federation. The rainy-day fund has been debated politically in an informal meeting of the Ecofin Council¹⁷ and is also mentioned in the European Parliament's report on budgetary capacity for the Eurozone.¹⁸ In its Reflection Paper, the Commission also suggests that allowing the fund to issue debt would increase

¹² Communication from the Commission, "A blueprint for a deep and genuine economic and monetary union – Launching a European Debate" COM(2012) 777 final. ("Commission Blueprint"); *Four Presidents' Report*; J.-C. Juncker, D. Tusk, J. Dijsselbloem, M. Draghi and M. Schulz, "The Five Presidents' Report: Completing Europe's Economic and Monetary Union" (2015) ("Five Presidents' Report"); *Commission Reflection Paper*; Communication from the Commission, "Further steps towards completing Europe's Economic and Monetary Union: A Roadmap" COM(2017) 821 final ("Commission Roadmap").

¹³ Commission Blueprint, pp.31-32.

¹⁴ *Five Presidents' Report*. See also Pisani-Ferry, Vihriälä and Wolff (2013).

¹⁵ Under ESM Treaty, art. 3 its purpose is "to mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States."

¹⁶ C. Allard et al. (2013).

¹⁷ Slovak Presidency, "Issues note: Deepening the EMU – fiscal pillar, Informal ECOFIN" (9 September 2016), <http://www.eu2016.sk/data/documents/presidency-issues-note-emu-fiscal-pillar.pdf> [Accessed 7 September 2017].

¹⁸ European Parliament, "Report on Budgetary Capacity for Eurozone" (2017) 2015/2344(INI), <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A8-2017-0038+0+DOC+PDF+V0//EN> [Accessed 7 September 2017].

its capacity to provide support in bad times.¹⁹ The question of what would back up that debt (the EU or the Member States, pro rata or jointly) is not raised, but is obviously of fundamental importance.

A third variant of the fiscal stabilisation mechanism embeds risk sharing into the provision of a cyclically sensitive public good, usually unemployment insurance. In its most ambitious form, this variant would entail a full-fledged EU unemployment insurance system to complement the national systems.²⁰ More often, what is envisaged is a system of cross-subsidisation between national unemployment insurance funds, where national systems with cyclically low unemployment would subsidise those with cyclically high unemployment.²¹ The Commission Reflection Paper calls this variant a European Unemployment Reinsurance Scheme. The Commission also notes that the scheme would likely require further convergence of labour market policies and characteristics.

Finally, the Commission Reflection Paper suggests that the stabilisation function could take the form of an investment protection scheme. The Commission refers to the well-known fact that in economic downturns, public investments are typically the first to face significant cuts. According to the Commission, “with the protection scheme, which could be in the form of a financial instrument, investment projects could still be continued.”²² There are no further explanations as to how the investment protection scheme would work or how exactly it would incentivise Member States not to cut public investment during recessions.

While these policy proposals themselves have been general and vague, they have been fleshed out in more detail in a number of academic proposals. When read together, these proposals emphasise certain shared key features, providing hints of how such a system could operate. In particular, three such key features seem to be part of most proposals.

¹⁹ Despite art.310(4) TFEU, the EU budget is already used as collateral for issuing a limited quantity of debt, backed up by the right of EU to call on own resources from the Member States, up to a ceiling, proportionally to their GNI. See Council Regulation (EU) No. 407/2010 establishing a European financial stabilisation mechanism as amended by Council regulation (EU) 2015/1360 [2010] OJ L118/1. The EU budget includes a budget line for the purpose of guaranteeing EU loans raised under the EFSM. The volume of outstanding loans or credit lines is limited to the available margin between EU payment appropriations and the own resources ceiling of the budget, presently set at 1.20% of EU GNI. At the time of its establishment, the maximum capacity of the EFSM was estimated at €60 bn. Communication on the European Financial Stabilisation Mechanism, COM(2010) 713 final, pp.3-4. See also Council Regulation (EC) No. 332/2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments [2002] OJ L53/1.

²⁰ L. Andor, “Social dimension of the Economic and Monetary Union: what lessons to draw from the European elections?” (13 June 2014) Lecture at Hertie School of Governance, Berlin, http://europa.eu/rapid/press-release_SPEECH-14-455_en.htm [Accessed 7 September 2017]; L. Andor, “Basic European unemployment insurance: Countering divergences within the Economic and Monetary Union” (29 September 2014) Speech at Vienna University of Economics and Business, Vienna, http://europa.eu/rapid/press-release_SPEECH-14-635_en.htm [Accessed 7 September 2017].

²¹ M. Beblavý, D. Gros and I. Maselli, “Reinsurance of National Unemployment Benefit Schemes”, CEPS Working Document No. 401 (2015), <http://www.ceps.eu/system/files/wd401.pdf> [Accessed 7 September 2017]; M. Dolls, C. Fuest, D. Neumann and A. Peichl, “An Unemployment Insurance Scheme for the Euro Area”, ZEW Discussion Paper No. 14-095 (2014), https://www.ecb.europa.eu/pub/conferences/shared/pdf/20161110_fiscal_policy/paper_6.pdf [Accessed 7 September 2017]

²² Commission Reflection Paper, p.30.

The first key feature is a *focus on cyclical rather than structural shocks*. This was made clear already in the Four Presidents' Report: "Over time, each euro area country, as it moves along its economic cycle, would in turn be a net recipient and a net contributor of the scheme." Further, the Report stresses that the system should not be conceived as income equalisation tool.²³ Therefore, whether or not a Member State in severe economic difficulties would be eligible to benefit from financial support would depend on whether the difficulties are deemed to be temporary (eligible), or permanent (not eligible). Apart from being somewhat counterintuitive, this feature may create some political vulnerabilities, which we will return to later.

The second key feature, part of nearly all proposals,²⁴ is the *avoidance of "permanent transfers"*. This is widely seen as a political imperative, arising primarily from the recognised limits to European solidarity, but has also a legal dimension, related to the no-bailout clause of art.125 TFEU. What exactly constitutes a permanent transfer is usually left undefined, perhaps in the belief that the concept is self-explanatory. In reality, however, its exact meaning is far from clear. In its weakest form, the absence of permanent transfers could mean that the net contribution of each country from the mechanism should *ex ante* be zero, while *ex post*, once the diverging economic fortunes have been revealed, some countries could end up net contributors while others would be net beneficiaries. This would be essentially a classical insurance policy, where the unlucky receive permanent transfers from the lucky. A slightly stronger requirement would be that the composition of net recipients and net contributors ought to change over time, with no country remaining permanently in one category.²⁵ In an even stronger form, it could mean that, over a sufficiently long horizon, even the *ex post transfers* should be zero, i.e. the cumulative net payments converge to zero. Any net drawings from the system would accumulate a negative balance that would later need to be paid back with interest.²⁶ Under this interpretation, the system would not be in the business of providing insurance but rather – presumably interest-bearing – loans. The exact definition of avoidance of permanent transfers has important implications on the stabilising properties and indeed on the usefulness of the whole system.

The final key feature is the *strict conditionality of access*. The Five Presidents' Report suggests that the right to benefit from the stabilisation function should be "tightly linked to compliance with the broad EU governance framework and to progress in converging towards... common standards".²⁷ Similarly, in its report, the European Parliament sees that full access to the fiscal capacity should be

²³ *Four Presidents' Report*, p.12.

²⁴ Commission Blueprint, p.32; *Five Presidents' Report*; Slovak Presidency, "Issues note: Deepening the EMU – fiscal pillar, Informal ECOFIN" (9 September 2016) final at 32; European, Parliament, "Report on Budgetary Capacity for Eurozone" (2017) 2015/2344(INI).

²⁵ The proposal by Dolls et al. seems to fall into this category. M. Dolls, C. Fuest, F. Heinemann and A. Peichl, "Reconciling Insurance with Market Discipline: a Blueprint for a European Fiscal Union" (2016) 62 *CESifo Economic Studies* 210.

²⁶ For a fully specified model of this type, see H. Oksanen, "Smoothing Asymmetric Shocks vs. Redistribution in the Euro Area: A Simple Proposal for Dealing with Mistrust in the Euro Area", *CESifo Working Paper No. 5817* (2016), https://www.cesifo-group.de/DocDL/cesifo1_wp5817.pdf [Accessed 7 September 2017].

²⁷ *Five Presidents' Report*, p.15.

conditional on observance of a “convergence code”, a broad set of mutually agreed macroeconomic policies. According to the Commission Reflection Paper “access to the stabilisation function should be strictly conditional on clear criteria and continuous sound policies, in particular those leading to more convergence within the euro area. Compliance with EU fiscal rules and the broader economic surveillance framework should be part of this.” A country’s access to the mechanism would thus be conditional on compliance under the Stability and Growth Pact (SGP) and the Macroeconomic Imbalances Process (MIP), and possibly the “agreed standards” set up under the “more binding convergence process” proposed by the Reflection Paper. Although it is not stated explicitly, we assume that this suspension would only concern the benefit side of the system, and that a transgressing Member State would still be expected to contribute to the system. In its December 2017 package, the Commission maintains all these basic elements and indicates a preference towards the investment protection scheme.²⁸ In addition, the Commission seems to raise the possibility of making participation in the stabilisation function voluntary for Member States. Beyond that, there is little in terms of new detail. A fully fleshed-out proposal is promised for 2018.

Such plans, should they come to fruition, would bring substantial changes to the way public money flows within the EU as well as new forms of interference by the EU in matters under Member State competence, and thus they raise important questions of democratic accountability and legitimacy of decision-making. Yet such issues have attracted very limited attention in these proposals. The Blueprint envisages the “progressive pooling of sovereignty and thus responsibility as well as solidarity competencies to the European level”.²⁹ Since then, the matter has received little attention. To the extent concepts such as sovereignty, competence, democratic accountability or legitimacy are discussed at all, their handling has been perfunctory.

Proposals involve stronger engagement of the European Parliament, and to a more limited extent, national parliaments in EU-level debates but without granting them formal decision-making powers. The Commission Reflection Paper follows the same tradition and treats the accountability challenges mainly as caused by the mixed institutional architecture of the EMU, which includes a number of intergovernmental bodies and practices, and results in multiple and complex “checks and balances”. The Commission also notes that issues relating to the common interest of the euro area are not sufficiently represented in public debate and decision-making. Addressing these problems would require equipping the European Parliament and national parliaments “with sufficient powers of oversight, following the principle of accountability at the level where decisions are taken”. In addition, the regular dialogue between the Commission and the European Parliament could be formalised by the two institutions and extended to the Eurogroup, and translated into (yet another intergovernmental) agreement on the democratic accountability of the euro area, to be later integrated into the EU Treaties.

²⁸ Commission Roadmap; Communication from the Commission, “New Budgetary Instruments for a Stable Euro Area within the Union Framework” COM(2017) 822 final.

²⁹ Commission Blueprint, p.12.

Before analysing further the EU's capacity to operate fiscal stabilisation mechanisms of nature proposed, it is instructive to remind ourselves of the vehicles the EU already possesses and consider their potential for countercyclical purposes. The obvious candidate is the EU budget, which is already highly redistributive and involves sizeable permanent transfers. As to its cyclical properties, the EU budget is, if anything, procyclical,³⁰ as a significant part of its expenditure is tied to the co-financing of public infrastructure projects, an activity which is inherently cyclical. The Commission Reflection Paper in fact suggests, though in a half-hearted manner, to consider ways to strengthen the stabilisation features of the EU budget already by 2019, but notes that due to its small size, "the overall macroeconomic stabilisation properties of such an approach remain limited".³¹

It is true that the EU budget is small relative to the federal budgets of mature federations. Yet, had the will been there to make the revenue and the expenditure sides of the EU budget as responsive to the economic cycle as possible, it could still be making a significant contribution to fiscal stabilisation. The reality is that no real attempt has ever been made to adapt the EU budget to that purpose. Its purposes are elsewhere, mainly in compensating the perceived asymmetric benefits that different countries draw from the single market. Considering its size, it is actually remarkably effective at this job.³² If the Member States wished to improve the countercyclicality of the EU, the simplest way to proceed would be on the revenue side, by linking Member States' contributions to a cyclical revenue base such as the corporate tax or progressive income tax.³³

Politically, touching the EU budget is generally considered a no-go.³⁴ In EU budget negotiations, Member States' success is measured by changes in net contributions at the national level, not by the contribution to the common good or to stabilising asymmetric shocks. The power of inertia is immense since, in the absence of agreement, the *status quo* will prevail. Though the political obstacles to working through the EU budget are formidable, there may be some positive momentum building, as Brexit will force the reopening of some of its key elements. And in any case, one must ask, why would the political forces that lead to the calcification of the EU budget be any less powerful in the case of a newly established fiscal capacity?

³⁰ J. Rodden and E. Wibbels, "Fiscal decentralization and the business cycle: an empirical study of seven federations" (2010) 22 *Economics & Politics* 37.

³¹ The Reflection Paper also mentions the creation of a separate euro area budget, which "could ensure broader objectives, covering both convergence and stabilisation, and would need a stable revenue stream". The visions of the French President Emmanuel Macron also include plans for a new euro budget, see e.g. A. Rettman, "Macron calls for powerful eurozone budget" (31 August 2017), *EUobserver*, <https://euobserver.com/economic/138841> [Accessed 7 September 2017].

³² Many small EU countries receive annually 3-4 percent of their GDP in net transfers from the EU, a figure that compares well among federations with much bigger federal budgets.

³³ Rodden and Wibbels (2010).

³⁴ *High Level Group on Own Resources, "Future Financing of the EU" (2016)*, http://ec.europa.eu/budget/mff/hlgor/library/reports-communication/hlgor-report_20170104.pdf [Accessed 7 September 2017].³⁵ *Five Presidents' Report*, p.14.

3. Fiscal risk sharing in mature federations

The discussion about a Fiscal Union seems to be predicated on an assumption that, in mature monetary unions, most of which are federations, the central government plays an important role in counteracting state-level asymmetric shocks. The Five Presidents' Report claims rather boldly that "all mature Monetary Unions have put in place a common macroeconomic stabilisation function to better deal with shocks that cannot be managed at the national level alone".³⁵ Beyond this general statement – which is not justified or elaborated – the European discussion makes very little use of experiences by others. One could of course argue that the *sui generis* nature of EMU reduces the value of experiences elsewhere. But while all monetary unions / federations are *sui generis*, each in their own way, the questions of fiscal federalism, to which the issue at hand belongs, and their relation to democratic processes are very much shared.

From that viewpoint, it is not easy to identify within existing federal fiscal structures elements that are aimed at the particular purpose of stabilising asymmetric fluctuations at state level. What generally exists is a federal budget that performs various public functions, some of which may provide varying degrees of state-level stabilisation, while others are actually procyclical. Virtually all federations subsidise sub-central expenditure in programs that the federal level considers worthy. In addition, many federations provide "solidarity" through equalisation payments that seek to even out, on a permanent basis, part of the differences in states' capacity to provide public services to their citizens. The extent and modalities of such systems vary considerably.³⁶ Over the next few pages, we provide a brief overview of such fiscal arrangements in five established federations, Australia, Canada, Germany, Switzerland and the United States. We concentrate in particular on the nature of their federal transfer systems, their performance in countering state-level asymmetric shocks, and on the possible preconditions for state access to these transfers.

Perhaps the best example of something close to a fiscal stabilisation function can be found in Australia. There the federal government's dominant role in taxation³⁷ has resulted in a significant vertical fiscal imbalance between the federal level and the states, making the Australian states heavily reliant on federal funding to carry out their responsibilities.³⁸ To counteract this, Australia has developed a system of federal grants which comprise of "tied" grants, to be spent on functions or projects specified by the Commonwealth, and a complicated system of "untied" equalisation payments (Horizontal Fiscal Equalization ("HFE")) "*for the purpose of making it possible for the State, by reasonable effort,*

³⁵ *Five Presidents' Report*, p.14.

³⁶ R.L. Watts, *Comparing Federal Systems* (Montreal: McGill-Queen's University Press, 2008), pp.108-109.

³⁷ See eg J.P. Smith, "Taxing Popularity: The Story of Taxation in Australia" (2004) *Australian Tax Research Foundation Research Study No. 43*, pp.74-76.

³⁸ See eg A. Twomey, "Reforming Australia's Federal System" (2008) 36 *Federal Law Review* 57, 65.

to function at a standard not appreciably below the standards of other States".³⁹ Both the tied grants and the HFE are meant to rebalance structural differences between states, not cyclical fluctuations, but there is some evidence that the system as a whole may actually also provide very modest smoothing of state-level asymmetric shocks.⁴⁰ Beyond the earmarking of the tied grants, there is no conditionality attached to federal grants in Australia.

Canada has a fairly complex system of transfers from the federal to the provincial level. The bulk of the transfers consists of programs earmarked for health and social spending, available to all provinces.⁴¹ Beyond these earmarked transfers, the Canadian Constitution Act 1982 also provides for equalisation payments "to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."⁴² These payments are administered by a politically divisive formula, which in 2013-14 identified six out of the ten provinces as eligible recipients.⁴³ Apart from the process of earmarking itself, the federal transfers do not contain further conditionality relating to the use of these funds. As in Australia, the aim of the transfers is structural, not cyclical, but unlike in Australia, the Canadian system does exactly what it intends to do and no more. Empirical research shows that, if anything, instead of smoothing state-level asymmetric shocks, the Canadian system of federal transfers seems to accentuate them.⁴⁴

Germany is a unique case in terms of the very high share of joint taxes that is a defining characteristic of its federal fiscal system.⁴⁵ More than two thirds of the total tax revenues in Germany are collected jointly and then divided between the federal government and the state and local governments. The joint taxes include the VAT, the personal income tax, and the corporate tax. These revenues are allocated to the states in a multi-stage equalisation process, based on art.107 of the German constitution (*Grundgesetz*). In the first instance, each state receives a share of the income tax and corporate tax accrued within the state and its per-capita share of the VAT. In the next step, there is a series of horizontal equalisation payments from the well-off states to the poorer states, which eliminate some

³⁹ Section 5(1) of the Commonwealth Grants Commission Act 1973. On this, see S. Kirchner, "Lessons from the Australian Experience" in J. Clemens and N. Veldhius (eds), *Federalism and Fiscal Transfers: Essays on Australia, Germany, Switzerland, and the United States* (Fraser Institute, 2013), <https://www.fraserinstitute.org/sites/default/files/federalism-and-fiscal-transfers-rev.pdf> [Accessed 7 September 2017]. Also see L. Finlay, "The Power of the Purse: An Examination of Fiscal Federalism in Australia" (2012) 24 *Journal of Constitutional History* 81; I. McLean, "Fiscal Federalism in Australia" (2004) 82 *Public Administration* 21.

⁴⁰ Rodden and Wibbels (2010).

⁴¹ See e.g. *Canadian Department of Finance, "Federal Support to Provinces and Territories"* (2016), <https://www.fin.gc.ca/access/fedprov-eng.asp> [Accessed 7 September 2017]. Although, as noted elsewhere, grants given by the federal government to the provinces tend to be so general as to be unconditional. *Watts* (2008), p.106.

⁴² Canadian Constitution Act 1982, s.36(2).

⁴³ J. Clemens and N. Veldhius, "Federalism and Fiscal Transfers in Canada" in Clemens and Veldhius (2013), p.16.

⁴⁴ Rodden and Wibbels (2010).

⁴⁵ *German Ministry of Finance, "The Federal Financial Equalisation System in Germany"*, https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Oeffentliche_Finzen/Foederale_Finanzbeziehungen/Laenderfinanzausgleich/Eng-Der-Bundesstaatliche-FAG.pdf?__blob=publicationFile&v=1 [Accessed 7 September 2017].

three quarters of the per-capita differences in tax revenues. The final stage is vertical supplementary grants from the federal government to the states whose per-capita tax revenues still remain below the national average or which otherwise face special circumstances. Like in Canada, these grants come with no conditionality attached. The final outcome of this process is an almost full elimination of tax revenue differences among the states.⁴⁶

The way the German equalisation system ties the federal grants to states to the outcome of the revenue equalisation process makes it somewhat difficult to make a clean distinction between revenue equalisation and grants, and to assess their relative roles in smoothing shocks. However, to the extent such a distinction can be made, the empirical results do not find that German federal grants contribute to smoothing state-level asymmetric shocks.⁴⁷

The defining feature of the US federal system is a strong presumption of state fiscal sovereignty.⁴⁸ As a rule, the federal government does not interfere with state-level fiscal decisions and does not seek to regulate their fiscal debt or deficit. There is no obligation for the federal level to support states in difficulties, and there is no system of federal equalisation grants to reduce fiscal disparities between the states or to smooth their economic fluctuations.⁴⁹ However, the federal government does provide substantial amounts of specific-purpose grants to states out of the general federal coffers.⁵⁰ These grants may come with conditions attached, but the nature of the conditionality is constrained by the jurisprudence of the US Supreme Court, according to which the conditions imposed must be clear and reasonably related to the purpose of the expenditure.⁵¹

Most studies find that, rather than smoothing state-level asymmetric fluctuations, federal direct spending (including grants and transfer programs) is, if anything, procyclical. On the other hand, these studies find a very significant smoothing from the revenue side, where the federal tax system is found to compensate for 25-36 percent of a fall in state income.⁵² In contrast, Alcidi and Thirion find

⁴⁶ As an example, before equalisation payments, the per-capita tax revenues in the State of Hessen are about three times higher than in Mecklenburg-Vorpommern. After equalisation payments, this difference shrinks to roughly 8 %. C.B. Blankart, "Federal Transfer Programs in Germany" in Clemens and Veldhuis (2013), p.60.

⁴⁷ Rodden and Wibbels (2010).

⁴⁸ C.R. Henning and M. Kessler "Fiscal Federalism: US History for Architects of Europe's Fiscal Union", Peterson Institute for International Economics Working Paper Series WP 12-1 (2012), p.15. K.J. Stark, "Rich States, Poor States: Assessing the Design and Effect of a U.S. Fiscal Equalization Regime" (2011) 63 Tax Law Review 957.

⁴⁹ T. Virkola, "Fiscal Federalism in Four Federal Countries", ETLA Reports No. 3 (2014), p.35, <https://www.etla.fi/wp-content/uploads/ETLA-Raportit-Reports-38.pdf> [Accessed 7 September 2017].

⁵⁰ The 2016 Catalogue of Federal Domestic Assistance contains more than 3300 pages. J.F. Kirkegaard, "Study: Economic Governance Structures in the United States" (2015), p.6, [http://www.europarl.europa.eu/Reg-Data/etudes/STUD/2015/542668/IPOL_STU\(2015\)542668_EN.pdf](http://www.europarl.europa.eu/Reg-Data/etudes/STUD/2015/542668/IPOL_STU(2015)542668_EN.pdf) [Accessed 7 September 2017]. Regarding grants-in-aid, see also C. Edwards, "Fiscal Federalism in the United States" in Clemens and Veldhuis (2013).

⁵¹ A.E. Moody, "Conditional Federal Grants: Can the Government Undercut Lobbying by Nonprofits through Conditions Places on Federal Grants?" (1996) 24 Environmental Affairs 133. The lead Supreme Court case is *Massachusetts v United States*, 435 U.S. 444, 461 (1978). See also *Ivanhoe Irrigation Dist. v. McCracken*, 357 U. S. 275, 294-296 (1958).

⁵² I. Malkin and D.J. Wilson, "Taxes, Transfers, and State Economic Differences" (2013)

much more modest total smoothing (11 percent and diminishing) by the federal budget, and a very different composition.⁵³ According to their results, federal grants do indeed have countercyclical properties and compensate about 8 percent of state-level shocks, while the tax system plays a small countercyclical role. The federal unemployment insurance system is found to play almost no role at all. Compared to the significant cross-state private risk sharing taking place through the capital and credit markets, the combined role of all channels of fiscal risk sharing is found modest.⁵⁴ Nearly all US states have rainy day funds, though, notably, these have been established and are maintained by the states themselves with no federal intervention, and they operate at the state level, with no interstate risk sharing.

Finally, Switzerland presents yet another unique (con)federal model. It shares some key features with the US, including the presumption of cantonal fiscal autonomy and no interference by the confederal government in cantonal fiscal matters.⁵⁵ On the other hand, the Swiss model strikes a different balance between the federal and state levels in fiscal matters. The right of the Confederation to raise taxes is strictly circumscribed by the Swiss Constitution,⁵⁶ resulting in one of the most decentralised federal systems in the world, with the federal level spending less than a third of all public expenditure – the smallest share of all major federations in the world.⁵⁷ In 2008, as part of a constitutional reform primarily focused on the disentangling of tasks between the Cantonal and Confederate levels,⁵⁸ Switzerland introduced a new fiscal equalisation scheme. The system, which constitutes the dominant vehicle of federal grants to the Cantons, aims to bring per capita financial resources in all Cantons up to a minimum of 85 percent of the national average. About 40 percent of the equalisation takes place horizontally between the Cantons, with the remaining 60 percent being financed from the federal budget.⁵⁹ In keeping with the fiscal sovereignty of the Cantons, the equalisation payments come with

FRBSF Economic Letters 2013-36, <http://www.frbsf.org/economic-research/publications/economic-letter/2013/december/taxes-transfers-redistribution-us-federal-government-states/> [Accessed 7 September 2017]. J. Feyrer and B. Sacerdote, “How Much Would U.S. State Fiscal Integration Buffer European Unemployment and Income Shocks? A Comparative Empirical Analysis.” (2013) 103 *American Economic Review* 125. Rodden and Wibbels (2010).

⁵³ C. Alcidi and G. Thirion, “Fiscal Risk Sharing and Resilience to Shocks: Lessons for the euro area from the US”, *CEPS Working document No 2017/07*, https://www.ceps.eu/system/files/No%202017_07%20CA%20and%20GT%20Fiscal%20risk-sharing%20and%20resilience%20to%20shocks.pdf [Accessed 7 September 2017].

⁵⁴ P. Asdrubali, B.E. Sørensen and O. Yosha, “Channels for Interstate Risk sharing: United States 1963–1990” (1996) 111 *The Quarterly Journal of Economics* 1081.

⁵⁵ G. Kirchgässner, “Fiscal Institutions at the Cantonal Level in Switzerland”, *University of St. Gallen Discussion Paper No. 2013-04* (2013), <http://ux-tauri.unisg.ch/RePEc/usg/econwp/EWP-1304.pdf> [Accessed 7 September 2017].

⁵⁶ Federal Constitution of the Swiss Confederation, arts 128-133.

⁵⁷ See Watts (2008), pp.102-103.

⁵⁸ R.L. Frey and G. Wettstein, “Reform of the Swiss Fiscal Equalisation System”, *CESifo DICE Report 1/2008* (2008), p.22, <https://core.ac.uk/download/pdf/6631016.pdf> [Accessed 7 September 2017].

⁵⁹ *Swiss Federal Department of Finance*, “National fiscal equalization” (2017), <https://www.efd.admin.ch/efd/en/home/themen/finanzpolitik/national-fiscal-equalization/fb-nationaler-finanzausgleich.html> [Accessed 7 September 2017].

no earmarking or conditions.⁶⁰ While the system is too new to allow empirical assessment of its cyclical properties, it is clearly tuned for equalising structural disparities in financial strength rather than for countercyclical purposes.

This short overview of federal fiscal arrangements allows the drawing of some stylised conclusions. First, mechanisms specifically designed to smooth state-level asymmetric shocks do not generally exist in mature federations. Instead, there often exist systems to compensate for structural differences in states' fiscal capacity through federal grants or, less frequently, through horizontal transfers between states. The federal level also provides grants to subsidise some public expenditure deemed in the national interests, and runs a number of federal programs such as federal unemployment insurance or social security programs.

Second, while federal expenditure programs may operate countercyclically at the national level, there is little evidence that these systems actually stabilise state-level idiosyncratic shocks. Most empirical work on the cyclical properties of federal grants focuses on the USA and generally finds the federal expenditure side more likely to accentuate than to smooth state-level shocks. Those federal programs with an explicit countercyclical purpose and design (such as the federal unemployment insurance system) tend to be small and their effects crowded out by the more procyclical elements of the federal expenditure. The limited empirical evidence outside of the USA indicates that these conclusions hold more generally. According to an OECD study, on average of 40 percent of grants from the central government match expenditure at the sub-central level. When state investments programs are cut during a recession, the matching federal grants are cancelled as well. The study concludes that “[intergovernmental] transfer systems tend to be pro-cyclical in general and in more than half of OECD countries they tend to destabilise sub-central budgets.”⁶¹

Third, although the fiscal equalisation systems typically provide little smoothing at cyclical frequencies, they do provide substantial insurance against more permanent shocks. The equalisation payments are typically pure, permanent transfers, and there is no attempt to balance net contributions over the long term. A province in Canada or a *Land* in Germany experiencing a permanent loss of economic performance can expect, over time, to recoup a majority of the costs in equalisation transfers from the rest of the federation, and keep on benefiting as long as the damage to the economy persists. In this way, equalisation systems in many federations provide a true insurance function for the states.

⁶⁰ See P. Bessard, “Switzerland’s Reformed Fiscal Equalization System: Still Substantial Room for Improvement” in Clemens and Veldhüs (2013).

⁶¹ H. Blöchliger and B. Égert, “Fiscal Consolidation Across Government Levels - Part 3. Intergovernmental Grants, Pro- or Counter-cyclical?”, OECD Economics Department Working Papers No. 1072 (2013), <http://www.oecd-ilibrary.org/docserver/download/5k43nxqrlmtf-en.pdf?expires=1504782609&id=id&ac-name=guest&checksum=3DF3B20D27552728F5B95776A9828BDF> [Accessed 7 September 2017].

Fourth, federal grants may come with earmarking or procedural provisions aimed at ensuring effective use of the funds for their intended purpose, and to achieve “political ‘cleanliness’, equity and fairness”,⁶² but conditionality in *stricto sensu* is rare. In particular, we do not find a single example of macroeconomic or other broad conditionality not linked to the purpose of the funds.

Fifth, and importantly, while federal expenditure is found to provide little or no smoothing of state-level shocks, the federal revenue side tends to perform better. Federal tax revenues raised from a state tend to be highly sensitive to the economic conditions within the state and thus provide a substantial degree of automatic stabilisation.

Finally, while the arrangements of fiscal federalism differ, a deep federal fiscal role is always supported by a high degree of political integration. Even in other highly decentralised federations (Switzerland) political parties maintain integrated structures.⁶³ Non-integrated and truncated parties are only found in Canada.⁶⁴ In Germany, parties are so integrated that *Land*, local and even European elections tend to be referenda about the federal government.⁶⁵ Parties at the federal level generally face strong incentives to maintain integrative linkages and exercise control over the state-level parties, enhancing overall policy coherence within the party,⁶⁶ through accommodating diverse regional and state level interests within the parties in order to keep ranks closed over the different orders of government.⁶⁷ Party competition is decisive for the allocation of political power at the different levels of government. Federal and party systems are intertwined, and organise both conflict and conflict resolution,⁶⁸ through a continuous process of negotiations between the administrations of the two orders of government. The contrast with the shallowness of the political integration in the EU is striking. EP elections are characterised by the virtual absence of campaigning on European issues, and voters tend to see EP elections as a referendum on national political matters or as a forum for protesting against the EU in general.⁶⁹

This short overview demonstrates that the proposals for the euro area presented in section 2 are indeed *sui generis*, with no real precedent in mature federations. This does not necessarily mean they are faulty; there is a first for every step towards better governance. However, federal fiscal structures are

⁶² P.B. Spahn, “Using conditionalities in intergovernmental grants: What can be learnt from the US and EU experiences” (21 June 2012) Presentation at OECD Workshop on Effective Public Investment at Subnational Level in Times of Fiscal Constraints, Paris, <https://www.oecd.org/cfe/regional-policy/Using-conditionalities-intergovernmental-grants-ppt.pdf> [Accessed 7 September 2017].

⁶³ Thorlakson (2009), 170.

⁶⁴ L. Thorlakson, “Patterns of Party Integration, Influence and Autonomy in Seven Federations” (2009) 15 Party Politics 157, 169.

⁶⁵ W. Renzsch, “Bifurcated and Integrated Parties in Parliamentary Federations: The Canadian and German Cases”, *Queen’s University IIGR Working Paper 2001/4 (2011)*, p.22, <http://www.queensu.ca/iigr/sites/webpublish.queensu.ca/iigrwww/files/files/WorkingPapers/Archive/2001/2001-4WolfgangRenzsch.pdf> [Accessed 7 September 2017].

⁶⁶ Thorlakson (2009), 164.

⁶⁷ Renzsch (2001), p.22.

⁶⁸ Renzsch (2001), p.22.

⁶⁹ L. Thorlakson, “Representation in the EU: multi-level challenges and new perspectives from comparative federalism” (2017) 24 Journal of European Public Policy 544, 550 and 557.

not accidental, but rather among the most carefully thought out features of federal systems, the result of long and meticulous preparation and political compromise. It seems reasonable to contrast what is being proposed for the euro area with what exists elsewhere and ask whether there might be good reasons why existing federations have chosen otherwise. The obvious question is, why is there, in existing federations, neither explicit mechanisms aimed at stabilising state-level idiosyncratic shocks, nor an active debate on their potential usefulness? Granted, the federal budget, and in particular federal taxation, already performs some automatic smoothing but, as shown above, the effect is more modest than often believed. If mechanisms can be devised to do better, surely there is a case for trying. We believe the answer has much to do with the inherent political sensitivities of regional redistribution, which create challenges even in mature multi-level political structures.

To maintain peaceful intergovernmental fiscal relations, federal structures “should be based on stable, transparent, non-arbitrary, universal, and non-negotiable rules.”⁷⁰ Accordingly, existing federal redistributive systems, once agreed upon – after what are invariably lengthy and divisive political negotiations – are not meant to be reopened. They are permanent in nature and rely on rigid, mechanistic formulas linked to measureable variables. In contrast, a system that seeks, at least annually and perhaps more often, to reallocate funds on the basis of divergent cyclical situations in states would have to be forward looking and rely considerably on economic analysis and discretion. This would almost surely make it a venue of recurrent political battles. We suspect such a prospect may have encouraged existing federations to look elsewhere.

4. The economics, law and politics of fiscal stabilisation

To form a full picture of the feasibility and usefulness of a fiscal stabilisation mechanism, one must examine it from several separate but intertwined perspectives. One angle is economics. If implemented to perfection, would such a mechanism be helpful and meet its stated goals? What elements would contribute to or detract from its effectiveness? Another angle is law. How comfortably would it sit in the legal framework of the Union? What legal bases are available, and how do they limit the range of choices? The third angle is political science. How would the proposed mechanism relate to the degree of political integration in the EU? What limitations would real politics place upon EU decision-making bodies’ ability to operate the mechanism, and what exactly are the crucial points in the event of implementation faltering? All of these angles seek to respond to the same overall question relating to enforcement: is it reasonable to presume that a mechanism could be designed and adopted that would deliver the expected results? What would need to be taken into account when sketching the mechanism?

⁷⁰ P.B. Spahn, “Decentralized Government and Macroeconomic Control”, *World Bank Infrastructure Note Urban No. FM-12 (1997)*, <http://documents.worldbank.org/curated/en/370061468314988622/pdf/383290ove.pdf> [Accessed 7 September 2017].

The economics angle has been covered elsewhere, so we can be brief.⁷¹ There are many design possibilities for a mechanism that redistributes funds between Member States on the basis of objective rules linked to macroeconomic developments and, at least on paper, stabilises public revenues. The choice of the right indicator is complicated, as the output gap suffers from sizeable revisions and unemployment rate tends to lag behind the business cycle. One could also add that the measurement of the output gap – also a key element in the application of the current SGP – has proved to be a highly political issue, attracting active correspondence between the EU and finance ministers.⁷² Even in the best of cases, the economic benefits of the envisaged systems have not been robustly demonstrated. Beblavý and Lenaerts find that the degree of stabilisation provided by a scheme linked to unemployment rate was “relatively limited”.⁷³ Other studies find more substantial stabilising effects, but these seem to be linked to the assumption that transfers from the system would, quickly and fully, translate into increased government spending.⁷⁴ We find this assumption highly unrealistic, except perhaps for a government that has lost its access to the financial markets and is therefore acutely liquidity constrained. In contrast, a government that maintains access to financial markets would more likely use the bulk of a temporary injection of liquidity to reduce net borrowing and distribute any additional spending over a long period of time, thus substantially diluting the countercyclical effect.

This last point is part of a broader issue that has been largely overlooked in the discussion. By itself, just *sending* money between Member States provides no cyclical stabilisation at all. Stabilisation is about demand management, and in order to stabilise the mechanism needs somehow to motivate the recipient governments to *spend* the money they receive. This cannot be solved, for example, simply by earmarking the money for particular expenditure, such as investment; money is fungible, and earmarking would likely just result in national money being replaced by European money. For a government to spend the money it receives from the mechanism, it needs to believe that its capacity to maintain spending has increased. This is difficult to achieve within a system that is supposed to avoid permanent transfers. Economics tells us that it is precisely the permanence of an income that encourages one to spend it. Fleeting windfalls will not and should not result in increased spending.

Finally, we have doubts about the wisdom of concentrating purely on cyclical fluctuations. This is partly because purely cyclical fluctuations should be straightforward to smooth through borrowing in

⁷¹ See e.g. G. Wolff, “A budget for Europe’s monetary union”, *Bruegel Policy Contribution No. 2012/22* (2012); J. Pisansani-Ferry, E. Vihriälä and G. Wolff, “Options for a Euro-area fiscal capacity”, *Bruegel Policy Contribution 2013/01*; (2013); or M. Beblavý, D. Gros and I. Maselli, “Reinsurance of National Unemployment Benefit Schemes”, *CEPS Working Document No. 401* (2015). H. Enderlein, L. Guttenberg and J. Spiess, “Blueprint for a cyclical shock insurance in the euro area”, *Jacques Delors Institute. Studies and Reports* (2013), <http://www.notre-europe.eu/media/blueprintforacyclicalshockinsurancene-jdissept2013.pdf?pdf=ok> [Accessed 17 October 2017]. See also E. Tereanu, A. Tuladhar and A. Simone, “Structural Balance Targeting and Output Gap Uncertainty”, *IMF Working Paper WP/14/107* (2014), <https://www.imf.org/external/pubs/ft/wp/2014/wp14107.pdf> [Accessed 8 September 2017].

⁷² For an example of such correspondence, see <http://estaticos.expansion.com/opinion/documentosWeb/2016/03/31/Cartadeficitestructural.pdf> [Accessed 17 October 2017].

⁷³ M. Beblavý and K. Lenaerts, “Feasibility and added value of a European unemployment benefit scheme”, *Centre for European Policy Studies* (2017), <https://www.ceps.eu/system/files/EUBS%20final.pdf> [Accessed 17 October 2017].

⁷⁴ Eg. Enderlein, Guttenberg and Spiess (2013).

financial markets, but also because such an approach easily leads to outcomes that appear counterintuitive and unjust. To demonstrate this latter point, suppose a country faces a negative shock that was initially diagnosed as cyclical (temporary). This would make it eligible to receive support from the stabilisation mechanism. Suppose that a couple of years down the road, it is discovered that the shock was actually structural, and represents a permanent reduction in the country's capacity to generate income. In consequence, the country would be liable to pay back the support it had received on the basis of the false diagnosis, at the precise moment when its situation turns out to be worse than expected. Not only would this appear unjust but in anticipation of such risks a country would be even more wary of spending the funds it receives from the mechanism.

Alternatively, consider a model of unemployment reinsurance system that would subsidise those Member States which are experiencing an unemployment rate higher than recent past (say, five-year average), with transfers from other Member States where unemployment rate is in decline. Such a system would make the countries with the post-crisis legacy of high but hopefully declining unemployment net contributors to the mechanism for many years to come. We suspect the idea of subsidising unemployment benefits in the core countries with unemployment rate a fraction of their own would not be easy to understand to those countries' taxpayers, and there is little doubt that such solidarity would be challenged in their national politics.

From the legal point of view, setting up and funding the mechanism would be a non-trivial but probably not impossible task. The main questions concern the compatibility of a stabilisation mechanism with the Treaties and specifically with the no bail-out clause (art.125 TFEU), identifying a possible legal basis for its set up and collecting funds, and the relationship between the convergence code and envisaged conditionality, on the one hand, and the EU's economic policy competence, on the other.

Article 125 TFEU, which prohibits the Union and the Member States from assuming the commitments of the Member States, does not seem to pose insurmountable obstacles to a stabilisation mechanism. The CJEU established in *Pringle* that, when evaluating the compatibility of the establishment of the European Stability Mechanism with the EU Treaties, the Article does not prohibit the granting of financial assistance to a Member State that "remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy".⁷⁵ This could be read as suggesting that a mechanism would be likely to violate art.125 TFEU only if the transfers it provides were to be too closely linked to the degree of debt distress of a Member State. By that reading, a fiscal stabilisation mechanism, even if it results in permanent transfers to Member States, would not violate the no-bail out clause, as long as these Member States still maintain market access. Redistribution as such is not prohibited by EU law and, as noted above, already takes place within the EU budget.⁷⁶

⁷⁵ *Pringle* (C-370/12) EU:C:2012:756 at [137].

⁷⁶ Even though previous practice is not considered to create precedents that would justify derogating from Treaty rules, *Parliament v Council* (C-271/94) EU:C:1996:133 at [24].

However, even if the mechanism is compatible with the no-bail out clause, setting it up as a Union measure requires a legal basis, and the EU has no specific competence to set up a fiscal stabilisation function. A proper analysis of the options would require a concrete proposal whose aim and contents could be subjected to closer scrutiny for the purpose of establishing the main or predominant objective or component of the act and thus its centre of gravity.⁷⁷ What can be said is that the stated objectives of the mechanisms reach beyond the provisions of the three economic-policy related legal bases (arts 121, 126 and 136 TFEU). The question would then be whether some of the more generally worded legal bases (art.114 TFEU or art.352 TFEU) could be applied. The former would presume a link to internal market, which is not evident, and specifically excludes fiscal provisions. The latter would require a link to Union objectives more generally. A stabilisation mechanism could conceivably be seen as a measure that would contribute to “the sustainable development of Europe based on balanced economic growth and price stability” for the purposes of art. 3(3) TEU, but would then presume the unanimity of all EU States and the consent of the European Parliament. Finally, one could consider art.175(3) TFEU, which allows for the establishment of specialised funds at EU level that lead to the strengthening of economic, social and territorial cohesion in the Union;⁷⁸ aims that could be considered sufficiently vague to also house a stabilisation mechanism.⁷⁹ While the ordinary legislative procedure applied under this legal basis would allow lower institutional thresholds to be applied, the use of art.175(3) would presume defining the objectives of the exercise more carefully than art.352 TFEU, which encompasses all Union objectives in a much broader sense. Under both of these legal bases the mechanism would need to operate within the EU budget and be funded through the EU’s own resources;⁸⁰ limitations that would be difficult to reconcile with the proposed schemes. The short-term alternative might be to build the mechanism on intergovernmental arrangements, following the current model of the ESM. This presumes that the mechanism can be created in a way that would not affect common Union rules or alter their scope,⁸¹ and rely on Member States as sources of funding outside EU structures.

The final challenge relates to the suggested conditioning of access to the mechanism on observance of the fiscal rules, the MIP and the (envisaged) convergence code. While the fiscal rules and the MIP

⁷⁷ See e.g. *Commission v. Parliament and Council (C-411/06) EU:C:2009:518* at [45].

⁷⁸ Article 175(3) TFEU was recently used as a legal basis for Regulation (EU) No 1309/2013 on the European Globalisation Adjustment Fund (2014-2020). Article 153 TFEU and related Court jurisprudence might, however, prevent establishing even a more limited Unemployment Benefit Scheme on the basis of this Article. See *R. Repasi, “Legal Options and Limits for the Establishment of a European Unemployment Benefit Scheme”, Centre for European Policy Studies (2017)*, https://www.researchgate.net/publication/314116870_Legal_Options_and_Limits_for_the_Establishment_of_a_European_Unemployment_Benefit_Scheme [Accessed 21 December 2017].

⁷⁹ AG Bot argues that these objectives constitute “a broad overall concept with imprecise contours”, Opinion of AG Bot in *Parliament v Council (C-166/07) EU:C:2009:213* at [82]; or as the Court argues, the relevant provisions “merely lay down a programme”, *Portugal v Council (C-149/96) EU:C:1999:92* at [86].

⁸⁰ For the “own resources” system, see art.311 TFEU.

⁸¹ See e.g. *Pringle (C-370/12) EU:C:2012:756* at [101].

are known quantities, the exact content and nature of the convergence code remain unclear. The Commission EMU Reflection Paper foresees it consisting of “measures to improve the quality of public spending; investment in education and training; embracing more open and more competitive products and services markets, and creating fair and efficient tax and benefit systems” possibly “combined with minimum social standards, as envisaged in the European Pillar of Social Rights.” The latter refers to another recent Commission initiative establishing a framework for guiding primarily euro area countries actions relating to “a number of key principles and rights to support fair and well-functioning labour markets and welfare systems”.⁸² All in all, the conditionality would seem to cover a wide spectrum of economic policy fields and, importantly, would by necessity have to be country specific, tailored to the particular situation and the legal system in each Member State.

It needs to be emphasised that, in terms of functionality and motivations, such conditionality is entirely external to the stabilisation mechanism itself. There is little reason to believe that an economy with bad economic structures responds to cyclical stimulus any less strongly than an economy with good structures. Thus, for the mechanism to meet its stated stabilisation goals, there is no obvious economic necessity to make access to it conditional upon the observance of the economic governance framework, and none of the proposals we have reviewed have even tried to make such a claim. Rather, macroeconomic conditionality has been justified either as a precondition for political acceptability of the mechanism, or simply because the mechanism provides an opportunity to further incentivise convergence and compliance within the economic governance framework.

Notwithstanding the dubious economic foundations of the claim, presenting macroeconomic conditionality as a necessary precondition for the stabilisation mechanism’s effectiveness might still be the most feasible option to situate such conditionality in the current Treaty framework. Thus, macroeconomic and structural convergence would be dressed as a secondary and subordinate objective, indispensable to the primary goal of stability and, ultimately, the mechanism’s ability to contribute towards the Union objective of “sustainable development of Europe based on balanced economic growth and price stability”. This approach is used in virtually all EU conditional spending, including the possibility to suspend structural and investment funds to a Member State in violation of the economic governance framework, as provided in the ESI Regulation, adopted on the basis of art.177 TFEU.⁸³ The ESI Regulation is clear that the purpose of the conditionality is “to ensure that the effectiveness of expenditure under the ESI Funds is underpinned by sound economic policies and that the ESI Funds can, if necessary, be redirected to addressing the economic problems a Member State is facing”.⁸⁴ In other words, the aim is not to encroach on Member States’ competence in the field of

⁸² Communication from the Commission, “Establishing a European Pillar of Social Rights Brussels” COM(2017) 250 final (“Commission Communication on Establishing an EPSR”). Commission Recommendation of 26.4.2017 on the European Pillar of Social Rights C(2017) 2600 final.

⁸³ Regulation (EU) No. 1303/2013 laying down common provisions on the European Regional Development Fund, etc [2013] OJ L347/320 (“ESI Regulation”), art.23.

⁸⁴ Regulation (EU) No. 1303/2013, recital 24.

economic policies,⁸⁵ but to ensure that Union funds find effective use and support Member States in times of distress.

Although there is some logic in the claim that effective absorption of the ESI Funds, aimed at strengthening the Union's economic, social and territorial cohesion, depends on a minimum level of functionality of the economic structures, the link to the observance of the full economic governance framework can be seen somewhat tenuous. Be that as it may, the Court seldom second guesses the legislator's intent.⁸⁶ We believe that presenting conditionality as critical to the effectiveness of the mechanism would – presuming that political appetite exists for its approval - suffice for successful passage, and even possible subsequent Court scrutiny of the legislation itself. However, this does not mean it would provide a stable basis for the enforcement of the conditionality in individual cases. The Court has demonstrated that while heavily reliant on legislative intent as far as the adoption of legislation is concerned, in disputed cases of enforcement it takes the substance of this intent seriously.⁸⁷ Establishing, in individual cases, a plausible link between specific macroeconomic or structural policy actions and the objectives of the mechanism would be more than just a formality. We suspect this would in practice act as serious brake for the enforcement of the conditionality.

Alternatively, conditionality could, perhaps more honestly, be presented as an independent objective and a means in itself, an additional incentive for Member States to follow appropriate economic policies, whether or not those choices are relevant for the proper functioning of the stabilisation mechanism. In our view, this approach would raise issues of compatibility with the existing division of competences and the Treaty basis. The foundation of this division is laid out in art.2(3) TFEU, which provides that “[t]he Member States shall coordinate their economic and employment policies within arrangements as determined by this Treaty, which the Union shall have competence to provide”. Thus, economic and fiscal policies fall under Member State competence,⁸⁸ but are subject to Union level coordination under the two key procedures provided by arts 122 and 126 TFEU, the Excessive Deficit Procedure (EDP) and the multilateral surveillance procedure.

The intrusiveness of Union competence depends on the meaning of the term “coordinate”. This term is defined in art. 2(5) TFEU rather clearly as follows: “In certain areas and under the conditions laid

⁸⁵ Legal uncertainties were among the reasons that the European Court of Auditors raised against extending the application of macroeconomic conditionality to EU funds. European Court of Auditors, Opinion 7/2011 on the proposal for a Regulation of the European Parliament and of the Council laying down common provisions on the European Regional Development Fund, etc [2012] OJ C47/1 at [20].

⁸⁶ On legislative technique and Court scrutiny, see e.g. P. Leino, “The Institutional Politics of Objective Choice: Competence as a Framework for Argumentation”, in S. Garben and I. Govare (eds), *The Division of Competences between the EU and the Member States, Reflections on the Past, Present and the Future* (Oxford: Hart Publishing, 2017), pp.224-230.

⁸⁷ On this, see V. Vita, “Revisiting the Dominant Discourse on Conditionality in the EU: The Case of EU Spending Conditionality” (2017) 19 Cambridge Yearbook of European Legal Studies 1, 22.

⁸⁸ *Pringle (C-370/12) EU:C:2012:756* at [64]: “Articles 2(3) and 5(1) TFEU restrict the role of the Union in the area of economic policy to the adoption of coordinating measures” at [64]. On economic policy competence, see also *Hinarejos (2015)*, pp.65-79.

down in the Treaties, the Union shall have competence to carry out actions to support, coordinate or supplement the actions of the Member States, without thereby superseding their competence in these areas.” The TFEU Chapter on economic policy defines further how Union level coordination is to be organised in this policy field but does not expand Union competences within it. Hence, the fundamental limitation remains: Union competence cannot be used to supersede Member State competence or to settle substantive outcomes in the field of economic policy.⁸⁹

Against these limitations, one could argue that, already in its present form, EU coordination of Member States’ economic and fiscal policies within the European Semester stretches its legal bases remarkably far. Financial sanctions attached to compliance with Council recommendations were introduced to economic policy coordination through secondary legislation in 2011, and now exist in the preventive arm of the SGP⁹⁰ and the MIP, a legally remarkably weakly circumscribed exercise.⁹¹ The Treaties mention sanctions only in the context of the EDP (art.126(11) TFEU), under which persistent transgressions from the fiscal rules may lead to fines. No such basis for sanctions exists in the Treaties on the side of economic policy coordination, where we consider the risk of overreach most acute. Adding to this existing landscape a new sanction, access to the fiscal stabilisation mechanism, would complicate matters further. At a minimum, it would contribute to an increasing blurring of the division of competences between the Union and the Member States in the field of economic policy.

In our reading, art.126(11) TFEU is intended as exhaustive, listing four possible measures that may be considered as sanctions in case of a Member State’s failure to correct excessive deficit. One might argue that discontinuation of access to the mechanism should not be seen as a sanction but rather as a withdrawal of benefits and would therefore not fall within the scope of the art.126(11) TFEU list. We are not sure about the relevance of this distinction in law,⁹² much less so for politics and perceptions.⁹³ Receipts from the mechanism are not transfers like social security benefits. If the mechanism is supposed to be an insurance policy where each country, over time, contributes as much as it receives, then freezing a country’s access to funds it has itself contributed to the mechanism is very much a sanction. In any case, the Treaty list already includes an item of the withdrawal-of-benefits

⁸⁹ A similar limitation applies to Art 352 TFEU if this was used as a legal basis: the said Article cannot be used to circumvent the prohibition of harmonisation of national legislation where the Treaties exclude such harmonisation.

⁹⁰ Regulation (EU) No. 1173/2011 on the effective enforcement of budgetary surveillance in the euro area, art. 4.

⁹¹ Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances [2011] OJ L306/25, art.2. For a discussion, see *P. Leino and T. Saarenheimo, “Discretion, Economic Governance and the (New) Political Commission” in J. Mendes (ed), Executive Discretion and the Limits of Law (Oxford: Oxford University Press, forthcoming 2018).*

⁹² “The sanction [attached to spending conditionality] may consist in postponement, suspension or permanent withdrawal of funds (negative conditionality).” Vita (2017), 7.

⁹³ There is little doubt that the prospect of suspending ESI-funds to Spain and Portugal in 2016 was clearly perceived and debated as a sanction, both in Brussels and in the capitals concerned. See e.g. J. Valero, “Sanction procedure on Spain and Portugal within days”, *Euractiv* (5 July 2016), <http://www.euractiv.com/section/euro-finance/news/sanction-procedure-on-spain-and-portugal-within-days/> [Accessed 3 January 2018].

type, namely inviting “the European Investment Bank to reconsider its lending policy towards the Member State concerned”.⁹⁴

The relationship of the envisaged convergence code with Union competence is even more problematic. The wide variety of labour market, social, and tax policies to be covered today mostly fall under national competence.⁹⁵ The Commission’s Reflection Paper stresses that the objective is not full harmonisation, but does not address the issue of competence directly. It is evident that the Union does not currently have competence to legislate and thus lay down the substantive Member State policies in most of the relevant policy fields and thus the convergence code could not be set up as a directive explicitly aiming, as its main objective, to harmonise national legislation in those fields. Yet, according to the Commission, these standards would be “binding” and “enforceable”. The Reflection Paper explains that the “binding nature of such standards could only be acceptable if compliance could be strengthened by a strong link between related reforms, the use of EU funds and access to a potential macroeconomic stabilisation function”. This seems to suggest that Member States could only be compelled to respect the binding convergence process if enforcement is backed by a sufficiently sizeable arsenal of financial sanctions: in this case the threat of suspension of access to EU funds and the stabilisation mechanism. It seems to us that the intention is to sidestep the limitations of Union legislative competence by achieving similar outcomes through executive action, ie regulating access to the stabilisation function, thereby also avoiding the procedural safeguards attached to the adoption of legislation – such as broader transparency, duties of consultation and impact assessment or subsidiarity control.

We believe that such an approach would further alter the non-binding nature of the preventive economic governance procedures.⁹⁶ How would the adoption and enforcement of binding “standards” by the EU institutions in reality differ from the exercise of full legislative competence on the matter? True, the national parliaments would still have the right to formally adopt the necessary budgetary or legislative measures needed to comply with those standards. However, they would do so subject to the previous choices of the EU institutions and the prerogative of the EU institutions to sanction (or reward) their actions. A Member State of course has the option to ignore the standards and lose access to the stabilisation mechanism. Depending on the amount of money at stake, this might or might not be decisive for its decision. But we see here a far-reaching choice. If this kind of conditionality is defined, in principle, as an acceptable way for the EU to influence decisions beyond its competence, then the door is open to increasing the sanctions further to a point where they definitely become decisive.

⁹⁴ The way art.126(11) TFEU is formulated, while the Council has discretion as to whether it wishes to apply sanctions or not (the Council may decide to apply...”), the list of measures enumerated in the paragraph is exhaustive (“the Council may decide to apply or [...] intensify one or more of the following measures”).

⁹⁵ In particular the primacy of the national welfare state is explicitly stated in the Treaties. See in particular art.153(4) TFEU and art.168(7) TFEU.

⁹⁶ One could argue that some parts of the European Semester already sit uncomfortably within the division of competences.

Regardless of the legislative approach chosen, the weakness of the Union competence in the policy areas that form the conditionality would likely prove a serious hindrance for effective enforcement. In its jurisprudence relating to conditionality in the area of common agricultural policy, the Court has stressed that a Member State's failure to implement EU standards laid down in a directly applicable EU regulation can be used as a basis of suspension of EU funds only to the extent that those standards did not leave the Member States discretion as to the need to implement them within the national legal order.⁹⁷ Court scrutiny would indeed not be any easier in the field of economic policy, where EU competence does not replace Member State competence, and EU recommendations, as a matter of EU law, "shall have no binding force" (art.288 TFEU) and "are not intended to produce binding effects".⁹⁸

To be clear, we are not questioning the standard practice of conditioning EU funds on a wide range of same-sector conditions that relate, inter alia, to the usage of the funds for the intended purpose, to various governance safeguards to ensure their efficient and effective use, and more broadly to the cross-sector respect of certain fundamental rights such non-discrimination and labour rights. Conditionality of this variety can be justified based on the objectives of EU legislation, the effectiveness of the funds and, overall, the "political cleanliness" of the projects. The issue at stake here is something very different: using cross-over or generic conditionality of access to EU funds as a source of leverage to influence Member States' policies in areas which fall under national competence and, as a rule, bear no relation to the aims of the program.⁹⁹ Such conditionality has seen regular use only in the pre-accession processes of prospective new members¹⁰⁰ and external relations,¹⁰¹ both situations characterised by a highly asymmetrical relationship. Among EU Member States, this kind of conditionality has only been used in the context of adjustment programmes; again a situation of extreme asymmetry, due to the existential importance of financial assistance for recipient states,¹⁰² where the conditionality has proved not only an effective means to impose economic reforms but also a significant

⁹⁷ See *Latvia v Commission (T-661/14) EU:T:2016:412* at [45].

⁹⁸ See *Grimaldi v Fonds des maladies professionnelles (C-322/88) EU:C:1989:646* at [13], [16].

⁹⁹ For a typology of spending conditionality, see Vita (2017).

¹⁰⁰ In relation to enlargement, see P. Leino, "Rights, Rules and Democracy in the EU Enlargement Process: Between Universalism and Identity" (2002) 7 *Austrian Review of International and European Law* 53.

¹⁰¹ On EU Membership, see art.49 TEU; on conditionality in all external policies, see arts 21 TEU and 205 TFEU. P. Leino, "European Universalism? The EU and Human Rights Conditionality" (2005) 24 *Yearbook of European Law* 329; P. Leino and R. Petrov, "Between 'Common Values' and Competing Universals – The Promotion of the EU's Common Values through the European Neighbourhood Policy" (2009) 15 *E.L.J.* 654.

¹⁰² A. von Bogdandy and M. Ioannidis, "Systemic deficiency in the rule of law: what it is, what has been done, what can be done" (2014) 51 *C.M.L. Rev.* 59, 90.

dividing force due to the perceived unfairness of the setting.¹⁰³ Combining country-specific conditionality of EU funding with the sovereign equality of all Member States (art.4(2) TFEU), which forbids “unjustified” differences of treatment,¹⁰⁴ is likely to prove difficult.¹⁰⁵

All in all, our conclusion is that the envisaged kind of macroeconomic conditionality reaches beyond the current EU competence to decide on methods of coordination “without thereby superseding [Member States’] competence in these areas”. Creating binding and enforceable standards, tied to conditionality, is not part of such competence. Union competences can be broadened or strengthened through Treaty revision procedures that exist for that purpose (art.48(2) TEU). Such a process would be laborious and time consuming, but it would ensure a broad political debate that is fundamental to establishing the broadest political support and thereby legitimise the change. Dressing such amendments as merely “technical monitoring” that is innocent from the point of view of competence divisions is fundamentally misleading.

These are our concerns, regarding the envisaged conditionality, from the legal point of view. However, our most fundamental concern relates to the requirements of democratic decision-making. In this regard, it is important to stop for a moment and think about the real magnitude of what is at stake. The policies in question – labour market, social and tax policies – are the most fundamental matters of peacetime politics, the key societal choices that form the heart of political decision-making and the primary dimension of political organisation. They are all fundamentally about trade-offs between equality and efficiency, between protection and flexibility. They involve questions of social justice, which touch upon some of the deepest values of society.¹⁰⁶ For democracy to have real content, decisions regarding them must be contested and legitimised through democratic elections.

Of course, in many established federations, such societal choices are an accepted part of the federal powers. But the limitations of EU level democratic and political processes leave it poorly equipped to guarantee the political contestation and competition that making choices of this nature would presume.¹⁰⁷ The citizens have far fewer direct opportunities to influence Union policy choices than citizens in national settings do when choosing between parties offering sharply distinct programmes.¹⁰⁸ The possibilities of the European Parliament to hold the Commission accountable or the national parliaments to be informed or have dialogue on matters shifted to the EU agenda are no compensation for the limitation of national debates and the loss of the autonomy in social and political choice. The difficulty of replicating the national accountability mechanisms at the EU level would be compounded

¹⁰³ C. Kilpatrick, “Are the Bailouts Immune to EU Social Challenge Because They Are Not EU Law?” (2014) 10 *European Constitutional Law Review* 393.

¹⁰⁴ See e.g. *Spain v. Commission (C-304/01) EU:C:2004:495* at [31].

¹⁰⁵ See R. Bieber and F. Maiani, “Enhancing Centralized Enforcement of EU Law: Pandora’s Toolbox?” (2014) 51 *C.M.L. Rev.* 1057, 1061.

¹⁰⁶ J.H.H. Weiler, “To be a European citizen - Eros and civilization” (1997) 4 *J.E.P.P.* 495, 502. K. Tuori, *European Constitutionalism (Cambridge: Cambridge University Press, 2015) pp.229, 233.*

¹⁰⁷ Weiler (1997), 512.

¹⁰⁸ Weiler (1997), 513.

by the sheer complexity of defining and monitoring the appropriate structural convergence path for each of the 19 or more Eurozone countries with widely differing starting positions. This complexity would virtually guarantee that any substantive discussions would stay at the level of the executive: Commission services and technical committees.

Therefore, if strictly enforced, conditioning EU funds in the proposed manner could have far-reaching consequences on the democratic nature and political content of economic policy decision making in the euro area. But is it realistic to expect that it would be strictly enforced? The EU has never been particularly good at implementing conditionality. In relation to EU funds, difficulties have emerged when trying to enforce conditionality among EU Member States, since access to such funds has traditionally been treated as an entitlement by the Member States.¹⁰⁹ The same difficulties have characterised the use of sanctions throughout the economic governance framework. No financial sanctions have ever been used, in any part of the framework, and not for a lack of opportunities. Since 2011, a purely mechanistic reading of the fiscal framework would have offered ample grounds to escalate the procedures, even all the way to sanctions. Instead, rules have been repeatedly adjusted, reinterpreted or bent, to allow consensual solutions to be reached and to avoid sanctions.¹¹⁰ To us, this shows that it is not the insufficient size of the currently available sanctions that is hampering enforcement, it is the fact that the EU does not seem to possess the political legitimacy to make use of them.

Forcing a national government, in highly political matters, through financial sanctions, to follow certain paths of action would almost certainly overload the EU's modest legitimacy resources and result in a highly visible and embarrassing clash of authority. Rather than incentivising a Member State to follow the convergence code, a heavy-handed application of sanctions would be more likely to feed discord, play into the hands of anti-European forces in the Member State, and further undermine the EU's authority in these matters. The pressure to find consensual solutions would be formidable. As Bieber and Maiani write, "if they are not carefully designed, sanctioning mechanisms may backfire, upsetting constitutional arrangements in ways that would weaken rather than strengthen the authority of EU law."¹¹¹

Ultimately, we do not think the outcome of the proposed conditionality would be sudden empowerment of the Brussels technocracy and meek submission of national polities on questions of national economic, social and structural policies. More likely, national polities would find ways to fight back and, with the cooperation of the Commission, reclaim a large part of their competence through subversion and creative interpretation of the conditionality, just as they have in the context of the fiscal framework. The result would be a process that is thoroughly political, but in a manner that is less predictable, transparent, accountable and even-handed than a system based on a clear division of

¹⁰⁹ Bieber and Maiani (2014), 1078.

¹¹⁰ P. Leino and T. Saarenheimo, "Sovereignty and Subordination: on the limits of EU Economic Policy Coordination" (2017) 42 E.L. Rev. 166.

¹¹¹ R. Bieber and F. Maiani, "Enhancing Centralized Enforcement of EU Law: Pandora's Toolbox?" (2014) 51 C.M.L. Rev. 1059.

competences. The same conclusion, we believe, extends beyond conditionality, to the general rules-based operation of the mechanism itself. Methods would be sought and found to avoid outcomes that, albeit rules-based, would appear unjust.

The conviction that the EU would be able to operate a rules-based system of funds redistribution between euro countries and make effective use of it as leverage to steer countries towards better economic and structural policies seems much like a second marriage: a victory of hope over experience. It is very difficult to use money to steer Member States' policy choices without getting into conflict with national democratic systems. And when rules and democratic systems are in conflict, it tends to be the rules that eventually bend. Rather than be allowed to operate mechanistically, the stabilisation mechanism, like the fiscal framework before it, would be subjected to repeated discretionary adjustments, the content of which would be a matter of constant political dispute.

5. Conclusions: Managing the Second Best

The debate on the establishment of a fiscal stabilisation mechanism suffers from a curious disconnect. It is framed in terms of “completing” the EMU and predicated on the assumption that such mechanisms are a standard part of monetary unions (federations) around the world. Yet the proposed models tend to be *sui generis*, without precedents elsewhere. They seek to simulate the stabilisation property that a real federal budget serves, typically to a modest extent, without replicating the actual federal tasks from which this stabilisation arises.

We view such proposals as problematic in many ways. First, the economic case for a fiscal stabilisation mechanism is far less clear than often claimed. At best, it might provide a modest degree of cyclical smoothing, at worst, mistimed transfers could destabilise things further. To claim that it would in any sense be critical for the survival or even proper functioning of EMU seems to us simply incorrect. Further, there are complications relating to legal basis and political realism in particular relating to the use of EU budget.

In general, we recommend making more use of the experience of other (con)federal structures. While the EU in itself is *sui generis*, the issues of sub-central fiscal control and cyclical stabilisation are not. If a seemingly promising solution is not in use anywhere in the world, the likelihood is that there is a good reason for that. We would look in the direction of the EU's existing tools, which have so far been largely ignored in the debate. The EU budget, and particularly its revenue side, provides plenty of opportunities for Member States to share their fiscal risks. None of them is achievable without extensive and difficult political negotiations. But while the political obstacles are undoubtedly real, believing that matters are more easily arranged outside the EU budget is probably an illusion. Whatever the context, distribution of money is always a politically contested matter.

To us, perhaps the most worrying aspect of the proposals is their cavalier attitude towards national political processes and Member State autonomy in settling key societal questions, the clearest expression of which is found in the proposed extensive macroeconomic conditionality. Bringing decisions that form the core of national economic policy competence within the EU's powers to sanction or reward would undermine, in a manner that is also legally questionable, Member States' political decision-making, thus hollowing out their democratic process. This would be risky, at least as long as the EU-level democratic structures remain manifestly unable to fill the vacuum. But even for a far more developed EU-level democracy, trying to determine the appropriate economic policy choices for each euro area Member State would almost certainly prove overwhelming. The sheer dimensionality of the issue would ensure that the responsibility for substantive choices would disperse within the EU executive, with little effective democratic oversight. There are matters for which technocratic delegation is appropriate and possible, but structural and macroeconomic policies do not fall within that category. The powers so entrusted to the EU executive would prove difficult to use in practice.

The heart of the matter is that the EU is not a mature federation with developed channels of EU-level political accountability. It is a union of sovereign states where national imperatives remain decisive and shape EU decision-making. If poorly designed, the mechanism could become an enduring source of political discord, a force for disintegration rather than for integration. The mechanism needs to be designed for operation in the real world where the enforceability of EU rules is weak and dependent on Member States' willingness to give them effect. Otherwise it is likely to morph into a discretionary and politically sensitive exercise, only without the proper channels of accountability and scrutiny that such use of public power should be subject to in a democratic society.

To avoid this, the mechanism should not be overburdened with multiple objectives, particularly ones that put it structurally on a collision course with national democratic systems. If the mechanism is intended to smooth cyclical fluctuations, this objective should not be diluted by the essentially unrelated and thoroughly political goal of promoting structural convergence. Or if the mechanism aims at sharing the cost of unemployment, making it conditional upon government policies that have no obvious link to the right of the unemployed to receive benefits would almost certainly prove to be politically poisonous and ultimately fail. In particular, strong reasons exist for not making use of unmeasurable or otherwise disputable indicators, such as the output gap. If an indicator used as a basis for allocation of money can be disputed, it will be.

Fiscal redistribution always gets assessed through the prism of justice, making it an inherently political exercise. As Hamilton said, true and trite, there is nothing men differ so readily about as the payment of money. When challenges are genuinely political in nature, they should be solved as political questions and not as a regulatory exercise. Broad political debate, while difficult and slow, is a crucial part of laying a solid foundation for durable integration.