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## IN-DEPTH ANALYSIS

# Economic policy coordination in the euro area under the European Semester

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Provided at the request of the  
**Economic and Monetary Affairs Committee**

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External author: Fabian Zuleeg  
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Provided in advance of the Economic Dialogue with  
the President of the Eurogroup  
in ECON  
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**Abstract**

This paper assesses the economic policy coordination process in the euro area under the European Semester, making recommendations on how implementation could be enhanced and what further developments are necessary to improve coordination of economic policies within EMU.

This paper was requested by the European Parliament's Economic and Monetary Affairs Committee.

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## LIST OF ABBREVIATIONS

<b>CSR</b>	Country Specific Recommendations
<b>EFB</b>	European Fiscal Board
<b>EFSF</b>	European Financial Stability Facility
<b>EMU</b>	Economic and Monetary Union
<b>EP</b>	European Parliament
<b>ESM</b>	European Stability Mechanism
<b>IMF</b>	International Monetary Fund
<b>MIP</b>	Macroeconomic Imbalance Procedure
<b>NCB</b>	National Competitiveness Board
<b>RQMV</b>	Reverse Qualified Majority Voting
<b>SGP</b>	Stability and Growth Pact
<b>SRF</b>	Single Resolution Fund
<b>SRSS</b>	Structural Reform Support Service
<b>TSCG</b>	Treaty on Stability, Coordination and Governance
<b>VP</b>	Vice President

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## EXECUTIVE SUMMARY

This briefing paper was requested by the ECON Committee of the European Parliament, ahead of the regular Economic Dialogue with the Eurogroup President. It takes stock of the European Semester 2015 cycle and the current proposed changes to the European Semester process, identifying shortcomings in policy implementation and providing recommendations for improvement. Specific attention was paid to what actions the Eurogroup President could take.

The paper concludes that the implementation of the Country Specific Recommendations under the 2013 and 2014 European Semester processes has been less than satisfactory. While the proposed changes will streamline the process and make it more effective, an implementation gap will remain, driven by a fundamental political economy problem: implementation of reforms decided at EU level have to be justified politically at the national level.

A fully-fledged Economic and Monetary Union (EMU) with real decision-making power at its heart - implying significant transfer of sovereignty to the Eurozone level - would address this implementation gap, but this is not on the political cards. Instead, the Eurozone will continue to rely on a governance mechanism that can best be described as 'enhanced coordination', associated with limited enforcement/implementation mechanisms.

This process can be improved: a more efficient, transparent and inclusive European Semester is required to better support the smooth functioning of the EMU. In the short run, the improvements in the Commission's package of measures, which build on the Five Presidents' Report, are a useful starting point: two successive stages for the European Semester (a European and a national stage); a more streamlined European Semester with fewer and less detailed CSRs; a stronger implementation of the Macroeconomic Imbalances Procedure and the introduction of (a system of) National Competitiveness Boards and a European Fiscal Board are useful reforms of the system, although details could still be improved.

To help to facilitate implementation of this more effective governance framework, the Eurogroup President, in close cooperation with the European Commission and Parliament, should:

- Foster political commitment from all members to adhere to and publicly support the new governance;
- Require clarification of the VPs and Commissioners' roles and responsibilities;
- Be seen to be urging and coordinating the Member States to deliver on the commitment for EMU reform.

Concerning the necessary broader economic governance reform, due to domestic political considerations, decisive actions are taken only in a state of acute crisis. In the European Council response to the Five Presidents' Report, one can see the current lack of urgency: despite the Report proposing an implementation table that could in no way be perceived as ambitious, the response by the euro area members has been half-hearted at best.

Reform is crucial to make EMU sustainable in the longer term. EMU must improve both its preventive and corrective mechanisms in order to avoid or mitigate future significant crises. To support this process, a fiscal capacity, *ex ante* risk sharing facilities, active dialogue between the European institutions and national governments and effective measures to ensure implementation of national reforms and facilitate increases in public and social investments are required.

In the end, to make EMU stable in the long-term will require a transfer of sovereignty. A genuine EMU is not an option but a necessity to avoid further crises. Whether the current timetable will deliver these

reforms quickly enough, given the lack of urgency, remains to be seen. In the meantime, steps should be taken that can be the starting point for further integration in future:

- Flexibility in the fiscal framework to encourage public and social investment, alongside a framework that ensures that this flexibility is dedicated to productive investment rather than simply enabling Member States to avoid fiscal consolidation;
- A fiscal capacity to underpin this investment approach, providing an incentive for reform and ensuring that Member States have the capacity to invest; and
- Contractual arrangements as a mechanism to underpin the implementation of CSRs, tied to the increased resources provided by the fiscal capacity.

This combination of measures would enable the EMU to, at least partially, achieve more effective economic coordination by overcoming the implementation gap between necessary domestic structural reforms and investments, and the lack of trust which hampers cross-border support.

## 1. INTRODUCTION

This briefing paper was requested by the ECON Committee of the European Parliament ahead of the planned regular Economic Dialogue with the President of the Eurogroup. This briefing paper has a two-fold purpose:

- To examine the policy recommendations and decisions adopted under the 2015 Semester Cycle and to make recommendations on how the President of the Eurogroup could facilitate their enforcement/implementation. This also implies a question on how the policy recommendations under the previous European Semester cycles have been implemented;
- To look forward and to make suggestions on how the European Semester could be made more effective, transparent and inclusive and how it could better support the smooth functioning of EMU, taking into account the Commission's measures as set out on 21 October<sup>1</sup>.

The paper is based on European Commission and Parliament documents and builds on previous EPC publications. It is structured as follows: Chapter One provides background on this study and the European Semester process. Chapter Two assesses the proposed changes to the European Semester under the Five Presidents' Report, as well as the 2015 European Semester cycle. Chapter 3 puts forward recommendations for a more efficient, transparent and inclusive European Semester. It also examines the wider implications of the European Semester and how it could support the smooth functioning of the EMU. Chapter 4 draws conclusions from the report and provides recommendations for action to be taken by the European Institutions and, in particular, the President of the Eurogroup.

### 1.1 Background – the European Semester

While the agreement with Greece prevented the disastrous consequences of a Grexit - at least for now - this summer's crisis sharply highlighted the tricky political economy at the heart of the Eurozone-crisis: economic imbalances and political interdependence at EU level necessitate domestic structural reforms, with the political consequences of such actions remaining at the domestic level. Simultaneously, countries in financial distress require support from Eurozone partners, conditional on an EU level agreement on reforms and an actual transfer of economic sovereignty. However, when countries are not in acute distress, there are only weak mechanisms to compel them to carry out reforms. Not only does this raise questions about the effectiveness of Eurozone economic co-ordination mechanisms, but also more fundamental questions about sovereignty and democratic legitimacy that are unanswerable within the current governance framework<sup>2</sup>.

There is an obvious answer to this dilemma: a fully-fledged Economic and Monetary Union (EMU), with real decision-making power at its heart (an 'economic government' as some have termed it). This implies a significant transfer of sovereignty to the Eurozone level, including the mutualisation of debt and a Eurozone Finance Minister. However, such an ambitious integration step is currently not on the cards politically. Instead, the Eurozone has created a new governance mechanism that can best be described as 'enhanced coordination', i.e. coordination mechanisms associated with limited enforcement/implementation mechanisms (rules-based/legal, public opinion/peer review, conditional support and sanctions), alongside regular monitoring of progress, but with the main responsibility for implementation at the Member State level.

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<sup>1</sup> European Commission (2015a) Completing Europe's Economic and Monetary Union: Commission takes concrete steps to strengthen EMU, available at [http://europa.eu/rapid/press-release\\_IP-15-5874\\_en.htm](http://europa.eu/rapid/press-release_IP-15-5874_en.htm) [Accessed 22 October 2015]

<sup>2</sup> See also Nicoli, F. (2013) Pathways to achieve a Genuine Fiscal Union, EPC Policy Brief, 3 June



Implementation of the EU's economic coordination is organised annually in a cycle, known as the European Semester. Under the European Semester, the Commission analyses the fiscal and structural reform policies of the Member States providing recommendations (Country-Specific Recommendations - CSRs) and follow-up on their implementation, as well as assessing whether macroeconomic imbalances are present, potentially triggering the Macroeconomic Imbalances Procedure (MIP). The European Semester process' potential lies in revealing structural macroeconomic weaknesses in Member States, triggering and fostering debate about what needs to be done at national level and, in the end, resulting in structural reforms that can address unsustainable fiscal positions and deficiencies in competitiveness.

However, implementation of the CSRs in 2013 and 2014 has been less than satisfactory: "despite all the time and energy invested at both national and European level, in most cases the recommendations attracted little attention"<sup>3</sup>. Even when the more controversial CSRs have entered the national debate, implementation remains patchy<sup>4</sup>. The level of change triggered by the CSRs might be even lower than it first appears, as it is impossible to determine which of the reforms being implemented by Governments would have been taken forward in any case, even without the European Semester. When it comes to the MIP, even the Five Presidents' Report<sup>5</sup> recognises that a stronger MIP is needed, being enforced in all Member States<sup>6</sup>.

This implementation gap might be due to a bedding-in period – it simply takes time before the system is fully functioning. But it could also indicate more systemic problems with the EU's economic coordination system; potentially, this could be for a number of reasons:

- Inappropriate or unfeasible structural reform recommendations (e.g. not sufficiently differentiated by country; too many recommendations; an excessive focus on cost-cutting rather than growth-enhancing reforms and investments; recommendations that require a high implementation capacity or initial investments that countries are unable to make);
- Deficiencies in the economic governance construct, i.e. an over-reliance on rules/legal mechanisms with insufficient flexibility to adjust to changing circumstances;
- Insufficient ownership of the recommendations at member state level;
- A perceived lack of independence and impartiality of the recommendations;
- Absence of an effective enforcement/incentive mechanism that is able to ensure implementation of reforms, especially in economically strong countries that do not depend on Eurozone support mechanisms.

On balance, problems with implementation are probably due to a combination of many, if not all, of these factors. If one believes that structural reforms are necessary for growth<sup>7</sup>, this absence of an effective

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<sup>3</sup> Schneider, J., Zuleeg, F. and Emmanouilidis, J. (2014) Policy recommendations for the new European Commission: priorities for stabilising EMU, EPC Discussion Paper, 30 September, available at [http://www.epc.eu/pub\\_details.php?cat\\_id=1&pub\\_id=4858&year=2014](http://www.epc.eu/pub_details.php?cat_id=1&pub_id=4858&year=2014) [Accessed 15 October 2015]

<sup>4</sup> European Parliament (2015) Country Specific Recommendations (CSRs) for 2014 and 2015. A comparison and an overview of implementation, available at [http://www.europarl.europa.eu/RegData/etudes/stud/2015/542659/ipol\\_stu\(2015\)542659\\_en.pdf](http://www.europarl.europa.eu/RegData/etudes/stud/2015/542659/ipol_stu(2015)542659_en.pdf) [Accessed 18 October 2015]

<sup>5</sup> European Commission (2015b) Completing Europe's Economic and Monetary Union, available at [http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report\\_en.pdf](http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report_en.pdf) [Accessed 16 October 2015]

<sup>6</sup> See also Schneider, J., Zuleeg, F. and Emmanouilidis, J. (2014) Op. cit.

<sup>7</sup> NB: the author refers to structural reform as a convenient short hand for reforms carried out by national administrations that improve the business environment and thus foster investment, growth and employment. Fiscal consolidation measures can be structural reforms but they are not necessarily, for example additional taxes can stifle economic activity.

process to enforce structural reform implementation at national level implies that the EU lacks the mechanism to ensure that the growth potential of countries lagging in competitiveness can be lifted.

For these countries, the main adjustment mechanism thus remains internal devaluation, i.e. cutting wages to increase competitiveness. This has dire social and political consequences as well as questionable effects on economic growth, given the reduction in consumption resulting from ongoing wage cuts. In the longer term, internal devaluation could also become ineffective if, over time, internal devaluation policies are pursued by a wide range of countries, which would imply a minimal or no effect on relative competitiveness of these countries. In addition, the absence of growth aggravates the public finance crisis and creates an increasing need for large-scale intra-Eurozone transfers in the short to medium term. It is thus in the interest of all Eurozone countries to ensure that the European economic governance system - in particular the European Semester - works more effectively than it has done in its initial years.

In the following chapters, the paper assesses the European Semester process, including the current proposed changes, making recommendations on how to further improve implementation. It then looks more broadly at the process, discussing what elements are currently missing in the economic coordination process and how its effectiveness could be enhanced in future.

## 2. ASSESSMENT OF THE POLICY RECOMMENDATIONS AND DECISIONS ADOPTED UNDER THE 2015 SEMESTER CYCLE

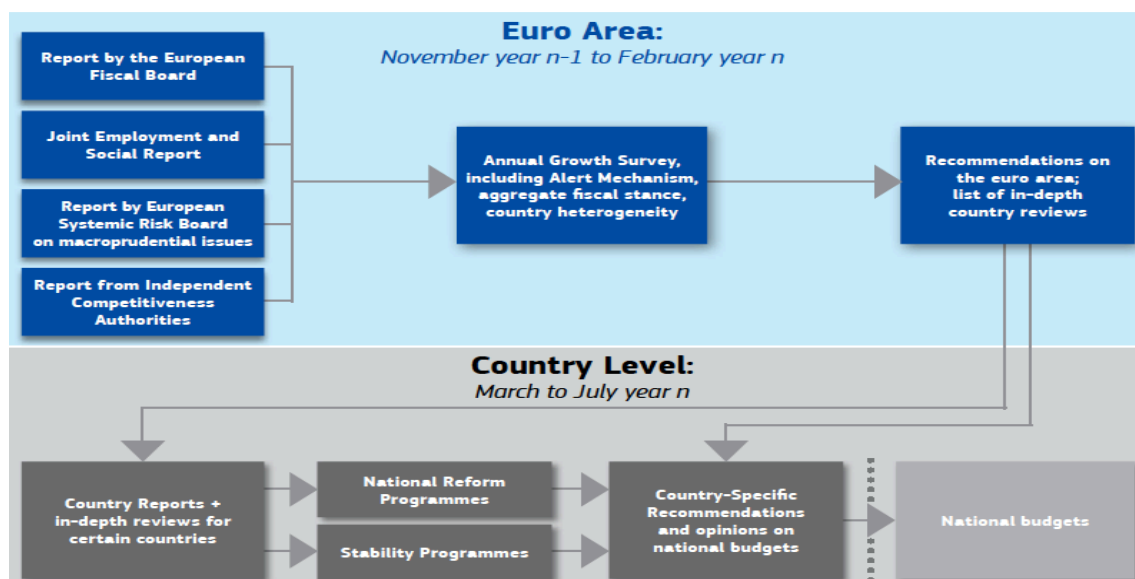
### 2.1 The European Semester in the Five Presidents' Report

The June 2015 Five Presidents' Report<sup>8</sup> sets out three different stages for completing EMU+, with the first stage being called "Deepening by Doing" and running from 1 July 2015 to 30 June 2017<sup>9</sup>. It aims to strengthen the use of existing instruments and implementation of Treaties in order to boost competitiveness and structural convergence. It also puts emphasis on relevant fiscal policies and on the completion of the Financial Union.

The Five Presidents' Report stipulated the need for a stronger coordination of economic policy, noting that the European Semester needs to be further strengthened: "Steps have been taken to simplify and strengthen the European Semester: a greater focus on priorities, fewer documents and more time to discuss them, greater outreach at political level and engagement with national authorities. These steps must be pursued further."<sup>10</sup> The Report also recognised that the Macroeconomic Imbalances Procedure (MIP) needs to be strengthened.

One crucial recommendation of the Five Presidents' Report was to divide the European Semester into two successive stages - a European and a national stage - to better integrate the euro area and the national dimensions. Reviewing the Eurozone as a whole before determining individual Member States' reform programmes could potentially result in better aligned policies, coordinating national reform programs with wider European objectives. This two-stage process is illustrated in Figure 1.

**Figure 1:** New Integrated European Semester



Source: Five Presidents' Report (2015), p. 22

On 21 October 2015, the Commission published a package of measures<sup>11</sup> to implement the first stage of the Five Presidents' Report. The measures include a revised approach to the European Semester, the introduction of National Competitiveness Boards and an advisory European Fiscal Board. The package

<sup>8</sup> European Commission (2015b) Op. cit.

<sup>9</sup> Followed by Stage 2 'Completing EMU', with the Final Stage being a deep and genuine EMU, which is achieved once all the steps are fully in place, at the latest by 2025.

<sup>10</sup> European Commission (2015b) Op. cit., page 9

<sup>11</sup> European Commission (2015a) Op. cit.

includes also a more unified representation of the Eurozone in the IMF and potentially other international institutions in the future.

## 2.2 European Semester Cycle 2015

The Juncker Commission has already taken some steps for the 2015 European Semester. It published the Country Reports in February, earlier than previously (three months before the CSRs were finalised), to strengthen dialogue with the Member States. In future, in line with the Five Presidents' Report, discussions and recommendations for the euro area as a whole will take place before the discussions related to specific countries.

The Commission's plan to streamline the European Semester process from 2015<sup>12</sup> advocates focusing on the priorities in the Annual Growth Survey, aligning CSRs with Euro area recommendations and improving the dialogue between Member States and stakeholders. Employment and social aspects are stipulated to feature strongly in the Semester.

The Juncker Commission chose to introduce a "more simple and targeted" approach to the CSRs, to ensure better implementation. The CSRs during the 2015 European Semester cycle are notably shorter in length and fewer in number for all Member States, individually and for the Eurozone. The recommendations do not, however, appear to be significantly different in substance, yet they are set out more clearly and target results, rather than processes. Concerning the content of the recommendations, priority is given to the following areas:

- Investment;
- Business environment;
- Public finances for growth;
- Employment policy and social protection.

The 2015 CSRs for social inclusion, education and skills were addressed to fewer Member States in 2015<sup>13</sup> when compared to 2014<sup>14</sup>. This could be the result of a significant improvement in this policy field over the period, as contended by the Commission<sup>15</sup>. However, the summary overview of the European Parliament<sup>16</sup>, based on the assessment of the Commission, shows only limited/ some progress on these recommendations in the Member States since 2014. It thus seems likely that these recommendations have fallen victim of the "more simple and targeted" approach of the Commission. Some have claimed that this demonstrates that the social dimension has a lower priority, although there are also fewer recommendations related to innovation and business environment in 2015 when compared to 2014. This is not the case for labour market and labour taxation where there are more CSRs, showing either a greater emphasis on these policies or a worsening of outlook in some Member States.

The CSRs for the euro area as a whole do not differ significantly from the previous period, which could be viewed as a positive sign of continuity; however, it might also be seen as demonstrating limited progress on the recommendations between the two periods. Another aspect of the recommendations is the promotion of growth-friendly fiscal policy coordination. There is a clear signal of a political shift from crisis management to prevention and surveillance, which is very welcome.

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<sup>12</sup> See COM(2015) 250 final

<sup>13</sup> See [http://ec.europa.eu/europe2020/pdf/csr2015/csr2015-overview-table\\_en.pdf](http://ec.europa.eu/europe2020/pdf/csr2015/csr2015-overview-table_en.pdf)

<sup>14</sup> See [http://ec.europa.eu/europe2020/pdf/csr2014/overview\\_recommendations\\_2014\\_by\\_member\\_state\\_en.pdf](http://ec.europa.eu/europe2020/pdf/csr2014/overview_recommendations_2014_by_member_state_en.pdf)

<sup>15</sup> See COM(2015) 250 final

<sup>16</sup> European Parliament (2015) Op. cit.

### 3. RECOMMENDATIONS ON HOW THE EUROPEAN SEMESTER COULD BE MADE MORE EFFICIENT, TRANSPARENT AND INCLUSIVE AND HOW IT COULD BETTER SUPPORT THE SMOOTH FUNCTIONING OF THE EMU

Better implementation can counteract some of the shortcomings of the current governance system, but this is not enough. Even the reformed governance mechanisms at EU level, as proposed by the Five Presidents' Report, still lack an effective way of ensuring the implementation of CSRs at national level; this will require a more systemic governance reform.

#### 3.1 Recommendations for enhanced implementation

The changes made to the European Semester, following on from the Five Presidents' Report, have by-and-large been positive. Streamlining the process will address the criticism that each part of the Commission adds recommendations in their specific area of interest with no prioritisation, creating a 'Christmas Tree' effect, which leads to low implementation of the individual recommendations. In particular, the proposals aim to simplify and focus the process, as well as involving Member States to a greater degree. However, Member States will continue avoiding implementation of recommendations that risk political backlash, especially when the reforms required are particularly sensitive towards matters directly affecting the electorate, such as public services or pensions<sup>17</sup>.

In the end, the key implementation mechanism for the CSRs remains domestic, coupled with peer review and (so far non-existent) public pressure. An area where the commitment of Member States is likely to be tested is in the stronger implementation of the MIP. It is very damaging to this process if certain Member States are seen to be (successfully) ignoring or criticising the coordination process. This was the case when the current account surplus of Germany came under scrutiny, where even the investigation of potential imbalances was enough to trigger a negative reaction from German media and politicians, being widely interpreted as an attempt to reduce Germany's export performance. A governance system that fundamentally relies on domestic implementation can only function if it is seen as being applied equally for all countries. The Eurogroup President can do more to foster political commitment from all members of the Eurogroup to adhere to the new governance and support it in public.

A greater level of coordination in the Commission itself would help the smooth functioning of the European Semester process. The new structure of the Commission is potentially a bonus here, aiming for Commissioners to break out of their policy silos through the new coordination role of the Vice-Presidents (VPs). However, the mission letters of the three Commissioners most important for EMU governance – Commissioner Pierre Moscovici<sup>18</sup> and VPs Jyrki Katainen<sup>19</sup> and Valdis Dombrovskis<sup>20</sup> – raise a number of questions on who is responsible for what, and how overlapping responsibilities will be dealt with.<sup>21</sup> In an essential area – providing a link with Member States, which is especially important when designing new proposals and recommendations – Commissioner Moscovici is the one to represent the Commission at the Eurogroup meetings, putting into question the direct influence of the VPs. A clarification of the VPs and Commissioners' respective roles and responsibilities, driven by the Eurogroup President, would be helpful<sup>22</sup>.

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<sup>17</sup> See also Zuleeg, F. (2015b) Can the eurozone's economic governance combine political accountability, legitimacy and effectiveness?, EPC Discussion Paper, 30 September, available at: [http://www.epc.eu/documents/uploads/pub\\_5870\\_eurozone\\_s\\_economic\\_governance.pdf](http://www.epc.eu/documents/uploads/pub_5870_eurozone_s_economic_governance.pdf) [Accessed 27 October 2015]

<sup>18</sup> Economic and Financial Affairs, Taxation and Customs

<sup>19</sup> Jobs, Growth, Investment and Competitiveness

<sup>20</sup> Euro and Social Dialogue

<sup>21</sup> Schneider, J., Zuleeg, F. and Emmanouilidis, J. (2014) *Op. cit.*

<sup>22</sup> Schneider, J., Zuleeg, F. and Emmanouilidis, J. (2014) *Op. cit.*

The new European Fiscal Board (EFB)<sup>23</sup> could be an authority to coordinate and provide support to the Commission in multilateral surveillance of the euro area. It would then have the potential to add significant value in respect of improved implementation of CSRs related to fiscal reforms in the Member States.<sup>24</sup> However, it will be limited to function as a Commission internal advisory board with the Annual Report being the only public document. To be fully effective, the EFB should have an independent capacity to assess Member State fiscal policies. In addition, the proposed role of the EFB is only advisory; it seems unlikely that this can address the weak implementation mechanisms<sup>25</sup>. Even if implemented as a more independent body, it would only be a step towards improved surveillance, but promises less for better coordination. More could be done - as discussed later in this paper - with fiscal capacity building<sup>26</sup> and *ex ante* fiscal risk sharing<sup>27</sup>.

The role of the National Competitiveness Boards (NCBs)<sup>28</sup> in assessing the competitiveness of the economy of Member States within the EU context and supporting targeted and aligned CSRs and MIP could bring the CSRs closer to Member States and by doing so, encourage greater ownership<sup>29</sup>. They could also improve flexibility, providing support to Member States in deciding how to implement the reforms. The Commission's Structural Reform Support Service (SRSS) should provide the technical support and guidance needed to implement the CSRs. However, in how far this can provide domestic politicians with a greater incentive to take European priorities into account remains to be seen, especially since their role and influence on established Member State processes, including social dialogue, has already attracted criticism. In addition, especially for countries where established versions of NCBs or similar institutions (like the German Council of Economic Experts) already exist, which could be assigned as NCBs if found to comply with specific requirements, the European dimension of these bodies and their recommendations might well be marginal.

More generally, it is important to recognise that EMU reforms are far from complete. The European Semester process should be seen as embedded in the much broader economic governance reform process as set out in the Five Presidents' Report. However, the timetable in the Five Presidents' Report lacks urgency. In addition, the initial reactions to the Five Presidents' Report in June and the Council's decision to postpone a thorough discussion on the future of the euro area again at its October's Summit indicate that the appetite in most capitals for additional major EMU reforms is very limited.

Multiple barriers are blocking further steps: (strongly) diverging ideas for reforms, a lack of political will for the transfer of powers, and fears that a new treaty might again fail to convince key Member States. Now, with the migration/refugee crisis occupying the political centre stage, EU governments and institutions feel compelled to concentrate all their energies on these more pressing issues<sup>30</sup> (Emmanouilidis 2015). However, the implementation of the Five Presidents' Reports needs to be given priority. There is imminent need for further improvement in the EMU mechanisms for prevention and responsive capacity to potential future crises. The Eurogroup President must be seen to be urging and coordinating the Member States to deliver on this commitment.

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<sup>23</sup> European Commission (2015c) Completing Europe's Economic and Monetary Union: Commission takes concrete steps to strengthen EMU, An Advisory European Fiscal Board, available at: [http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/factsheet-efb\\_en.pdf](http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/factsheet-efb_en.pdf) [Accessed 22 October 2015]

<sup>24</sup> European Commission (2015a) Op. cit.

<sup>25</sup> See also Zuleeg, F. (2015b) Op. cit.

<sup>26</sup> See page 14

<sup>27</sup> See page 15

<sup>28</sup> European Commission (2015e) Completing Europe's Economic and Monetary Union: Commission takes concrete steps to strengthen EMU. A system of National Competitiveness Authorities, available at [http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/factsheet-ncbs\\_en.pdf](http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/factsheet-ncbs_en.pdf) [Accessed 22 October 2015]

<sup>29</sup> See also Zuleeg, F. (2015b) Op.cit.

<sup>30</sup> See also Emmanouilidis, J. (2015) Europe's reactive and protective muddling through: the results of a summit in fire fighting mode, EPC Post Summit Analysis, 19 October, available at [http://www.epc.eu/documents/uploads/pub\\_6041\\_post-summit\\_analysis\\_-\\_19\\_october\\_2015.pdf](http://www.epc.eu/documents/uploads/pub_6041_post-summit_analysis_-_19_october_2015.pdf) [Accessed 19 October 2015]

## **3.2 Recommendations for an improved European Semester**

### **Efficient European Semester**

Critical to EMU governance is a fundamental political economy issue: while there might be willingness from the potential creditors to provide financial support to countries in financial distress, they fear that reforms might not be implemented in these countries and the need for ongoing transfers would continue. Consequently, these countries insist on mechanisms to monitor and enforce reforms. On the other hand, the price of giving up sovereignty for those needing support is often considered too high and, in many cases, is accompanied by limited institutional capacity to deliver. More systemic solutions are needed to overcome this challenge.

Potential solutions exist: a fiscal capacity, in combination with contractual arrangements could ensure that reforms will be undertaken<sup>31</sup>. The establishment of a fiscal capacity is therefore a priority. Eurozone members, the Eurogroup and EU institutions should focus on setting the conditions and roadmaps for the establishment of a fiscal capacity. The Commission should ensure a strong link between such a fiscal capacity and the European Semester process through contractual arrangements.

Given that the fiscal capacity will strongly affect the Eurozone, the Eurogroup should be further strengthened; a full-time Eurogroup President would be needed. Finance Ministers already have a heavy workload that might on some occasions conflict with the need for a more pro-active role and full attention to the governance development of the Eurozone required from the Eurogroup President. To create the capacity needed, it makes sense to create permanency in the Eurogroup Presidency post. This could also support the Eurogroup President's role to foster mutual trust in the governance tools and the needed peer support and peer pressure to help to implement them.

### **Inclusive and transparent European Semester**

If well designed and working together, economic and social policies could enhance inclusive growth. Social impact assessments should be carried out more widely to ensure that the European Semester policies are encouraging such growth. This would strengthen the legitimacy of the recommendations and could provide the rationale behind what is needed to soften the opposition to reforms in Member States. However, evidence-based decisions would require clarification on the indicators used and the alternative options considered in order to garner sufficient trust.

Dialogue with national Parliaments and the European Parliament about the political direction of the priorities before drawing the Annual Growth Survey would increase the transparency of the European Semester process. The Eurogroup President would have an important role to support this dialogue over the Semester cycle.

In addition, the focus of policy needs to shift towards stronger emphasis on investment and reform, as well as fiscal policy consolidation. There is still an emphasis in the overall governance framework on fiscal policy and within the European Semester process on cutting expenditures rather than enabling growth. But spending that enhances long-term growth - through social investment in human capital for instance - is very important, even in times of fiscal distress. Furthermore, public investment has a role in long-term sustainable reforms (e.g. creation of jobs, preventative measures on health, invest-to-save in digitalisation). Specifically, there is a concern that public and social investments are not sufficiently considered and that the idea of 'invest-to-save' to improve the long-term efficiency and effectiveness of public services does not feature in the new economic governance. The aim of achieving sustainable public finance consolidation should be complemented by more flexibility to maintain or increase domestic public/social investment, with flexibility being justified when expenditures are investments rather than costs.

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<sup>31</sup> See also Zuleeg, F. (2015) Op. Cit. and Schneider, J., Zuleeg, F. and Emmanouilidis, J. (2014) Op. cit.



The current economic governance framework only allows flexibility regarding such investments in some limited areas<sup>32</sup> and it is insufficient for allowing sufficient public/social investment in a crisis. Furthermore, excluding large social investments financed by national budgets (e.g. education and health) makes this form of flexibility only applicable to a very small part of public investment, most likely excluding those that are most important for creating sustainable growth.

However, a clear definition for social investment is needed to avoid potential misuse of preferential treatment in the Stability and Growth Pact (SGP). This is difficult as the impact of public/social investment is not easy to quantify, as it is social as well as economic. In addition, the returns from public/social investment also depend on the effectiveness of the measures taken. A new assessment framework for the returns from public/social investment is therefore needed but, for pragmatic reasons, it might be more straightforward to start with an assessment of which spending can definitely be considered as social investment before establishing the comprehensive measurement framework. In addition, an independent and trusted institution will be needed to assess public spending in light of this investment logic; this could be a role for the newly introduced EFB discussed above. More effective flexibility on public deficits could be permitted in future if the Commission develops such a framework at EU level<sup>33</sup> without weakening the EU role in economic coordination.

The Commission together with the Council should find a way forward regarding flexibility/adherence in the context of deficit targets. It is also essential to clarify how public/social investment should be included and who would have the authority to decide on that. Deciding on the Commissioner responsible for the development and implementation of proposals on this is also related to the effectiveness of the new structure of the Commission discussed above.

At member state level, EU countries with relatively low public debt and deficit levels could use this flexibility within the fiscal space they have available to lead the public and social investment drive required for Europe's economy to recover. But flexibility on its own is not enough: for those countries with insufficient fiscal space, support is needed to make these investments. The introduction of a fiscal capacity is thus necessary to support these investments and associated reforms.

### **3.3 Wider support for smooth functioning of the EMU**

#### **Alignment of policies and budgets**

There is also a need to align the policy objectives and EU budget expenditures. In 2016, the mid-term review of the MFF should be used to review the spending to support Member States in implementing their CSRs. The focus and investments should also be increased in areas where multiple medium- to long-term objectives overlap - such as energy efficiency and security, the completion of the (digital) single market and better regulation. Progress in completing the single market could contribute to growth through positive spill-over effects across various sectors.

As far as the identification of the appropriate sectors for investment is concerned, one way to target public investment and reform could be to identify the connections between under-developed and already successful sectors. This implies that there is a need for a much more explicit investment/reform appraisal process to develop the CSRs.

#### **The political economy of EMU**

There is also a need to depoliticise some technical aspects of economic governance. Increasingly, the Commission has become a political actor, which clashes with its independent assessment and

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<sup>32</sup> See Zuleeg, F. with Schneider, J. (2015) What role for social investment in the new economic governance of the Eurozone? EPC Policy Brief [upcoming, 2015] and European Commission (2015d) Op. Cit.

<sup>33</sup> See also Zuleeg, F. (2015b) Op. cit.



implementation role, including in the fiscal policy field. There is a need to re-think what role the Commission will take in future governance and whether some new institutional arrangements are needed, to enhance the level of acceptance of EU recommendations and decisions concerning the Member States.<sup>34</sup>

The introduction of the NCBs and the EFB will, to some extent, shift the technical role from the Commission to macro-economic experts, which could be a first step towards more independent agencies/bodies at EU level. Bringing technical expertise through these boards is an essential prerequisite to success, as it implies that the decisions at European level will be more informed and based on evidence from the ground (Member States), while also being anchored in the Commissions' proposals.

### **More government than governance**

Within the current governance framework, it is now clear that there are serious shortcomings in the rules-based approach. How could one select and adopt fixed rules, suitable for various economic circumstances that may occur? With an ever-changing environment and more complex connections, it is increasingly challenging to fix rules that reflect all possible scenarios. Furthermore, the rules are designed and enshrined in law through costly and lengthy procedures, which makes them even less adaptable in a dynamic environment. In the end, any flexibility in the interpretation of the rules implies that there will need to be a transfer of sovereignty to the EU level to overcome the implementation gap<sup>35</sup>. However, this, in turn, would then require an explicit legitimacy mechanism.

Executive powers in EU will need to be strengthened, which is particularly important to enable prompt responses to future crises. Increasingly, national governments are insisting that the final decision-making power should be with the Member States or in the Council rather than empowering the Commission with a more executive role. But effective governance needs an accountability mechanism. At EU level it is unclear of who fulfills the role of the executive and to whom it is accountable to in the end: the Council, national parliaments, the European Parliament or maybe a combination of these?

Grand political bargains with significant powers transferred to EU institutions, which include treaty/institutional changes, are very unlikely in the current political environment, at least for now<sup>36</sup>. In the absence of a decisive move in this direction, strong commitment to the economic coordination mechanism is needed from the Member States, particularly important in case of excessive macroeconomic imbalances where these imbalances could potentially affect the smooth functioning of EMU. Therefore, the mistrust among Member States and between them and the Commission is an essential barrier that needs to be overcome.

Increased trust is also needed for further economic governance reform and establishing a fiscal capacity. The political bargain of stronger conditionality to accompany support - through contractual arrangements to tie support to specific structural reforms and/or public/social investment - could improve the situation. There is need for further developing stronger contractual arrangements within the European Semester that are not excessively bureaucratic and do not exert excessive control from the EU, but rather form the basis of an Investment and Reform Pact that is fully owned by the Member State. This, together with a support package underpinned by a fiscal capacity, is a crucial first step on the way to a better functioning EMU<sup>37</sup>.

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<sup>34</sup> See also Zuleeg, F. (2015b) Op. cit.

<sup>35</sup> See also Schneider, J., Zuleeg, F. and Emmanouilidis, J. (2014) Policy recommendations for the new European Commission: priorities for stabilising EMU, EPC Discussion Paper, 30 September, available at [http://www.epc.eu/pub\\_details.php?cat\\_id=1&pub\\_id=4858&year=2014](http://www.epc.eu/pub_details.php?cat_id=1&pub_id=4858&year=2014) [Accessed 15 October 2015]

<sup>36</sup> See also Zuleeg, F. (2015b) Op. cit.

<sup>37</sup> See also Schneider, J. (2015) Growth for Europe - Is the Juncker Plan the answer?, EPC Discussion Paper, 20 March, available at [http://www.epc.eu/pub\\_details.php?cat\\_id=17&pub\\_id=5420&year=2015](http://www.epc.eu/pub_details.php?cat_id=17&pub_id=5420&year=2015) [Accessed 15 October 2015] and Zuleeg, F. with Schneider, J. (2015) Op. Cit.

## 4. CONCLUSIONS

This briefing paper took stock of the measures adopted over the European Semester 2015 cycle and identified shortcomings in the policy implementation, for which it provided recommendations for improvement. Specific attention was paid to what actions the Eurogroup President could take.

In the framework of the European Semester, the EU introduced a number of instruments to ensure financial and fiscal stability in the Eurozone. However, the main economic coordination instrument - the European Semester process with the associated CSRs - is not functioning as originally envisaged. Its initial implementation raised questions on whether there is sufficient prioritisation and assessment of the ability/capacity of Member States to deliver the proposed reforms, as well as whether there is sufficient flexibility and guidance on how to achieve the objectives of the reforms. With few additional powers being transferred to the EU level and implementation down to Member States, it is also essential to recognise that a stronger link with Member States is needed.

Progress can already be seen in the 2015 European Semester cycle, but this will not be sufficient to overcome the implementation gap. On the necessary broader economic governance reform, due to domestic political considerations, decisive actions are taken only in acute crisis. In the response to the Five Presidents' Report, one could see no urgency for fast progress: despite proposing an implementation table that could in no way be perceived as ambitious, the response by the euro area members has been half-hearted at best.

### 4.1 European Semester as driver of the EMU

Accelerated implementation of the Five Presidents' Report is needed in order to further stabilise EMU. But the slow timetable for implementation and the Council's lack of response belies the urgency of the matter. Unless one believes that EMU can be unravelled without significant damage to the economic and political substance of the EU, the ultimate answer would be a genuine EMU, underpinned by EU-level democratic legitimacy. However, the current mood is for less Europe instead of more Europe. Realistically, while not the ideal answer, 'muddling through' is the way forward for now. Making small steps now can rebuild trust and become the seed for further governance reform in future, as well as putting the mechanisms in place that will be needed when the next crisis hits.

The proposed package of measures to revamp the European Semester will be a useful start, but it will not solve the lack of a strong implementation mechanism. The political economy issue for stronger EMU needs to be addressed. *Ex ante* risk sharing facilities and effective measures to ensure implementation of national reforms would build the trust that is required. A fiscal capacity could potentially support intra-euro area risk sharing, while a more inclusive and targeted European Semester and dialogue between Member States and EU institutions could ensure implementation of reforms. Contractual arrangements are a potential bridge to ensure that the European Semester embodies support and investment as well as structural reform and fiscal discipline. This does not provide a comprehensive solution to simultaneously having domestic political accountability and legitimacy mechanisms, coupled with the need for effective coordination of economic policies and external and intra-EU dependencies. It is however a step forward to the Genuine EMU as spelled out in the Four- and Five-Presidents' Reports.

### 4.2 Recommendations for action

To address these issues, the President of the Eurogroup, together with the Commission and the European Parliament should:

- do more to foster political commitment from the members of the Eurogroup to adhere to the new governance and publicly support it;
- require clarification of the VPs and Commissioners' respective roles and responsibilities;

- be seen to be urging and coordinating the Member States to deliver on the commitment for EMU reform as embodied in the Five Presidents' report.

In the end, to make EMU stable in the long-term will require a transfer of sovereignty. A genuine EMU is not an option but a necessity to avoid further crises. Whether the current timetable will deliver these reforms quickly enough, given the political lack of urgency, remains to be seen. In the meantime, steps should be taken that can be the starting point for further integration in future:

- Flexibility in the fiscal framework to encourage public and social investment, alongside a framework that ensures that this flexibility is dedicated to productive investment rather than simply enabling Member States to avoid fiscal consolidation;
- A fiscal capacity to underpin this investment approach, providing an incentive for reform and ensuring that Member States have the capacity to invest; and
- Contractual arrangements as a mechanism to underpin the implementation of CSRs, tied to the increased resources provided by the fiscal capacity.

This combination of measures would enable the EMU to, at least partially, achieve more effective economic coordination by overcoming the implementation gap between necessary domestic structural reforms and investments, and the lack of trust which hampers cross-border support.

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