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The European fiscal union creation process*

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ABSTRACT. The paper presents evolution of the European Union fiscal system creation process as well as outlines problems in functioning thereof that have arisen during recent years and the main reforming (modification) trends. The analysis is primarily focused on creation of the fiscal union within the EU. In this regard, the idea of two different groups of countries moving to the common goal at different paces is becoming ever increasingly much-talked-about in the EU. The first group comprises donor countries that adhere to all treaties and fiscal discipline, while demonstrating respective positive macroeconomic indicators. The second group implies countries of Euro-periphery, where the above processes take place along with significant complications or do not occur at all. In these countries Eurosceptic positions are also quite strong, which often leads to taking measures contrary to the jointly adopted decisions.

Currently, there is no clear understanding within the EU as to which way out of the crisis should be taken. However, profound understanding of the crisis causes and active work on preparation and implementation of measures to overcome the negative effects of this crisis suggest availability of sufficiently favorable prospects for further development of the EU fiscal system (including formal creation of the Fiscal Union).

Based on the conducted analysis conclusions have been made as to potential vectors of action aimed at improving EU fiscal system, while specific recommendations on actions to be taken by Ukraine have been developed (particularly, as regards budget forecasting and planning) with the purpose of harmonizing Ukrainian financial institutions and mechanisms with the EU fiscal system.

KEYWORDS. European Union, Maastricht Treaty, Fiscal Union, Stability and Growth Pact, European Financial Stability Facility, European Semester.

Introduction

Based on the 1957 Treaty of Rome signed by six countries of Western Europe, the European Union has been gradually expanding and eventually achieved membership of 28 countries. Another four countries have the status of candidates: Turkey (since 1987), Macedonia (since 2004), Montenegro (since 2008) and Serbia (since 2009). In 2009, applications for EU membership were also submitted by Albania and Iceland, though formal

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decision by the European Union on Albania's application is still pending, while in 2013 the government of Iceland decided to "freeze" further negotiations until a referendum on this issue has been held in the country. A "potential" candidate to the EU is Bosnia and Herzegovina.

At the same time, three Western European countries have decided not to join the European Union, while being partly still involved in the EU economic system: Liechtenstein and Norway as parties to the European Economic Area created in 1994, and Switzerland – on the basis of relevant bilateral agreements. Also based on separate agreements the single European currency (euro) is used along with supporting other forms of actual participation in the EU economic system by the so-called "dwarf" states Andorra, the Vatican, Monaco and San Marino. Finally, in the legal sense a part of the EU comprises a series of "overseas territories" or "outermost regions", which also use the euro, but for which certain exceptions to the rules or specific features have been established exactly on account of their remoteness (in particular, this concerns taxation issues). Such territories include island areas such as the Azores and Madeira (Portugal), Canary Isles (Spain), Guadeloupe, Mayotte, Martinique, St. Martin, Reunion (France) and a continental territory – French Guiana.

Furthermore, one should take into account ties of the European Union with 17 countries, with which the EU has concluded association agreements and/or free trade area agreements (in particular, Israel, Mexico, South Africa, South Korea, Serbia, Chile, etc.), as well as 53 member countries of the Commonwealth of Nations headed by the British monarch, which are indirectly (through relations with Great Britain) incorporated in certain segments of European integration (especially in matters of labor migration and international trade).

The European Union fiscal system development process attracts many researchers, while first of all, one should mention representatives of academic science (R. Mundell², B. Eichengreen³), as well as financiers and bankers (G. Soros⁴, J.-C. Triche⁵). Certain aspects of financial integration within the

² Inter alia: *Mundell R.* A Theory of optimum currency areas. *American Economic Review* 51, 1961, pp. 657-665; *Mundell R.* European Monetary Union and the International Monetary System – *Rivista di Politica Economica*, 1994, pp. 83-128.

³ *Eichengreen B.* Should the Maastricht Treaty Be Saved? *Princeton Studies in International Finance*, No. 74, December 1992 (International Finance Section, Princeton), 74 p.; *Eichengreen B.* European monetary Unification: A Tour D'Horizon, *Oxford Review of Economic Policy* 14, 1998, pp. 24-40.

⁴ *Soros G.* The Tragedy of the European Union: Disintegration or Revival? – *Public Affairs*, 2014, 210 p.

European Union are considered in numerous publications by researchers not only from the EU, but also from other countries (including Ukraine).

Basic part

The first element of real European economic integration was in fact the "Marshall Plan", as it envisaged abolition of trade barriers and creation of economic policy coordination institutions within Europe. According to the original plan, it was supposed to apply to all European countries, including the Soviet Union and countries of "socialist democracy". Already at this stage, the need for creating a specific financial and credit system occurred. In particular, the Organization for European Economic Cooperation established a special European fund to mitigate the negative effects of increased competition for European companies. An important component of the new system was the London Debt Agreement of February 27, 1953, which regulated the private and public debt of Germany formed during the Second World War and taken over by the Federal Republic of Germany as the German Empire (Deutsches Reich) successor, including private debts (although formally, the successor state was not responsible for them⁶). The said Agreement also stipulated maintenance principles of the new debts, which arose as a result of foreign economic assistance programs during the post-war period (especially, the Marshall Plan). The declaration forming a supplement to the draft Agreement and filed by representatives of the USA, Great Britain and France read: "The three countries agree that the plan include an appropriate satisfaction of demands towards Germany so that its implementation does not jeopardize the financial situation of the German economy through unwanted repercussions nor has an excessive effect on its potential currency reserves. The first three countries are convinced that the German federal government shares their view and that the restoration of German solvability includes an adequate solution for the German debt which takes Germany's economic problems into account and makes sure that negotiations are fair to all participants⁷".

In practice, this implied writing off 62.6% of the debts, granting the possibility of debt repayment in Deutschmarks,

⁵ *Triche J.-C.* "Economic Integration in the Euro Area", 15th European Regional Conference of the Board of Governors – Tel Aviv University. Paris, 31 March 2006.

⁶ *Guinnane T.W.* Financial vergangenheitsbewältigung: the 1953 London Debt Agreement- Yale University, Center Discussion Paper No. 880, January 2004, p.21 - [Electronic resource]. Access mode: http://www.econ.yale.edu/growth_pdf/cdp880.pdf

⁷ *Hersel Ph.* El Acuerdo de Londres de 1953 (III) // La Insignia, 3 enero del 2003. – [Electronic resource]. Access mode: http://www.lainsignia.org/2003/enero/econ_005.htm

promotion of German exports development (by creditor countries) and limiting the cost of debt servicing by 5% of export revenues.

In September 1961, the Organization for European Economic Cooperation, which by the time had fulfilled its function of organizing use of financial aid under the "Marshall Plan", was transformed into the Organization for Economic Cooperation and Development – OECD, membership in which was also extended to non-European countries. Eventually, OECD actively started addressing financial problems, in particular those related to attraction of international investment, taxation and export crediting. In 1976, the governments of OECD member countries adopted the Declaration on International Investment and Multinational Enterprises. However, this neither established a new international law in this field of relationship, nor reflected current practices at national level, but at the same time proved to be a very important step in development and enunciation of principles, compliance with which was expected from the member countries⁸. Above all, it concerned rules introduced within the EEC. In 1978, a document was adopted that became fundamental in terms of issues regarding export crediting – *Guidelines for Officially Supported Export Credits*, also known as the "Consensus" aimed at promoting competition among exporters from OECD countries to be based on the price and quality of goods, but not on favorable state support terms. Finally, the OECD has also developed a series of recommendations on coordinating issues of double taxation prevention. The latter provided regulatory prerequisites for further economic development of countries striving for European integration with the new integration tasks taken into account as well as with consideration of the need for coordination and harmonization of the respective rules with the main economic partners (firstly, with USA and Turkey, and later on -with Japan, Australia, New Zealand, etc.).

During recent years the global shocks caused by the crisis to the global economy were exacerbated by a serious problem within the EU associated with the need for correcting the very concept of European integration on account of significant quantitative and qualitative expansion of the European Union. It was expected that new circumstances would be taken into account by the EU Constitution, a draft of which had been signed in 2004.

⁸ Horn N. International rules for multinational enterprises: the ICC, OECD, and ILO initiatives/ The American University Law Review ,vol. 30:923, 1981, p.936 – [Electronic resource]. Access mode: <http://aullawreview.com/pdfs/30/30-4/Horn.pdf>

The most important novelty of the Constitution was supposed to be granting the international legal entity status to the European Union. Besides, the principle of the EU legislation prevalence over national legislation was to be stipulated as well. However, this draft was rejected at referendums held in France and the Netherlands, which led to another European Union identity crisis. Only at the EU summit in 2007 it was decided to carry out the necessary institutional reform as the next modernization step – through adoption of a new treaty. The said Treaty was signed late in 2007 in Lisbon. The Treaty of Lisbon is intended for keeping the balance between intergovernmental and supranational principles of EU governance. At the same time, the Treaty established the balance between the goals and interests of EU member states by virtue of granting the "superpower" status to the EU and recognizing its legal standing, thus enabling the EU to enter into international agreements (under certain conditions).

It is also important that the Treaty of Lisbon has amended the qualified voting mechanism in the Council of Europe (set forth by the so-called "Treaty of Nice"). Under the new Treaty, decisions would be adopted subject to having been voted for by more than 55% of countries (at least 15 countries), representing at least 65% of the population. At the same time it was stipulated that the "blocking minority" should comprise at least 4 countries.

The EU also seeks to create an "internal market" and achieve a number of objectives: full employment, social progress, discrimination combating and so on. It is clear that achieving these ambitious goals requires a new level of development and integration of financial mechanisms – above all, the fiscal one and the bank crediting one. This situation was significantly worsened by the fact that the global financial and economic crisis of 2008-2009 first slowed and then actually rendered impossible achieving the "European welfare" uniform high standard (which mostly socialist and social-democratic governments of European countries have been trying to achieve based on "European solidarity" principle (subsidies from the EU budget) and "social budget policy" of individual countries. The limitedness of budget funds has led to a deep crisis in "peripheral" EU countries (Greece, Portugal, Spain, and partially – Italy), where budget deficits and debt burden proved too heavy for low-efficient economies (mainly due to low labor productivity and innovation lag). The difficulty of overcoming the crisis was mainly caused by the fact that these countries were members of the European Monetary Union and use of the single European currency deprived them of opportunities to use traditional instruments – the exchange rate and interest rate,

since presence of a single financial market virtually eliminates the possibility of manipulating by certain countries. Thus, solution to this problem involved selection of one of two further options: 1) exclusion of fiscally indisciplined countries from the euro area, or 2) actual review of the principles underlying formation of the European Union and preventing financing of sovereign debts and budget deficits from the Union budget. "Without exaggeration, the fight over the options described implies the quintessence of the European political process. Positions taken in the fight represent those starting points by which the politicians of European countries assert their identity. Disagreements on the issue do not only determine the balance of political forces in the "united Europe", but also create a semantic matrix of this strange "unity"⁹. "In general, we can conclude that the institutional reform of the EU is still far from accomplishment. (...) This means that one will have to think seriously about a new institutional reform of the European Union"¹⁰. Above all, the latter should involve financial mechanisms of the European integration.

The founding fathers of the European Union saw gradual integration of national public finances as the basis of post-war unification of Europe. This process was essential to overcome profound differences and national isolation being causes of the two world wars and by now remaining an obstacle to common economic development.

Despite the fact that the Maastricht Treaty of 1993 created certain "safety locks" (prohibition of budget deficit financing by central banks and privileged access of public sector institutions to the resources of financial institutions, establishing "ceiling" for budget deficits and public debt, etc.), many professionals still drew attention to the hazard for the EU occurring due to the absence of adequate fiscal control. In this regard, two additional elements were subsequently introduced to the EU system: 1) accession to the euro functioning area required provision of certain convergence criteria, and 2) in 1997, EU member countries agreed to sign the Stability and Growth Pact (SGP), which concerned common taxation and budget policy. The Pact was based on Art. 99 and 104 of the Maastricht Treaty, while envisaging monitoring of tax policies of individual member countries and setting forth procedure for imposing sanctions against countries

⁹ Smirnov A.N. Testing by euroscepticism: the crisis of European integration in the mirror of conservatism / *Politika*, No. 4, 2013, p. 50. [In Russian].

¹⁰ Pronikova D.V. Institutional reform of the European Union and the Treaty of Lisbon / *World and Politics*, 31.05.2012 – [Electronic resource]. Access mode: http://mir-politika.ru/313-institucionnaya_reforma.html. [In Russian].

violating the agreed rules (in particular, restriction for the annual budget deficit at below 3% of GDP and that for national debt – below 60% of GDP).

It should be noted that in fact the Stability and Growth Pact consisted of the European Council resolution on the Stability Pact (adopted on June 17, 1997 in Amsterdam) and two Regulations* on technical aspects of monitoring budgetary policy and coordinating economic policies of the Member States, as well as on measures to be taken in the event of excessive budget deficits, which were adopted by the European Council on July 7, 1997 (and amended in June 2005). According to these documents, the Member States committed themselves to complying with the medium-term requirements in relation to the government budget status, which should remain close to balance or surplus, while ensuring that the state budget deficit does not exceed 3% of GDP (the so-called "preventive arm of the Pact"). These commitments were taken by the countries under the Maastricht Treaty.

If a Member State violates the maximum permitted budget deficit or public debt level, this country becomes subject to actions taken pursuant to the procedure for excessive budget deficit elimination (the so-called "corrective arm of the Pact"). In case of repeated violation of the rules, the European Commission may recommend imposing sanctions on the country (by voting and subject to support by two-thirds of voters, while the country in default has no voting right at that). As a punishment, a fine in the amount ranging from 0.3 to 0.5% of GDP may be imposed, the demand on disclosing more details on budget expenditures and debt may be set, or the European Investment Bank crediting policy for the country may be revised. At that, force majeure circumstances may imply cases of natural disasters or serious economic collapse.

Programs to ensure stability (or Convergence Programs for countries outside the euro area) are provided to the European Commission on an annual basis. While evaluating the provided stability (convergence) programs, attention is also drawn to the long-term sustainability of public finances. EU bodies provide common long-term budget forecasts at the EU level, as well as assess and monitor the situation in individual member countries.

The "preventive" arm of the Pact requires EU countries to adopt balanced budgets, and if possible – with a surplus in order

* Regulation 1466/97: On the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (the so-called "preventive arm" of the Pact) and Regulation 1467/97 on the processing of budget deficit data, if the Member State exceeds the threshold set at 3% of gross domestic product (the so-called "corrective arm").

to create certain reserves for the cases of business activity drop. The "corrective" arm comprises the procedure for deficit correction, i.e. restricting thereof by 3% of GDP by virtue of emergency measures. However, the "Achilles' heel" of the Pact was absence of a mechanism to compel adherence to the fiscal discipline. In particular, to apply certain penalties to the offender the European Commission must first enlist the support of European Commissioners, and this contributes to soft-pedaling sanctions against individual countries. In addition, adopting such a decision requires qualified voting majority, while under circumstances when "the offender" is not deprived of the right to vote in the case, finding additional "contra" votes from other countries potentially being "offenders" is not a big problem. Moreover, among offenders are not only such "problem" countries as Greece (maximum budget deficit reached 12.7% and the debt – 142.8% of GDP), Portugal (9.1% and 93%) or Ireland (deficit – 32.4%), but also the relatively successful Germany (12.7% and 83.2%), France (7.0% and 81.7%) and Austria (4.6 and 72.3%). Therefore it is no accident that, according to experts, the first decade of the euro functioning (1999-2007) could be dubbed a "wasted period of time", which might have been efficiently used for building a sound fiscal system instead of resorting to mutual concessions and compromises.¹¹ In this regard, "many experts recognize that the fiscal integration deepening may contribute to essential increasing stability of the Economic and Monetary Union in Europe"¹².

Implementation of the Stability and Growth Pact was first seriously criticized in 2002-2005, as France and the Federal Republic of Germany repeatedly violated the criteria for keeping the budget deficit at 3% of GDP, while the Ecofin Council refused to impose sanctions against them despite recommendations of the European Commission. The dispute between the European Council and the European Commission (with lawsuit filed by the latter) was considered by the European Court, which in essence agreed with the position of the European Commission, but pointed to the need for a clearer distribution of responsibilities between the two EU bodies (the lack of which led to a similar "stalemate" situation in the case of Italy). It would, however, be wrong to believe that the established rules had been of no effectiveness at all. A number of countries (including Belgium, Spain

¹¹ Schuknecht L., Moutot Ph., Rother Ph., Stark J. The Stability and Growth Pact. Crisis and Reform// ECB – Occasional Paper, No. 129/September, 2011, p.10 – [Electronic resource]. Access mode: <http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp129.pdf>

¹² Khudyakova L.S., Sidorova E.A. The reform of financial sector regulation in the European Union //Dengi i kredit, No. 4, 2014, p.33. [In Russian].

and Austria) have succeeded in complying with the set requirements and managed to consolidate their financial resources so as to avoid excessive deficits. Moreover, Ireland, Luxembourg and Finland, which had experienced fiscal problems before, managed to improve their finances and join the euro area even with budget surpluses (although, Belgium and Luxembourg suffered budget deficit later again)¹³.

As a result of the judgment (under pressure from Germany and France) the rules were softened. In particular, the Ecofin Council agreed that the 3% ceiling of GDP for budget deficit and 60% of GDP for public debt are recognized officially, but are also subject to additional criteria, under which the deficit is recognized as excessive, namely: cyclically adjusted budget behavior, debt level, slow growth period duration, progress in implementing market-oriented pension reforms and the possibility of the deficit being related to productivity increase procedures. Thus, decisions on sanctions should be adopted after consideration of a set of indicators (both objective and subjective). The Council decided that as a rule, the term for excessive deficit correction should fall within one year after identification thereof and thus, normally, expire on the second year after deficit occurrence. The Council also agreed that the elements to be taken into account when determining the initial term for the excessive deficit correction should be more specific and include, in particular, overall assessment of all the factors mentioned in the report under Art. 104 (3).

As a benchmark, countries with excessive budget deficits shall be obliged to apply fiscal efforts in order to achieve annual minimum deficit reduction by at least 0.5% of GDP (a cyclically adjusted indicator). If the said efforts prove sufficient to correct the excessive deficit in the year following identification thereof, the initial term need not be set beyond this year¹⁴. At the summit held during March 22-23, 2005, the European Commission endorsed this decision and made appropriate changes to the "preventive arm" of the Pact. In particular, this concerned introducing a number of fundamental concepts used in the decision-making process¹⁵:

¹³ *Morris R., Ongena N., Schuknecht L.* The Reform and Implementation of the Stability and Growth Pact – European Central Bank, Occasional Paper No. 47, June 2006, p.18 – [Electronic resource]. Access mode: <https://www.ecb.europa.eu/pub/pdf/scpops/ecboep47.pdf>

¹⁴ Improving the implementation of the Stability and Growth Pact / Ecofin Report , 22-23 March 2005, p.18 – [Electronic resource]. Access mode: http://www.eu2005.lu/en/actualites/documents_travail/2005/03/21stab/stab.pdf

¹⁵ Report on Public finances in EMU 2005// European Economy No. 3, 2005, pp. 83-84 – [Electronic resource]. Access mode: http://ec.europa.eu/economy_finance/publications/publication421_en.pdf

- Country-specific Medium-Term budgetary Objectives – MTO's. By the time (during 1999-2004) the Pact used to set forth the same objective for member states – "maintaining the budget state close to balance". Now, the objective was to be set along with consideration of "economic and budgetary positions and sustainability risks of the Member States" based on the current ratio of public debt to GDP and long-term potential GDP growth, while the overall objective in the medium term remained the same – maintaining a "state close to equilibrium". The exact calculation formula was not provided, however, but it was emphasized that the MTO upper limit should remain at the level providing a safety margin for continued compliance with the deficit limit of 3% of the state budget, while ensuring stability of the budget in the long term. In addition, the respective EC regulation stipulated that the MTO upper limit for the euro area states or ERM II for EMU-2 member states may not exceed 1% of GDP (in structural deficit), if the country is faced with a combination of low debt and high potential growth (or vice versa). At the same time, if subject to increasing age-related sustainability risks (i.e. *those related to growing average age of the population*) in the long term, the upper MTO limit should ensure budget balance or surplus. Eventually, it was decided that each member country should choose own MTO objectives in presenting its annual report on the implementation of the convergence/sustainability program, whereas a recommendation was also provided that governments always choose a more ambitious MTO level compared to the upper MTO limit, as long as it is more suitable for their medium-term fiscal policy.

- Minimum annual budgetary effort for countries that have not yet reached the medium-term objectives – MTO. All member states agreed that fiscal and tax consolidation of the budget should be carried out, as long as there are favorable economic conditions for that matter, i.e. during periods when the real growth exceeds the average potential long-term growth. The rule concerning windfall revenues was also agreed upon, while implying that such funds should be spent directly on reduction of both public deficits and debt. Moreover, a special rule for the euro area states and EMU-2 member states implied they undertake to implement annual improvements as to their structural deficit at the level of at least 0.5% of GDP.

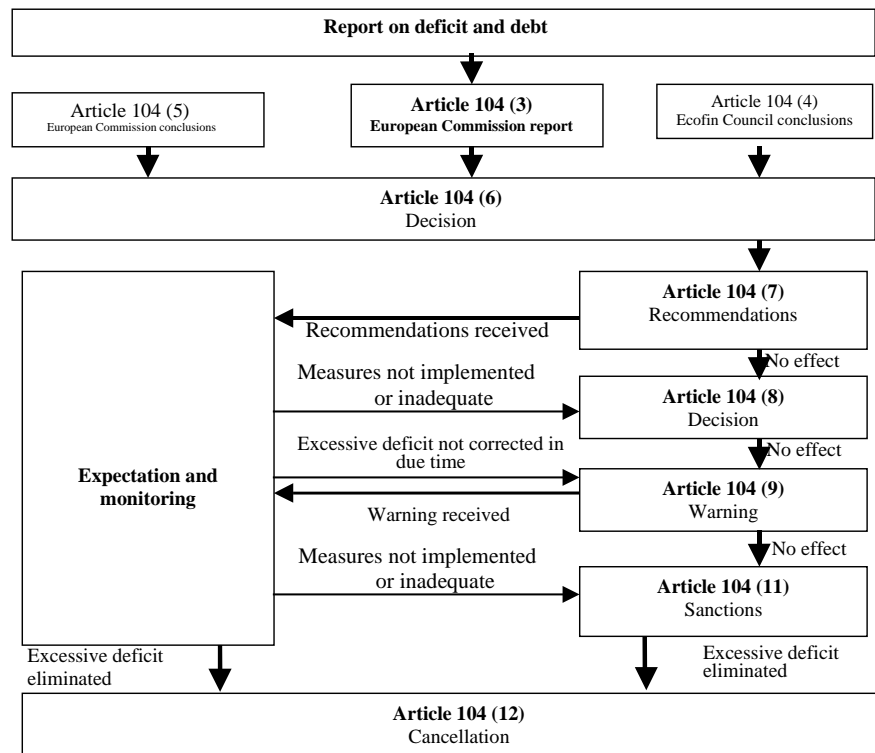


Fig. 1. Excessive deficit procedure sequence of actions (by the Maastricht Treaty articles)

Source: Morris R., Ongena N., Schuknecht L. *The Reform and Implementation of the Stability and Growth Pact – European Central Bank, Occasional Paper No. 47, June 2006, p.17*

- Early-warning system. The previously existing early warning system for potential violations of budget deficits was expanded and it was agreed that the system be based on the analysis of ten macroeconomic indicators. In addition, the European Commission has been granted the right to express its "opinion" to member states without discussing this issue at the European Council in situations where such an opinion serves as a formal recommendation for achieving the previously announced MTO. This implies that the Commission will be expressing its opinion/recommendation not only in situations of the 3% ceiling violation acute risk, but also in cases when its experts detect unjustified lower-scale deviations.
- Structural reforms. With the purpose of carrying out the necessary structural reforms, it was decided that the implementa-

tion of major structural reforms (provided those have a direct long-term savings effect) should automatically grant the right to temporary deviation from the MTO or correction thereof by the amount equal to implementation cost of the structural reforms (subject to maintaining the 3% ceiling and achieving the originally set MTO over the next four years).

At the same time changes were made to the "corrective arm" of the Pact, including: 1) in the definition of "excessive deficit" the concept of "severe economic recession" was revised as was the role of "other significant factors" – including tasks of the Lisbon Agenda or innovation programs; 2) the possibility of one-year prolonging the term for deficit correction was envisaged; 3) considerations related to the assessment of systemic pension reforms were added (with a view to ensure that budget deficits are corrected by the amounts of the corresponding costs on such reforms during the first five years); and 4) the need to ensure fiscal and debt sustainability was emphasized (along with demand for reducing the existing debts to a level of 60% of GDP)¹⁶.

Finally, the control and monitoring system has been improved in terms of fiscal (in particular, peer support) and statistical (increased transparency of budget information) aspects¹⁷.

However, the reform of 2005 was undermined already in 2007 by the actions of France, which started stimulating national economy through financial measures, which led to significant deviations from the indicators provided for by the Pact. With the onset of the economic crisis in 2008 such behavior of the EU member states has become virtually commonly accepted.

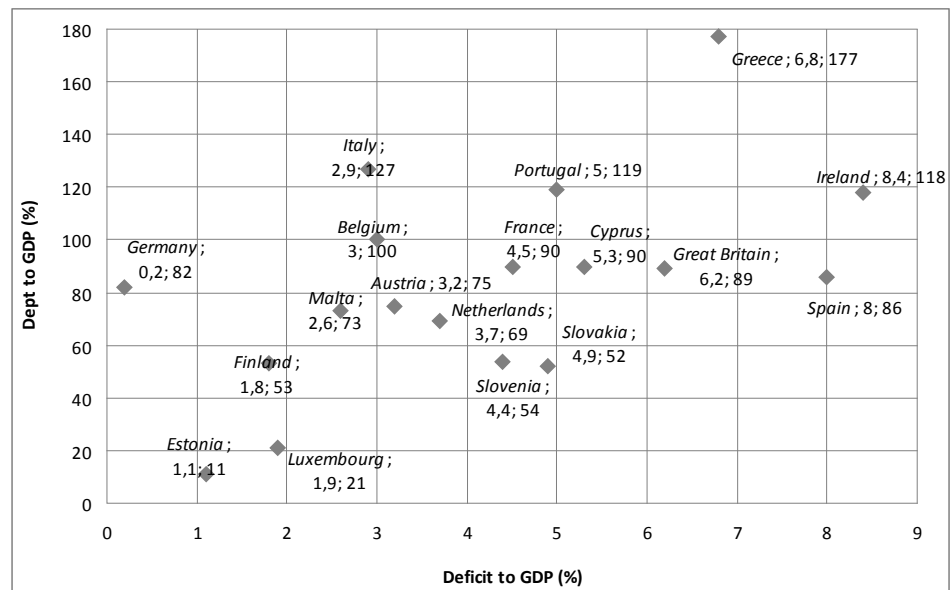
During the 2001-2012 period the rule regarding public debt restriction (60% of GDP) was broken 92 times by twelve of the seventeen euro area countries, whereas the rule as to the 3% budget deficit was breached 75 times by fifteen countries. However, the particular importance was vested in financial integration deepening as a result of the 2007-2012 global debt crisis aggravation. The signal for European debt crisis onset was given by the statement of the New Greek government in October 2009, when it appeared that the budget deficit was actually twice as large than the previous government had claimed and reached 12% of GDP. Thus, after several years of uncontrolled budget spending and failure to carry out reforms Greece was the first country in the euro area heading towards the destructive consequences of the

¹⁶ Ibid., pp. 84, 87-90

¹⁷ Ibid., pp. 90-91

economic crisis¹⁸. Soon, similar problems arose in Portugal (with deficit over 6% of GDP) and in Spain (11%). In Ireland, the deficit actually exceeded 30% of GDP (however, in this country the deficit formation was mainly due to the unsuccessful attempt of the state to support bankrupt financial institutions). These countries affected by the crisis have formed the group of "peripheral" EU member states in crisis known as GIPS (or politically incorrect – PIGS). After similar problems had arisen in Italy, the group became known as PIIGS.

In the euro area, the sovereign debt crisis has been particularly destructive, while affecting not only financial but also social sphere and political processes. EU political leaders declared their readiness to defend the euro area at all costs.



Within limits X: 0-3; Y: 0-60	SGP	Unsound X: 3-6; Y: 60-120	Critical X: 3-9; Y: 120-180	Unstable X: 0-3; Y: 120-180 X: 6-9; Y: 0-120
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Fig. 2. Ratio of budget deficit and public debt to GDP in 2012

Source: Eurostat data

Indeed, it was the crisis that gave a powerful impetus to further process of economic (in particular, budgetary and fiscal) consolidation of 28 EU countries. In order to overcome budgetary

¹⁸ European Debt Crisis Explained//Investment Contrarians – [Electronic resource]. Access mode: <http://www.investmentcontrarians.com/european-debt-crisis-explained/>

imbalances several general principles of the European Union were reviewed; in cooperation with the IMF loans were granted to Greece, Ireland, Portugal and other indebted countries, as well as to the banking sector in Spain. In particular, Greece which found itself on the verge of default in 2011 appealed for aid to the European Union and IMF, thus receiving circa USD 240 billion. Moreover, European banks have written off 53.5% of the private sector debts of Greece. Ireland, which also faced onset of the financial (banking) crisis, has requested EUR 67.5 billion of aid. Spain turned for assistance in the amount of EUR 100 billion (although later it was limited to the amount of EUR 41 billion). Portugal requested EUR 78 billion and carried out quite an effective reform program. In particular, the request for financial assistance was sent to the IMF and the European Commission along with a development and stability program after the Socialist government of Jos  Socrates in Portugal had resigned in March 2011 (though kept on performing duties till the early elections). The program had been developed two months in advance and agreed with the opposition. Although the opposition (Social Democrats) was not invited to the government, the need to achieve national consensus was clearly understood. Representatives of the IMF, European Commission and European Central Bank who came to Portugal in May agreed upon the program presented lending conditions and asked to endorse those both by the government (which still could manage to get the first tranche) and the opposition, which had solid chances to come to power in late June. Actually that was what later happened and the new Social Democratic government started developing a new program, which presented a modernized (and a more rigid) version of the previous government's program and was also agreed upon by the opposition – now the Socialists. Thus, eventually the crisis overcoming program proved not only more radical (in terms of budgetary savings and speed of the planned reforms) than initially proposed by the IMF experts, but really of national scale (such that met real objectives of the government and was acceptable (at least in terms of basic parameters) to the political opposition. As a result of strong measures, Portugal budget deficit in 2013 was reduced to 2.6% of GDP, which was below the level specified in the program (3%). The state's capability of providing for internal and external funding also increased. Interest payments on government obligations were significantly reduced: in late April of 2014 the average yield on ten-year bonds placed by Portugal reached 3.58%, which was a record since early 2006. The share of exports

in GDP has increased from 28% in 2009 to 41% in 2013. Manufacturing enterprises have improved their position in foreign markets (especially those of footwear industry), while the service sector began to rapidly develop. A positive trend in the economy implying return of foreign investors could be seen. So, it is not surprising that Portugal was the first of the so-called EU Southern periphery countries to overcome major economic problems and could afford to abandon the program of support by the IMF, European Commission and European Central Bank in May 2014.

The response to the financial crisis in the euro area was deepening of the fiscal and budgetary consolidation, an example of which was establishment of the European Financial Stability Facility (EFSF) in 2011 to combat the crisis and next – transformation thereof into the improved and permanent European Stability Mechanism (in September 2012). The functioning of these new institutions and the nature of their financial support indicate that EU countries have approached the new integration stage – ensuring confederal stability budget.

A significant role in this process was vested in the European Central Bank (ECB), which traditionally applied a strict monetary approach to macroeconomic regulation. However, it departed from the standard rules and introduced a new method implying purchase of government bonds from crisis-affected countries and filling their banks with adequate capital. Thus, the ECB has essentially financed the deficit of the future common EU budget.

The formal commencement of the fiscal integration process can probably be characterized by development of two versions of the draft regulatory acts in September 2010 aimed at amending the Stability and Growth Pact. The drafts were developed separately by two work groups of the European Commission and the European Council. In March 2011, the Ecofin Council prepared a preliminary draft agreement including a list of required regulatory documents (dubbed "the six pack"*) aimed at reducing budget deficits and achieving macroeconomic balance.

Four of the six instruments were designed to further reform the Stability and Growth Pact. This reform did not imply any changes in the existing rules, but was intended to ensure stricter

* 1. Regulation 1175/2011 amending Regulation 1466/97: On the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

2. Regulation 1177/2011 amending Regulation 1467/97: On speeding up and clarifying the implementation of the excessive deficit procedure.

3. Regulation 1173/2011: On the effective enforcement of budgetary surveillance in the euro area.

4. Directive 2011/85/EU: On requirements for budgetary frameworks of the Member States.

5. Regulation 1176/2011: On the prevention and correction of macroeconomic imbalances.

6. Regulation 1174/2011: On enforcement action to correct excessive macroeconomic imbalances in the euro area.

adherence to financial discipline and systematization of the procedure for imposing sanctions. For instance, if a country found in breach of the rules failed to exercise appropriate actions, it was bound to place an interest-free deposit in the amount of 0.2% of GDP. In case the required actions were still not implemented, the deposit would be transformed into a fine. In addition, such countries would be subject to restrictions as regards voting in the EU Council, while their national standards of statistics were to be harmonized with standard meeting EU requirements.

Another two documents of the "pack" were related to macro-economic balancing procedure and early warning system.

Since 2011, the activities on monitoring and coordination of the Pact implementation have been carried out under the so-called "European Semester":

- In March, the European Council (heads of the EU states and governments) sets priorities of the economic policy based on respective reports. This provides the basis for receiving recommendations on fiscal policy (stability and convergence programs) and economic policy (national reform programs).

- In April, the Member States provide the Commission with their medium-term budgetary and economic strategies based on targeted recommendations. The Commission assesses plans of the member countries and develops recommendations to the EU Council as to voting on this.

- In June and July, the European Council and the Ecofin Council carry out political consultations on common economic and fiscal policies for specific countries. Assessment of compliance with the recommendations will be implemented by the Commission next year.

The next step toward improving fiscal discipline was made on November 23, 2011, as the European Commission proposed another two regulatory documents (the "Two-pack"¹⁹), which were to introduce additional monitoring measures as to the budget processes in the euro area countries. However, they entered into force only in 2013 after implementation of the new requirements to the common EU fiscal legislation. In particular, it is now required that the EMU member countries provide the European Commission with a draft budget for next year not later than by

¹⁹ 1. Regulation 473/2013: On common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

2. Regulation 472/2013: On the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability.

October 15 (unless, of course, the country is subject to specific requirements of the Excessive Deficit Procedure, EDP, or Excessive Imbalance Procedure – EIP). Governments of the countries subject to the above procedures have to provide respective reports more frequently than under normal circumstances.

Eventually, it came to knowledge that France, Germany and Italy intended to initiate establishment of a new Stability and Growth Pact for the euro area, which would imply "severe sanctions" against countries violating requirements thereof. In early December 2011, Angela Merkel, the Chancellor of Germany, has promised to create a fiscal union of the euro circulation countries. At that, she strongly rejected the idea of introducing joint Eurobonds, while still acknowledging that the gradual evolution toward Eurobonds was in full swing by itself. In turn, W. Schäuble, the German Finance Minister, suggested that each member state transfer its debt exceeding the limit of 60% of the national GDP to the national redemption fund to be financed by the national target tax revenues in order to increase investor confidence in the feasibility of debt repayment. His suggestion resembled elements of the European redemption fund proposed by the German Council of Economic Experts, however lacked the key element – joint and several liability.

The French President N. Sarkozy has seemingly supported this idea and stressed that the euro area countries should do their budgeting in the same style while bearing in mind that they would face severe automatic sanctions in case of violating budgeting rules. He also supported changes to the EU treaty and the proposal to abolish the requirement for a qualified majority vote in order to ensure prompter decision making by the member states. However, of more critical essence was that Sarkozy did not opine on the fiscal union. As the French minister made it clear, France was deeply concerned about the idea that the European Commission would have a right both to review national budgets and to veto them. That is, France, on the one hand, seemingly supported introduction of severe automatic sanctions for violations of budgetary discipline, but, on the other hand, wished to retain the right of individual states to independent budgeting. On analyzing these suggestions (as well as statements of the German Bundestag oppositionists, who pointed out that such gradualist approach would only exacerbate the debt crisis), independent experts drew attention to the fact that the German intention to supplement the EMU with a fiscal union may also comprise joint liability, which would go beyond the narrow limits set out by the European Stability Mechanism. Moreover, there

were expectations of the growing recognition by the German government that the ESM's current design, which foresees public debt restructuring of the euro area member states as a regular crisis tool, is inconsistent with the euro's role as one of the world's leading reserve currencies. However, the sequencing of reforms is crucial and more joint liability may only come once binding fiscal rules and national economic reforms are in place ensuring solid public finances, and improved economic growth and employment for all member states²⁰.

On the same day (November 23), the European Commission presented the "Green paper" concerning feasibility of establishing joint bonds of the euro area countries ("Eurobonds" or "stability bonds"). The stability bonds were defined therein as "a tool created for daily financing general expenditures of the euro area countries through joint issue"²¹. It was presumed that such joint liability for government bonds would increase reliability, reduce the cost of borrowing (interest rates) and improve fiscal discipline (due to more stringent monitoring and control). The proposal has caused quite a robust discussion and, therefore, in July 2012 the European Committee for Economic and Social Policy provided the European Commission with its conclusions which, in particular, envisaged continued political work on the said project. At that, the Committee tended to the option, which would stipulate joint liability of the euro area countries (in the form of payment guarantees), but not with respect to all government bonds of the euro area countries, but only to a portion thereof (with the portion meeting certain criteria, which, however, were never developed). Later, a proposal was put forward that the first step should imply introducing common issue by the euro area countries of eurobills – short-term instruments to finance public debt with maturity term thereof varying from one to two years. Introduction of eurobills would not require immediate and complete integration of the fiscal policy.

In January 2012, a special Code of Conduct²² was issued (with the final version thereof agreed in September of the same year) presenting a detailed description of using the Stability and

²⁰ European fiscal union: what the experts say//theguardian.com, Friday 2 December – [Electronic resource]. Access mode: <http://www.theguardian.com/business/2011/dec/02/european-fiscal-union-experts>

²¹ Green paper on the feasibility of introducing stability bonds// European Commission, Brussels, 23.11.2011, p.3 – [Electronic resource]. Access mode: http://ec.europa.eu/commission_2010-2014/president/news/documents/pdf/green_en.pdf

²² Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes – [Electronic resource]. Access mode: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

Growth Pact mechanisms. This document also comprised detailed consideration of the basic concepts relating to the Pact as well as recommendations regarding the content of stability and convergence programs.

In March, 25 EU Member States (with the exception of Great Britain and Czech Republic) signed an agreement to ensure budgetary discipline known as the Fiscal Compact. The agreement entered into force in January 2013 after ratification thereof by twelve EU countries. Later on, the Compact was ratified by almost all of the other EU countries, including Czech Republic. Denmark and Romania declared accession to the Compact without ratification, while Bulgaria declared itself bound to implement the agreement in part (although the three countries are not euro area members, to which, in fact, the Fiscal Compact provisions apply). The only opponent to the new rules was Great Britain.

In practice however, everything is not as rosy. The matter is that immediately after signing of the Compact, it had to be ratified by Greece (which would not receive EU financial assistance otherwise). However, the procedure of its implementation into the national legislation was not carried out, which left a "legal loophole" for neglecting the Compact in the future²³. Given high social tensions in the Greek society and quite a real threat of Greece exiting the euro area, the European Commission did not insist on full compliance with the legal formalities. Though, further on the international lenders strictly controlled real implementation of the reform program, required by the Fiscal Compact provisions²⁴. However, a precedent had been created and Greece was followed by Cyprus, Malta, the Netherlands, Luxembourg, Belgium, Estonia and Romania. In particular, the need for observing the "golden rule" still in 2012 led to a government crisis and early elections in the Netherlands. The Dutch parliament faced the need to cut costs, since the budget deficit stood at 4.7%, but 11 parties in the parliament of the Netherlands disagreed on the methods of budget savings. The most radical proposals were submitted by socialists and nationalists. The Socialist Party proposed not to reduce social spending, but to introduce a tax on the rich and thus increase budget revenues. The Party for

²³ *Burret H.T., Schnellenbach J.* Implementation of the Fiscal Compact in the Euro Area Member States//German Council for Economic Experts, Working Paper 08/2013, November 2013, p. 36 – [Electronic resource]. Access mode: http://www.sachverstaendigenratwirtschaft.de/-fileadmin/dateiablage/download/publikationen/arbeitspapier_08_2013_engl.pdf

²⁴ *Papadimitropoulou I.* Eurogroup to examine the progress of Greece's fiscal adjustment program//Times of Changes, 19.06.2014 – [Electronic resource]. Access mode: <http://www.thetoc.gr-/eng/politics/article/eurogroup-to-examine-the-progress-of-greeces-fiscal-adjustment-programme>

Freedom felt it was important to cut financial aid to migrants making up to 10% of the population and to exit the euro zone. To overcome the political gridlock, early elections were conducted. Although they practically did not change the balance of power, agreement on the budget was nonetheless reached. Despite the fact that the majority did not want to ratify the Fiscal Compact, its abandoning was practically impossible. Eventually, an original solution was found – in March 2013 the parliament ratified the Compact and on July 26 it was signed by the King, but the document never became an obligatory legal norm for the Netherlands. The Compact was not implemented and remains recognized by the Netherlands as an international legal instrument having no priority over the national laws, i.e. compliance with the Compact on the Dutch side is, in fact, a matter of "good will"²⁵.

Sweden and Poland followed a somewhat different path – the agreement was ratified and implemented, but the implementation of the Covenant was postponed until accession of these countries to the euro area.

Not everything went smooth in Germany, where fiscal union opponents appealed to the Federal Constitutional Court with a lawsuit arguing that the European Stability Mechanism (ESM) was undermining Bundestag budgetary powers. However, in March 2014 Karlsruhe Constitutional Court ruled that despite the fact that the financial obligations of Germany as a result of joining the Mechanism reached EUR 190 billion, the German Bundestag budgetary autonomy remained sufficiently²⁶.

The Fiscal Compact essence implies legislative consolidation of the previous agreements on the so-called "golden fiscal rule", which requires maintenance of public finance indicators within rigid limits (budget deficit – within 3% of GDP, and the structural deficit below 0.5% of GDP), as well as on the "debt brake" implying public debt limitation at the level of 60% of GDP. In addition, while preparing the Fiscal Compact it was supposed that budgets of all EU countries should be sent for approval to the European Commission in Brussels before they get to the national parliaments. The suggestion was dramatically opposed by Greece, Great Britain, Czech Republic and other countries, which believed this procedure would infringe their sovereignty. For-

²⁵ The Golden Rule adopted in Dutch legislation?// Leiden University. Leiden Law Blogs, 05.10.2012 – [Electronic resource]. Access mode: <http://leidenlawblog.nl/articles/the-golden-rule-adopted-in-dutch-legislation>

²⁶ Verfassungsgericht weist Klagen gegen ESM ab// Die Bundesregierung, 18. März 2014 – [Electronic resource]. Access mode: <http://www.bundesregierung.de/Content/DE/Artikel/2014/03/2014-03-18-bverfg-esm.html;jsessionid=622BB9AA48A15170216D34D493E676DC.s3t1>

mally, this rule was cancelled, but in practice it still works, because draft budgets are still sent to the European Commission in terms of monitoring compliance with the "golden rule".

Further budgetary and fiscal consolidation of the EU largely depends on the position of Germany, which is now acting as its main engine. Berlin advocates unconditional implementation of the Fiscal Compact, ensuring compliance with all budgetary and monetary constraints allowing to overcome the crisis by joint effort. The German government also supports transfer of sovereign powers in the financial sector to supranational bodies. These approaches are not always admired by their partners in the European Union which are not in a position to restore order in their public finances, and sometimes European officials in Brussels join them as well. Actions of Germany are often counterweighed by the alliance of France, Italy and Spain. For example, a conflict arose concerning potential issue of Eurobonds and establishment of the so-called "transfer union". The Germans grow increasingly more blamed for the negative effects of measures aimed at budget funds saving.

The third largest economy of the EU – Great Britain occupies a special position. Since the moment of joining EU, Great Britain has been continuously inhibiting all the integration measures, especially in the monetary and budgetary spheres. The sovereign debt crisis has led to intensification of London's European integration process suspension. The British government has not signed the Fiscal Compact and, occasionally, raises the issue of potential exit from the EU.

Thus, the fiscal union creation has been formally completed, but in fact its members are faced with hard work on practical implementation of the mutual obligations as well as on establishment of mechanisms and tools that would ensure implementation of the "golden rule" and use of the "debt brake" without causing irreparable damage to the national economy and socio-economic state of society.

Today the EU financial system is a complex system of international relations and international institutions, whose task is to protect common interests of the member states in all areas of financial relations: lending and investment, international payments and exchange rate policy coordination, harmonizing rules of control over banking institutions, combating tax evasion and money laundering, budgetary policy coordination and so on. Significant changes in the geo-economic structure of the world, in particular, rapid growth of economic competition on the part of China and worsening of domestic political and economic problems within

the EU (failure of the EU Constitution, the banking and debt crisis of periphery countries, etc.), pose fundamental problems to the EU concerning correction of the European integration model. Thus, one can say that at present the European Union is at the bifurcation point, the passage of which proves possible only in one of two directions: *further federalization* and advancement towards the 'United States of Europe' or consolidating of the positions taken in order to *maintain the status quo* in terms of further globalization.

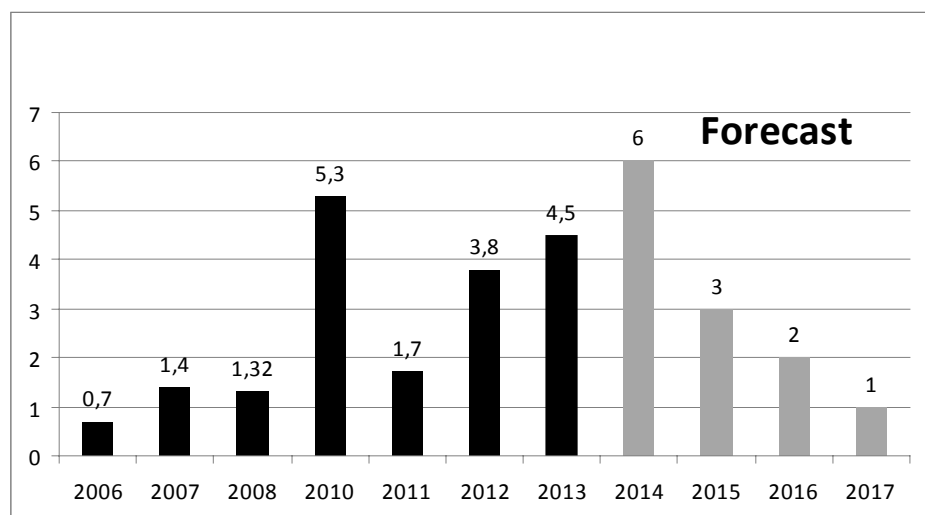


Fig. 3. Budget deficit of Ukraine (% of GDP)

Source: Ministry of Finance of Ukraine

Conclusion

What will the European Union financial integration scenario look like is to be seen already in the near future. However, the specified prospects of the European Union financial system modernization raise the need for certain steps on the part of the relevant financial authorities in Ukraine, arising from the EU integration objectives.

In the field of budgetary policy it should first of all concern attempts for ensuring compliance with the fiscal discipline criteria adopted in the European Union (although such requirements do not arise from the current objectives of Ukraine's integration into the EU). However, until recently it has not looked too difficult for the Ukrainian side, as the national debt during recent

years ranged from 12 to 40% of GDP (never going beyond this limit), which is significantly lower than the same figure for the vast majority of EU countries (except Poland). As for the budget deficit, over the 2006-2012 period it amounted on the average to 2.6% of GDP (i.e. stayed strictly within the Maastricht criteria). However, recent events related to the annexation of Crimea by Russia and military operations in the area of anti-terrorist operation in the eastern Ukraine have significantly worsened the state of the economy, resulting in the expected growth of the budget deficit. However, the government expects to achieve limiting thereof to 3% of GDP in a year, while the foreign debt is expected to be kept within 55% of GDP until 2017.

Regarding organization of the budgeting process, the short-term objectives include development of medium-term budget forecasting (planning) system, improving program-oriented approach to the budgeting process and analyzing effectiveness and efficiency of budget programs as well as improving exchange of information and experience on planning and meeting of the budget and public debt-related tasks. All the above should ensure development of the public internal control and external audit system based on international (European) standards and their compatibility with the fundamental principles of accountability, transparency, economy, efficiency and effectiveness. In particular, this implies the need for implementation of standards and methods of the International Organization of Supreme Audit Institutions (INTOSAI) and use of the EU experience in the field of external control and audit of public finances (while emphasizing independence of the relevant authorities). It is also essential to further develop the public internal financial control system through harmonization with the standards taking into account general European practice and agreed with the Institute of Internal Auditors (IIA), the International Federation of Accountants (IFAC) and the International Organization of Supreme Audit Institutions (INTOSAI).

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