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Economy and international financing

The European Union's 2021-2027 multiannual financial framework: new balances, new challenges

The ongoing negotiations on the next multiannual financial framework for the European Union (EU) were launched 18 months ago by the European Commission. This framework, discussed between the Member States, sets out the EU's main areas of spending and their ceilings over a seven-year horizon. Due to Brexit and the European parliamentary elections, the outcome of these negotiations was pushed back to autumn 2019 and should be concluded in early 2020. The multiannual financial framework negotiations reflect the power dynamics at play within the EU and highlight the major issues that currently jam the machinery of European integration. The debate on the euro area budget has been relaunched but shows the extent to which fiscal union, the missing piece of the Economic and Monetary Union, exacerbates differences in national positions.

Véronique Genre and Elsa Lamy
European and Multilateral Policies Directorate
European Relations Division

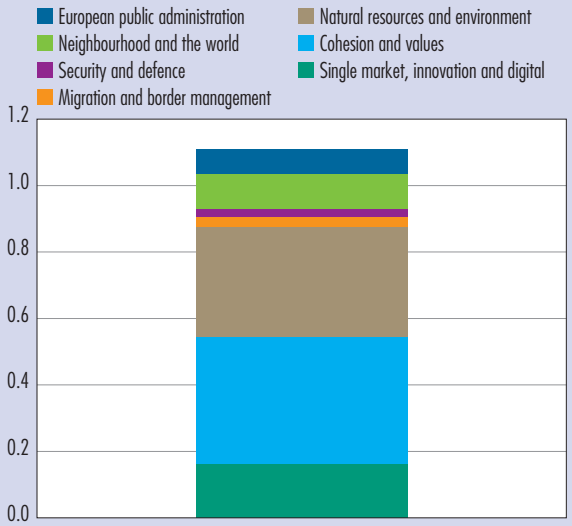
JEL codes
H10, H50,
H77

EUR 1,100 billion
the commitment appropriations for the seven-year period from 2021 to 2027

15% reduction
the European Commission is proposing to reduce Common Agricultural Policy (CAP) spending by 15% and spending on economic, social and territorial cohesion by 10%

Between 1.1% and 1.3%
the proportion of Member States' gross national income allocated to the European Union budget

Proposal for the distribution of European Union commitment appropriations under the 2021-2027 multiannual financial framework
(% of gross national income)



Source: European Commission.
Note: Commitments in current 2018 prices.

1 The European Union budget: an atypical instrument

An instrument historically controlled by the Member States

From the outset, EU fiscal autonomy has been a major sticking point in the debate on European integration. In 1951, the European Coal and Steel Community budget was independently run and entirely funded by levies on coal and steel production. However, the budget of the EU, and before that, the European Economic Community, is fixed with the agreement of Member States and financed through their contributions, calculated as a percentage of their nominal GDP. This system was initially intended to be transitional until contributions were eventually replaced by the EU's own resources, independent of Member States and definitively allocated to the Community, without the need for further negotiations with national authorities.

Own resources (mainly customs duties on imports from outside the EU) were only introduced after heated negotiations in 1970.[1] In 1988, as own resources were no longer sufficient, national contributions in the shape of a resource linked to the gross national product of each Member State were reintroduced to finance the EU budget. These have since been gradually increased and are now the primary resource.

Two key moments in the history of the EU budget are worth highlighting.

- From 1975 onwards, responsibility for adopting the annual budget, which had initially been the preserve of the European Council, was shared with the European Parliament. However, between 1979 and 1984, the widening gap between requirements and available resources created a conflictual climate in interinstitutional relations and the proposed budgets were repeatedly rejected by Parliament. The concept of "multiannual financial perspectives" was thus developed to plan spending in the medium term and to lock in interinstitutional agreement in advance. Finally in 2009, the Treaty of Lisbon transformed the multiannual financial framework (MFF) into a legally binding act.

- After years of disagreement and obstruction to European integration, it was decided in 1984 that the United Kingdom's contributions should be partly reimbursed as the British gained little from the Common Agricultural Policy (CAP), which accounted for the majority of the EU budget. This is the famous UK rebate or "British cheque".[2]

A public budget but without all the characteristics

The adoption of a budget is a very different political process for the EU from that of its Member States. Preparing the MFF involves setting out, in broad terms, the spending limits for the Union, the priority areas for their allocation and the rules for their financing and use for the seven years to come. Based on the MFF guidelines, the EU budget is fixed in greater detail through an annual budgetary procedure. This is all approved by the Council of Ministers after obtaining the consent of the European Parliament, on the basis of a legislative proposal from the European Commission.

Spending under the MFF for the 2014-20 period is limited to EUR 908.4 billion in payments (a little over 1% of the wealth generated each year by EU Member States). This proportion has grown slowly throughout the history of European integration[3] but remains extremely marginal compared with national budgets. In 2018, for example, the average national budget of a Member State[4] accounted for 46% of its gross national product.

1 The Treaty of Luxembourg of 21 April 1970.

2 The United Kingdom is reimbursed two-thirds of the difference between its payments and receipts. The part not paid by the British (i.e. the rebate) is divided between all the other Member States. Since 2002, Germany, the Netherlands, Austria and Sweden have obtained a "rebate on the rebate" and only have to pay 25% of the amount that would normally be due. Therefore, in reality France is the biggest contributor to the UK rebate with EUR 1.5 billion per year, currently. This is in part due to France being a substantial beneficiary of the CAP.

3 The 1% threshold was exceeded in 1984. Since then, the ratio has stabilised at around 1% and fluctuates in line with commitments and payments.

4 Total general government spending (source: Eurostat).

However, the EU budget has neither the same purpose nor the same characteristics.

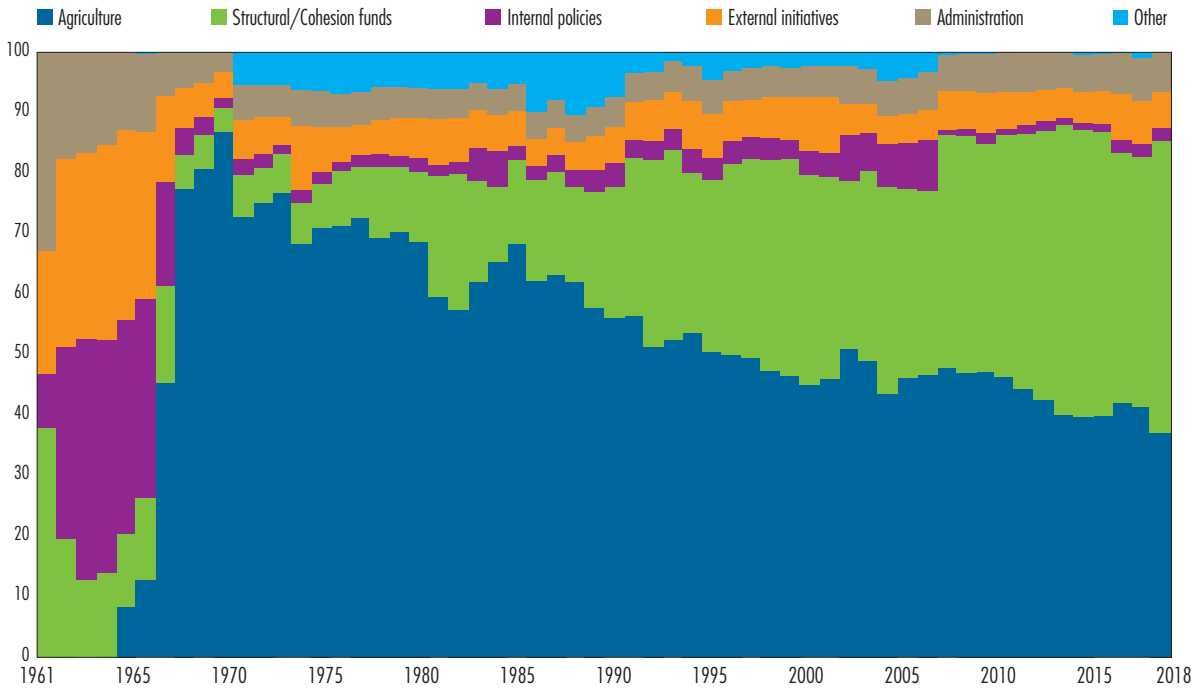
In terms of revenue, the European Union does not levy any taxes directly. The budget is funded by three main resources made available by the Member States. Between two-thirds and three-quarters of the budget is funded by Member State contributions, calculated according to their economic weight – "gross national income"-based contributions. Own resources (mainly customs duties on imports from outside the EU) account for around 14% of total revenue. Lastly, each Member State makes a VAT-based resource contribution corresponding to 0.3% of their VAT base. This was once a major source of own resources but now only accounts for 12% of the budget. The remainder (less than 2% of revenue) comes from: (i) taxes paid by EU staff on their remuneration; (ii) contributions paid by non-EU countries to certain European programmes; and (iii) fines imposed on companies that contravene competition rules or other regulations.

In contrast to traditional national budgets, the EU budget must balance spending and revenue and does not allow for any shortfall. In certain situations and on behalf of the EU, the European Commission has a borrowing capacity on the international financial markets. There are three fundraising programmes designed to help Member States in financial difficulty or, more rarely, another country experiencing balance of payments problems. Most of these tools have been part of the European Stability Mechanism (ESM) since 2005. The funds that are raised are then loaned to the country that needs them at the same market interest rate paid by the European Commission. This means that the recipient country benefits from a lower interest rate than it would have obtained had it sought market financing individually.

EU spending is almost exclusively operational or investment-related, intended to finance concrete activities on the ground. Operating costs (wages and pensions of EU public sector employees, spending on buildings and equipment) only account for 6% of the budget while

C1 Breakdown of European Union spending

(% of total budget)



Source: European Commission.

spending on intervention schemes related to EU initiatives and policies, takes up the remaining 94%. The vast majority of this spending goes to the CAP (37% of the budget in 2018) and the cohesion policy and structural funds (48%) that are aimed at reducing regional and social inequalities within the EU.

Contrary to practices in a federation of states or at a national level, providing public goods and services such as social security, health care, education and defence is the responsibility of the individual Member States, and not the EU.

Equally, and again unlike national budgets, the EU budget is not designed to provide an economic stabilisation function. A traditional national budget has an automatic capacity to smooth the impact of cyclical events. When the economy expands, higher consumption and lower unemployment mechanically boost tax revenues and reduce social security benefits in the public accounts. These spending and revenue variations automatically moderate growth. When the economy slows down, the opposite occurs, as public finances (paying more social security benefits and collecting less taxes) mitigate the recessionary effects. This is known as automatic stabilisation.

The EU budget provides neither of these two traditional public finance functions – stabilisation and redistribution – as it has no remit to raise taxes or distribute social security benefits and must remain in balance. It only has a marginal redistributive influence via the Cohesion Funds (Pasimeni and Riso, 2019).

In sum, the EU budget is the product of 70 years of European integration and compromises between sovereign nations. Its financial autonomy is limited and closely controlled and its areas of intervention are subject to Member States' goodwill.

2 The European Union's 2021-2027 multiannual financial framework: a new financial equation

On 2 May 2018, the European Commission officially launched negotiations on the EU's next multiannual financial framework (MFF) by publishing its proposals (European Commission, 2018). Negotiations were pushed back to autumn 2019 due to Brexit and the European parliamentary elections and are expected to continue until the end of the year. The new MFF is more than an accounting document. It is also a reflection of the major strategic choices that will confront the EU.

Brexit fallout: a decline in revenue and new balances to be established

This new framework will be the first without the United Kingdom. The departure of the United Kingdom will have major consequences for both the funding available and the redistribution of balances during the negotiations.

Firstly, the United Kingdom has always played a key political role in European negotiations, and particularly on the budget: it formed the "austerity coalition"[5] during the MFF 2007-2013 negotiations and was part of the "better spending" group[6] for MFF 2014-2020. It has often been the flag bearer for countries that advocate a Europe with a restricted budget of no more than 1% of gross national income (GNI). Germany and the United Kingdom are the two biggest net contributors to the EU budget and their interests in this respect have often converged.

Furthermore, the United Kingdom's net contribution represents around 5% of the EU budget,[7] or EUR 10 billion to EUR 12 billion per year. However, the Commission also proposes a phasing out of the "rebates on the UK rebate" over a five-year period.

5 Made up of six Member States: Germany, France, the United Kingdom, Austria, Sweden and the Netherlands.

6 Made up of five Member States: Germany, France, the United Kingdom, the Netherlands and Finland.

7 *http://www.europarl.europa.eu/factsheets/en/sheet/29/cadre-financier-pluri-annuel*
https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/articles/theukcontributiontotheeubudget/2017-10-31

Therefore, national contributions to the EU budget will have to change as a result of Brexit. To fully offset the loss caused by Brexit, the EU budget could rise to 1.23% of GNI for the next MFF. This could also be achieved without the need for legislative changes at the European level as the amount still complies with the ceiling set in the decision on the system of own resources of 12 February 2014.[8]

However, the withdrawal of the United Kingdom is not expected to lead to a mechanical redistribution and there are numerous scenarios for the redistribution of budget contributions between Member States. The Member States whose contribution would increase the most are the current beneficiaries of the rebates on the UK rebate, while France is in an intermediate position. For example, Germany's contribution could increase by EUR 2.8 billion while that of France and Italy could go up by EUR 1.2 billion and EUR 860 million, respectively (de Montgolfier, 2016).

Those countries least inclined to strengthen the EU budget could find themselves under pressure from their partners to agree to a permanent increase above the 1% GNI threshold. Indeed, if the Member States do not compensate for at least part of the UK withdrawal, it would amount to a total budgetary contraction of EUR 10 billion to EUR 12 billion per year, which is the equivalent of 7% of EU spending.[9]

New priorities, new allocation deployments

The European Commission's May 2018 proposal is for EUR 1,135 billion in commitments, equivalent to an average of 1.11% of GNI. It also aims to simplify budget items, reducing the number of programmes by one-third, and to steer the MFF towards new priorities.

To this end, several new headings appear in the MFF, including "EU values" and "environment". One-fifth of

T1 Multiannual financial frameworks: 2014-2020 vs 2021-2027

(EUR billions of commitment appropriations)

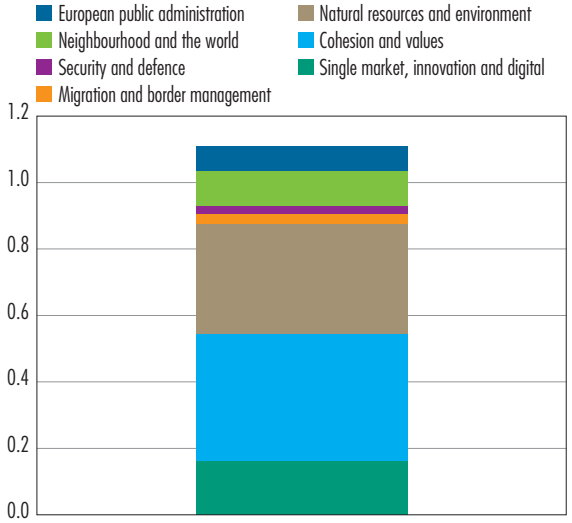
2014-2020	
Smart and inclusive growth	513.6
Sustainable growth: natural resources	420.0
Security and citizenship	17.7
Global Europe	66.3
Administration	69.6
TOTAL	**1,087.2**
As a % of gross national income	1.02

2021-2027 (under negotiation)	
Cohesion and values	392.0
Natural resources and environment	336.6
Single market, innovation and digital	166.3
Neighbourhood and the world	108.9
European public administration	75.6
Migration and border management	30.8
Security and defence	24.3
TOTAL	**1,134.6**
As a % of gross national income	1.11

Source: European Commission.

C2 Proposal for the distribution of European Union commitment appropriations under the 2021-2027 multiannual financial framework

(% of gross national income)



Source: European Commission.
Note: Commitments in current 2018 prices.

8 This regulation, adopted in accordance with a special legislative procedure under Article 31 of the Treaty on the European Union, requires unanimous approval from the Member States and authorisation of ratification from the national parliaments. It is therefore unlikely that this ceiling will be raised before the next MFF.

9 In 2018, the United Kingdom contributed EUR 19.7 billion to the EU budget. After deducting the EUR 4.7 billion UK rebate and EUR 4.9 billion received under the various European programmes that it participated in, the United Kingdom's net contribution amounted to EUR 10.1 billion. Since 2014, the United Kingdom's average net contribution has been EUR 11.8 billion per year (Keep, 2019).

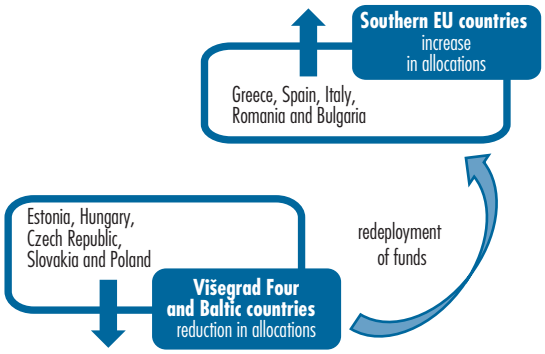
the budget is earmarked for the climate crisis through intentionally cross-cutting policies. The headings "migration and border management", with an allocation of almost EUR 31 billion over seven years, and "security and defence", with a significant budget envelop of EUR 24 billion, are also new.

Cohesion spending becomes the biggest budget item with 30% of total allocations, or EUR 337 billion over seven years. However, this corresponds to a 7% reduction in real terms (Darvas and Moës, 2018) and to a significant Cohesion Fund redeployment.[10]

Since the 2004 and 2007 enlargements of the European Union, structural funds have mainly targeted the new Member States[11] (with, for example, EUR 2,266 per person for Poland compared with EUR 403 per person for France during the MFF 2014-2020). The envisaged reduction would particularly affect the Visegrád Group countries[12] (an average drop of 23%) and funds would be redirected towards Southern EU countries such as Greece, Spain, Italy, Romania and Bulgaria, whose planned allocations would increase thanks to a change in the "transition regions" criteria (Bennahmias and Houbairi, 2018).

This reorganisation[13] is expected to impact all EU countries. The new arrangement would even make some regions of France more eligible for structural funds. Currently, there are 10 "transition regions" and 12 "more developed regions" in France. Under the new criteria, the number of transition regions would increase to 20, with only 2 regions defined as "more developed".[14] Germany expects the structural funds that it receives to decrease by 20.7%,[15] but its regions as a whole would still benefit.

C3 2021-2027 multiannual financial framework proposal
Redeployment of structural funds between countries



Source: Banque de France.

The radical transformation of these funds' objectives and criteria is far from anecdotal; it can also be interpreted as sending a political signal. The Commission proposes to suspend, reduce or restrict certain types of aid such as structural funds to countries that do not uphold the rule of law.[16] This desire to place conditions on the payment of structural funds could be interpreted as a riposte in the political dispute – over respect for the rule of law – that has driven a wedge between the EU and the governments of Poland and Hungary since 2016. The EU has used a variety of channels provided by the treaties (Article 7 TEU[17] against Poland and Hungary, Article 258 TFEU[18] against Poland), but they are time-consuming and the outcome is uncertain: suspending certain rights of a Member State in the European Council in accordance with the Article 7 TEU procedure requires unanimity (less the vote of the Member State concerned).

Another significant development is that for the first time in its history CAP spending would fall below 30%. Although the reduction had been announced, it proved to be greater than anticipated. France's CAP allocation

10 The Cohesion Fund is one of five structural funds along with the European Regional Development Fund (ERDF), the European Social Fund (ESF), the European Agricultural Fund for Rural Development (EAFRD) and the European Maritime and Fisheries Fund (EMFF).

11 Bulgaria, Cyprus, Croatia, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovakia and Slovenia.

12 Hungary, Czech Republic, Slovakia and Poland.

13 The eligibility threshold for transition regions would be raised from a range of 75% to 90% to a range of 75% to 100% of the European median income.

14 The Commission retains the former breakdown into 22 regions used prior to 2015.

15 The German government referred to this estimate in a letter dated 6 July 2018 in response to the Green Party.

16 This type of measure must be proposed by the Commission and is deemed to be adopted unless the Council decides by qualified majority to reject it (the reverse qualified majority voting procedure).

17 The Treaty on the European Union.

18 The Treaty on the Functioning of the European Union.

would decrease by EUR 5 billion compared with the EUR 55 billion it received under MFF 2014-2020. Support would be aimed even more closely at small farms and young farmers and would be conditional on compliance with environmental criteria. As the main historical beneficiary of the CAP budget, France has voiced its objection to any major reduction and has been joined in its negotiating position by other Member States including Ireland, Austria, Portugal and Greece, and also Slovakia and the Czech Republic which are opposed to cuts in the cohesion policy.

Lastly, the Commission has been innovative in proposing the creation of new own resources: a revamped EU emissions trading system, a national contribution based on plastic packaging waste and a 3% call rate on a new Common Consolidated Corporate Tax Base (CCCTB). The CCCTB proposal, relaunched in 2016, aims to ensure that companies with cross-border operations in several Member States comply with a set of common European rules for determining their taxable income and its allocation between the Member States concerned. However, it has not yet received the unanimity necessary in the European Council.

Towards the creation of a dedicated euro area budget

The final major development in the negotiations on the new MFF is that over the past few months the concept of a "genuine" euro area budget has been relaunched.

Towards the end of the 1970s, the MacDougall Report (1977) on the role of public finance in European integration concluded that a common fiscal mechanism was needed. It builds on the theoretical prerequisites essential to the construction of an optimum currency area (Mundell, 1961) and envisages a federal-type budget of between 5% and 7% of Community GDP. It stresses that, "If only because the Community budget is so relatively very small…this is an important reason why in present circumstances monetary union is impracticable."

However, two radically different stages of integration currently coexist, with (i) euro area members formed into a monetary union while (ii) budgetary, and particularly tax, policy is still the responsibility of the Member States and the "economic" dimension of the Economic and Monetary Union remains incomplete. A number of authors were quick to consider the consequences of monetary integration for budgetary policy (Wyplosz, 1990), but the 2007 financial crisis gave the debate particular relevance.[19]

After the 2008 crisis, the EU's fiscal framework, based on the Stability and Growth Pact, was enhanced with stricter supervisory and cooperation mechanisms, particularly the Treaty on Stability, Coordination and Governance (TSCG) of 2012. Despite the preventive arm of the fiscal rules and the supervisory mechanisms for macroeconomic imbalances, this framework falls far short of providing an effective macroeconomic monitoring and stabilisation tool for the euro area.

While it encourages economic coordination, it does not require Member States to take into account the economic situation of the euro area as a whole when deciding their domestic fiscal stance. This tends to place an excessive burden on monetary policy. It also fails to allow the EU to deal with unforeseen situations that require urgent decisions. It does not provide guidelines for sharing the burden of rebalancing between Member States in the event that their economic cycles diverge. Lastly, it encourages highly asymmetric decision-making, illustrated during the 2011-13 period when euro area fiscal consolidation was too hurried (Banque de France, 2017). In 2015, the European Fiscal Board, an independent body, was created with the aim of strengthening the economic governance framework. It evaluates the appropriateness of the fiscal stance at euro area and national level and also assesses the most appropriate prospective fiscal stance within the rules of the Stability and Growth Pact (European Fiscal Board, 2019). However, so far its role remains advisory.

19 *The Five President's Report: Completing Europe's Economic and Monetary Union* (2015), the product of almost three years of discussion on the subject, calls for the creation of automatic stabilisers at euro area level. The European Commission has financed a major economic research programme on the feasibility and value added of such a project, notably headed by the Centre for European Policy Studies (CEPS). The European Parliament also published a report on the subject (*http://www.europarl.europa.eu/RegData/etudes/IDAN/2016/589774/EPRS_IDA(2016)589774_EN.pdf*).

Nevertheless, an analysis of the experiences of various fiscal federations[20] shows that there is a wide choice of possible solutions for implementing a common fiscal tool. There is no single optimal system. Rather, there are common features of the systems that work. For example, a credible no-bailout rule between fiscal union members must be implemented to enable a high degree of independence in income and spending choices at local level, a transfer mechanism must be in place for use in times of crisis, and lastly, the central budget needs to be big enough.

With the European Stability Mechanism, the EU has taken a first step towards a form of fiscal union by introducing crisis management tools. In June 2018, the joint Franco-German Meseberg Declaration included a proposal for a budget to "promote competitiveness, convergence and stabilisation" in the euro area. This prompted opposition from some partners, particularly the Netherlands, and discussions have stalled. For some, private sharing of the risks resulting from financial integration, combined with sound domestic fiscal policies and collective macrofinancial supervision, removes the need for a common fiscal instrument (Heijdra et al., 2018). This view insists on the delinquent behaviour of some countries that fail to apply the rules, as well as on the fiscal responsibility imposed by market discipline if the no-bailout rule has sufficient credibility. For others, there is a complementarity between private risk sharing (via a financial union) and public stabilisation instruments (Jaillet and Vidon, 2018). A common fiscal tool is not only potentially extremely useful in countering the effects of asymmetric shocks, which are frequent within the Monetary Union, but can also accommodate a major common shock while avoiding often long and complex national fiscal policy coordination (Buti and Carnot, 2018). International institutions have recently made several contributions that have fuelled the debate on the merits of a common fiscal stabiliser (Arnold et al., 2018; Beetsma et al., 2018). Claveres and Strasky (2019) consider that such a fiscal stabiliser, leading to transfers of 1% of the GDP of the countries involved, would attenuate the negative effect of a shock on their consumption by one-third and would halve its impact on EU consumption as a whole. However, this has been opposed by certain parties that fear the permanent implementation of unidirectional transfers within the EU.

The debate is far from settled.[21] For the next MFF, the Member States agreed at the 21 June 2019 Euro Summit on the implementation of a moderately sized budgetary instrument for convergence and competitiveness.[22] This was a compromise between two very disparate positions, with one side advocating a common instrument for economic stabilisation and the other rejecting the very principle of a euro area budget. While the initial scope of this new instrument is limited, given its size and the fact that the idea of making it a stabilisation instrument was abandoned, it nevertheless foreshadows a specific budget framework for the euro area.

20 United States, Canada and Switzerland (Barbier-Gauchard, 2006); Argentina, Brazil and Germany (Bordo, Jonung and Markiewicz, 2011). To our knowledge, there is no reference framework for a fiscal union without a federal state.

21 Economic arguments aside, the legal solutions for the creation of an ad hoc euro area budget are very limited. Without amendments to the treaties, implementing a genuine euro area budget with its own resources and debt capacity is challenging.

22 The size will be determined during the MFF negotiations. Günther Oettinger, the European Commissioner for Budget and Human Resources, indicated that around EUR 17 billion was envisaged for this new instrument and that the exact amount would be subject to an agreement within the framework of MFF 2021-2027.

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