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IN-DEPTH ANALYSIS

How to further strengthen the European Semester?

External author: Xavier Ragot
OFCE and SciencesPo-CNRS

Provided at the request of the
Economic and Monetary Affairs Committee

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Xavier Ragot
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Provided in the context of Economic Dialogues with the President of the Eurogroup in ECON

Abstract

The economic governance of the European Monetary Union is yearly organized during the so-called European Semester. The improvement of the European Semester is an on-going process, and some recent propositions must be positively acknowledged. Still, the European Semester and Country Specific recommendations don't focus enough on issues with clear spill-overs on other countries. This Briefing Paper argues for a systematic discussion of a *nominal stance* at the European level, based on wage and price analysis. It would monitor price and wage developments to avoid nominal and current account divergences or deflationary convergence. Seven suggestions are provided to improve the European Semester and European Economic Governance.

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LIST OF ABBREVIATIONS

CSR	Country Specific Recommendation
MIP	Macroeconomic Imbalance Procedure
SGP	Stability and Growth Pact

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EXECUTIVE SUMMARY

The economic governance of the European Monetary Union is organized yearly within an annual framework called European Semester. This governance can be improved, as all actors and academics are still learning from the recent European and world crisis.

The European Semester should focus more on macro-economic policies with potentially strong spill-over effects, which can only be addressed at the European level. Among these, one can identify diverging nominal trends and deflationary pressures at the euro area level, an inadequate fiscal stance, and unsustainable current account imbalances.

This Briefing Paper justifies this claim and it proposes seven suggestions as concrete improvements of the European Semester.

Suggestion 1: Clearly ask National Productivity Boards to focus on nominal trends across tradable and non-tradable sectors and on the labour markets. These institutions should provide suggestions to increase convergence without deflationary pressures.

Suggestion 2: Based on the inputs of National Productivity Boards and the Commission, define a nominal wage stance in the euro area (and more generally in the EMU) consistent with the target of the ECB, which is inflation close to but below 2%. Use the nominal stance to provide relevant Country Specific Recommendations. These recommendations cannot be binding, but they can be relevant to national actors to factor in nominal trends.

Suggestion 3: Provide a hierarchy of CSRs. The recommendations could start with the ones with strong spill-overs or with injunctions based on legal requirements, then with recommendations with some spill-overs (such as the ones about fiscal stance) and then with recommendations with small or no spill-overs.

Suggestion 4: Systematically add CSRs about environmental issues and possibly energy policy, as these recommendations tackle issues with clear externalities.

Among these recommendations, a systematic assessment of the country regarding greenhouse gas emissions, renewable energy and more generally the assessment of progress for the achievement of the Paris agreement would be useful.

Suggestion 5: Add a temporal dimension to recommendations, with a possible medium-run time horizon. This horizon does not exclude yearly assessment of the progress. It would help distinguish between intermediate steps and final goals.

Suggestion 6: Start the European Semester with an assessment of the European economic situation on key aspects: Fiscal aspects (fiscal sustainability and fiscal stance), social aspects, financial aspects (based on current account imbalances) and nominal aspects (nominal wage stance).

Suggestion 7: To improve democratic debate, a systematic communication on recommendations with externalities would considerably ease national ownership. The Commission has to be heard by national parliaments for them to discuss potential European externalities. The European parliament should scrutinize the assessment by the Commission of these policies with strong externalities.

1. INTRODUCTION

The economic governance of the European Monetary Union (EMU) relies on a complex set of institutions and procedures to provide advices, recommendations or injunctions to Member States according to their compliance with the European rules.

The European decision-making process involves the European Commission, the Council, the European Parliament and Member States. It is structured each year by a time period denoted the European Semester, where formal documents circulate among the main actors and during which decisions are taken.

The European Semester is thus the practical device to transform legal requirements within European treaties and general principles on which Members States agree into actual policy making. For instance, and among many principles, the Preamble of the TFUE states that "*the essential objective of their efforts is the constant improvement of the living and working conditions of their people*". The Council may adopt Country Specific Recommendations (CSRs) for national policy making, to provide precise objectives.

The goal of this Briefing Paper is to contribute to the improvement of the European Semester, and thus of the economic governance of Europe, by analysing the main goal and outcomes of the European Semester.

The requested objective of this paper involves two main key issues. The first is the assessment of the achievements under the European Semester, and the second relates to possible changes, such as the introduction of well-defined multiannual perspectives in the yearly process of the European Semester or the introduction of financial incentives for countries to implement CSRs.

Before considering practical details (which is the goal of this paper), it is important to step back and to think about the objective of the whole coordination process at the European level. This is necessary to first understand what we are trying to assess and what we would like to improve.

2. WHAT IS THE GOAL OF THE EUROPEAN SEMESTER? FOCUSING THE EUROPEAN SEMESTER

This part elaborates on possible improvements, starting from a critical assessment of the Semester's main output: the Country Specific Recommendations (CSRs). Based on this critique, we will elaborate some recommendations for the whole European Semester.

2.1 The output of the European Semester: Country Specific Recommendations (CSRs)

First, the CSRs are a list of recommendations covering a very broad set of policy areas. It is almost comprehensive on economic policy. To be more concrete, Table 1 reports below the list of items considered in the spring package of the 2017 European Semester.

Table 1: Policy areas covered in the 2017 Country Specific Recommendations

Broad Category	Policy areas
Public finances & taxation	Fiscal policy & fiscal governance Long-term sustainability of public finances, incl. pensions Reduce the tax burden on labour Broaden tax bases Reduce the debt bias Fight against tax evasion, improve tax administration & tackle tax avoidance
Financial sector	Financial services Housing market Access to finance Private indebtedness
Labour market, education & social policies	Employment protection legislation & framework for labour contracts Unemployment benefits Active labour market policies Incentives to work, job creation, labour market participation Wages & wage setting Childcare Health & long-term care Poverty reduction & social inclusion Education Skills & life-long learning
Structural policies	Research & innovation Competition & regulatory framework Competition in services Telecoms, postal services & local public services Energy, resources & climate change Transport
Public administration & business environment	Business environment Insolvency framework Public administration State-owned enterprises Civil justice Shadow economy & corruption

Source: European Commission (2017) at https://ec.europa.eu/info/sites/info/files/csrs-policy-areas-covered.pdf

Considering this list, it is obvious that these items, or even these broad categories, do not have the same economic or political relevance.

The first key issue is the hierarchy of these items, which may obviously differ across countries and over time. In addition, there are obvious trade-offs between these items, which are the core of national policy debates. Among these trade-offs the question of the timing can be key. Some reforms may have some effect in the long run, while others may have a direct effect already in the short run. Prioritizing the CSRs thus raises political issues, as they may involve some financial costs or the use of limited political capital.

Second, this comprehensive list raises an obvious question: Are these items (and recommendations) important for the country, for the Union on top of the country's own interest, or for the Union only? Obviously, if recommendations aim at affecting only the country without spill-overs on other countries, one should be careful about the diversity of national preferences across each item. On the contrary, if there are spill-overs of a CSR in a given Member State on other States (described below), then there should be strong incentives to implement these CSRs. The estimates of spill-over should be based on expectations of all possible events, even during crisis periods where these spill-overs could increase suddenly. This question of incentives to implement recommendations under the European Semester is tackled in Section 4 below.

The very notion of subsidiarity relates to the hierarchy of the decision level (or sovereignties) according to the scope of the policies considered. Third, these recommendations obviously have different legal bases.

This justifies the structural investigation of the next section.

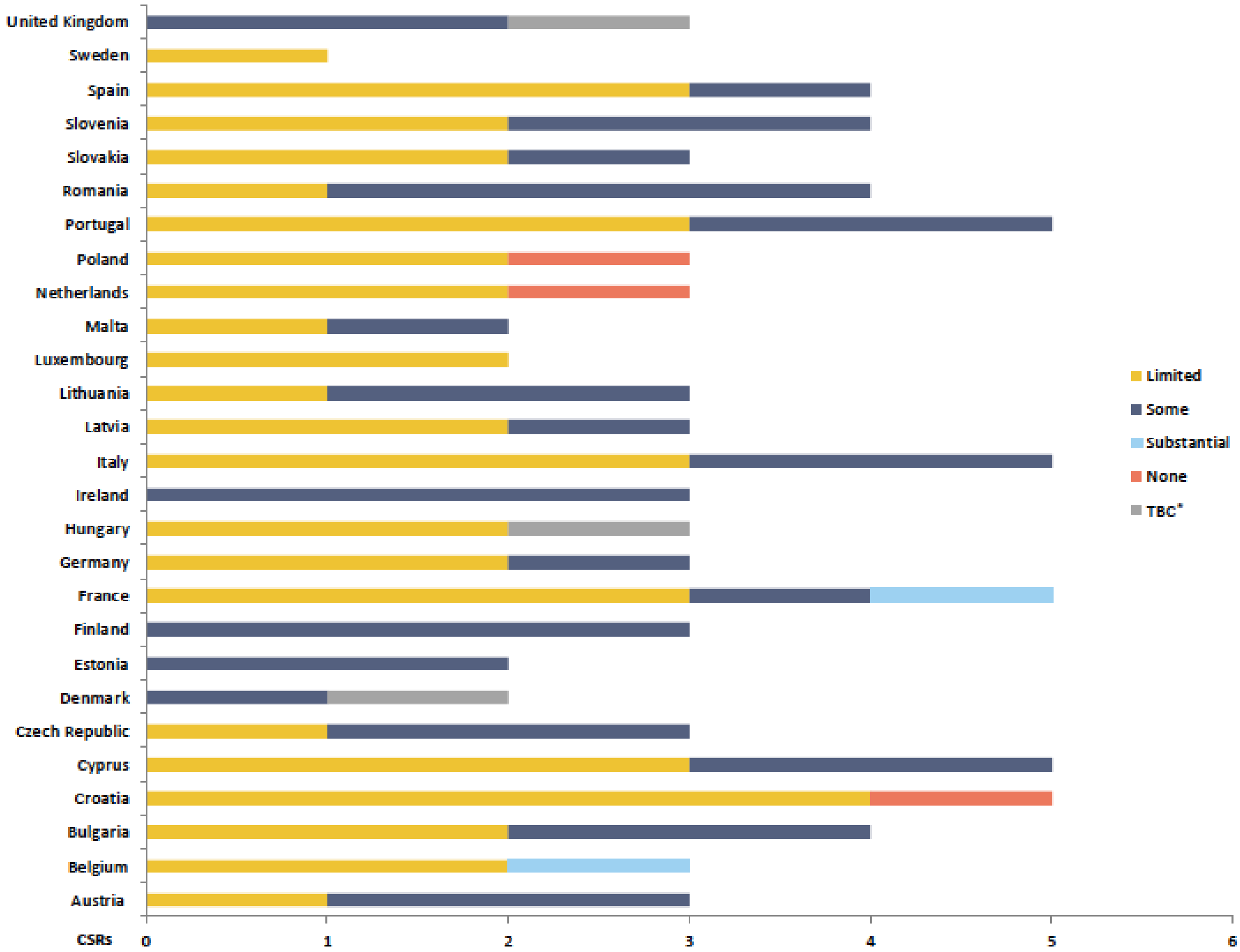
2.2 Assessment of the European Semester: A critical view

To justify the need for a more structural approach to the European Semester, one can start with a criticism of the now standard way used to evaluate the efficiency of CSRs: an assessment of the assessment, in a way.

The previous remarks indeed lead to a sceptical view of the now standard way to assess the European Semester and implementation of the CSRs. Following Deroose and Griesse (2014), Darvas and Leandro (2015/2016), Alcidi and Gros (2015) and Costello (2017), a standard way of reporting the achievements of European Semester is to consider the list of CSRs and to consider for each of them the evaluation of the Commission. Indeed, the Commission provides an evaluation on a scale from 0 to 4, with 0 being no progress and 4 being full implementation.

One can then report an average ranking for each country. The next figure taken from Costello (2017) is one of the most recent examples of such an analysis (countries are presented in reverser alphabetical order).

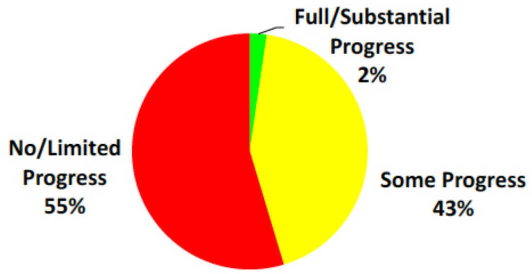
Figure 1: An example of a standard way to evaluate the implementation of recommendations (2016 CSRs)



Source: Costello (2017).

A more synthetic way of representing the whole implementations of the CSRs is provided in the next figure, which provides the percentage of CSRs within each class.

Figure 2: Implementation of the 2016 Country Specific Recommendations



Source: EP/EGOV based on the European Commission annual assessment, March 2017. http://www.europarl.europa.eu/RegData/etudes/ATAG/2017/587394/IPOL_ATA(2017)587394_EN.pdf

This type of analysis, although useful for some positive analysis, is not always insightful for policy making, as it is difficult to see whether the key policies have been implemented (and for what objective).

3. FOCUSING ON MAIN ISSUES: EXTERNALITIES

A hierarchy of recommendations could be made on a legal basis according to the commitments of Member States in the current set of treaties. This legal approach may miss some key spill-overs, which are not identified in the current legal environment but are now understood to be important for policy coordination. In other words, the EMU is incomplete. Indeed, there is an on-going learning process concerning the failures of economic coordination after the 2008 world economic crisis and the debt crisis in Europe. The lessons of these episodes will be always preceding any legal basis. As a consequence, economic analysis is key to improve the functioning of the EMU and the euro area.

3..1 Recommendations in an incomplete EMU

There is now a widespread acknowledgement that the euro area is an incomplete monetary union. The Five Presidents' report issued in 2015 is titled "Completing Europe's Economic and Monetary Union", and it defines two stages of the European process to complete the EMU architecture for economic union, fiscal union and democratic legitimacy.

As a consequence, all recommendations are made in an incomplete and evolving framework. Some recommendations are imperfect substitutes for the missing appropriate European framework, such as the coordination of fiscal policy, due to the lack of proper tools for macroeconomic stabilization (such as a European unemployment re-insurance scheme, for instance).

3..2 A TYPOLOGY OF RECOMMENDATIONS: THREE TYPES OF RECOMMENDATIONS

One should first distinguish three sets of CSRs according to the strength of their externalities on other countries.

1) The first set of recommendations gathers the policies that are necessary to ensure the very existence of the EMU and the euro area. This set is obviously of crucial importance for the Union and is described below.

2) The second set concern policies aimed at improving the welfare of citizens in some Member States, but having some spill-overs (or externalities) on citizens of other Member States. This may include for instance some regulatory change on fiscal issues or on the labour market that may increase efficiency and decrease inequality in a given country, but which may also reduce the cost of labour mobility in the Union.

3) The third set gather policies aimed at improving the welfare of citizens in a given Member State, with small spill-overs on other countries. Policies aiming to reduce inequalities or improve education may belong to this group.

The next figure summarizes these distinctions.

Figure 3: The three types of policies

1 - European requirement	2 - European/National policies	3 - National policies
• Policies necessary for the EMU and the euro area to exist • Environmental and energy policies • Nominal convergences: the necessity of a nominal wage stance in the euro area • Financial stability: financial stance	• Policies increasing the national welfare with spill-overs on other European citizens • Example: labour market reform reducing inequality and favoring European labor mobility; convergence of the basis and rates of corporate income tax; Aggregate demand management	• Policies improving the welfare of citizens of a Member State with a weak or no effect on other countries • Example: Education policies. Policies aimed at improving competion in the non-tradable sector.

The key point is that the nature of the policies within each set is evolving as our understanding of the weakness of the EMU and the euro area improves. In addition, the size of the spillover generated by any policy might change with the state of the economy. This doesn't create any operational implementation of recommendations according to these three classes. For instance, pension reform reducing inequalities should be considered under the third item (national policy). When the State public debt exhibits some possibility of unsustainability, the pension reform can be recommended under item 1 (European requirement) as public default can generate financial instability.[1]

The banking union and the set of new institutions for a European banking policy is a typical new set of policies and institutions initiated in 2012 after the eurozone crisis, which is necessary for the very existence of the euro area but which was not clearly identified when the euro was introduced.

Concerning the first set of policies (necessary for Europe to survive), I will now focus on the euro area. The policies concerning the EMU are much easier to define and less controversial, as they concern improvements of the single market. The contribution of Aussilloux, Bénassy-Quéré, Fuest and Wolff (2017) provide concrete steps to improve the EU's Single Market.

3..2.1 Necessary policies for the euro to survive and function well: The case for a Wage Stance

The euro area is an economic construction, which once for all removes exchange rates between national currencies and transfers the management of monetary policy (and now banking policy) to ECB and the Eurosystem. As a consequence, a nominal divergence cannot be corrected by external devaluation/ revaluation and one must make sure that nominal trends don't translate into unsustainable imbalances.

This is obvious, but there are no institutions to monitor and analyse nominal divergences in Europe. The reason for this is probably that it was assumed that more competition on the goods and financial markets would make factor prices (such as labour costs and housing prices) converge. This did not happen, and this naïve conception of market economies is one of the causes of the eurozone crisis. This is not the place to develop this claim, as it is presented in many reports.

[1] Some economists propose the introduction for a Sovereign Debt Restructuring Mechanism to allow for sovereign default and to increase market discipline. Such a system could increase the probability of sovereign default and financial instability. A very careful economic analysis is in order.

In the short run, nominal dynamics are determined by supply-and-demand factors on the goods market. In the medium run, two other factors durably affect nominal trends. First, current account imbalances can durably finance an excess demand, for instance in the housing sector, as in Spain. Second, the national institutions on the labour market affect the wage formation. These institutions include the minimum wage, unionization or de-unionization (or more generally changes in the bargaining power of workers), or the dynamics of civil servants' wage.

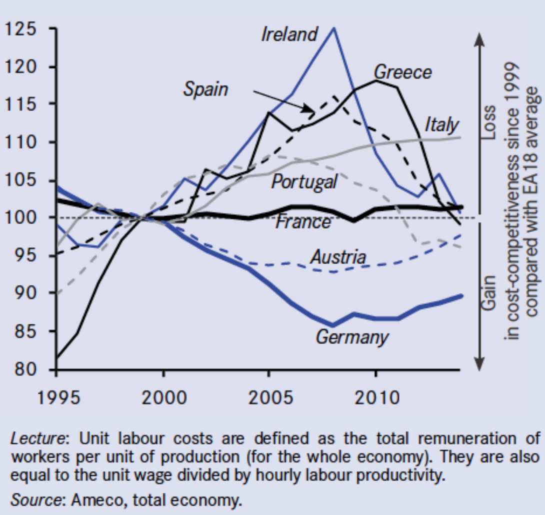
These institutions can produce inflation trends above the average euro area trend as in Spain, or durably low inflation compared to the euro area average, as in Germany.

The standard economic mechanism for nominal wage dynamics to follow a sustainable path is called the Phillips curve. An increase in unemployment above the natural rate of unemployment generates wage moderation, and a decrease in unemployment below the natural rate generates an average wage increase. This is not the place to discuss these economic mechanisms in detail. Two remarks are in order. First, the process of the adjustment goes through unemployment and is thus not consistent with a reduction of inequality or with an attempt to minimize the social cost of the adjustment. Second, there is a lot of empirical evidence that adjustments through the Philipps curve fail to materialise, due probably to nominal downward rigidities. (Hubert and Le Moigne 2016 for a recent contribution to this debate).

As a global consequence, one can no longer take for granted that increased competition on the goods and financial markets is sufficient to ensure nominal convergence.

A typical representation of these nominal divergences is provided in Figure 2, which plots nominal unit labour costs in some euro area countries. This figure is now well known. Two main lessons can be drawn. First, the divergence until the eurozone crisis is a market phenomenon. Second, the recent convergence is mostly a political phenomenon, as a result of active policies to reduce unit labour costs in deficit countries (i.e. internal devaluation).

Figure 4: Nominal Unit Labour Costs



Lecture: Unit labour costs are defined as the total remuneration of workers per unit of production (for the whole economy). They are also equal to the unit wage divided by hourly labour productivity.
Source: Ameco, total economy.

Source: Benassy-Quere and Ragot (2015).

A clear comment is in order. It has been known since the very beginning of the discussion of international imbalances that there is a bias to impose the burden of nominal adjustment on deficit countries. This creates deflationary pressure in the adjustment process. As a consequence, monitoring nominal divergence doesn't mean always asking for wage moderation in countries that are above the average, but also calls for more dynamic wage evolution in countries with "too low for too long" wage increases. Only a clear institutional incentive can efficiently fight against the deflationary bias, which is a very relevant objective when the monetary policy is stuck at the zero lower bound. This incentive may not be a legally binding constraint, because wage dynamics in each Member State is obviously not a policy choice. The recommendations about wage dynamics in CSRs should be advices for the Member State to do its best effort to help nominal convergences. These efforts can use fiscal tools (as the Crédit Impôt pour la Compétitivité et l'Emploi, CICE in France, which has been used to decrease the unit labour cost), regulated prices and wages (as the wage of civil servant), coordination incentives in the wage bargaining process, such as a public signal about a desirable wage trend.

Some aspects about nominal divergences are discussed within the framework of the MIP. This framework has not succeeded so far in this regard. A systematic treatment within the CSRs would reinforce the strength of these recommendations.

Obviously, there are some moments where there is a need to fight nominal upward bias in some countries, as in Spain before the 2009 crisis. The management of the crisis after 2009 generated a downward bias on nominal adjustments, which resulted in an inflation rate below the target of the ECB for almost ten years now. This is the new coordination failure revealed by the crisis.

These nominal trends in the monetary union are often discussed under the headings of "competitiveness" in the European Semester, without a clear recognition that competitiveness is a general equilibrium outcome: not all countries can increase their price-competitiveness at the same time. This is obviously different from productivity, as all countries can increase their productivity as the same time. Note that if the increase in productivity is the same in all countries, what is a desirable outcome, this doesn't help to reduce nominal imbalances. As a consequence, only a relative increase in productivity of deficit countries relative to surplus countries would help. On this side, productivity in Germany is increasing faster than in Spain or Italy[2]. Therefore, the observed productivity trends across euro area countries are contributing to increase divergences and not to reduce them. More generally, I think it is dangerous to think that the solution to nominal divergences is productivity increase. Nominal tools should be used to solve for nominal divergences, and real tools (such as incentives to increase productivity) are obviously useful for real objectives, such as long run sustainable growth.

The necessity to implement policy to induce a nominal re-convergence in a non-deflationary way and without increased unemployment was discussed in Bénassy-Quéré and Ragot (2015), where we also proposed the creation of a Council for Competitiveness and Social dialogue at the Member State level to discuss nominal trends in each country.

The Five Presidents' Report proposed the introduction of National Competitiveness Boards. Finally, on 20 September 2016, the Council issued a recommendation calling on the eurozone Member States to establish National Productivity Boards, referring explicitly to the Five Presidents' Report.

There is a clear risk that those boards analyse only real productivity trends. This is not a relevant objective for the very existence of the euro area. Obviously, higher productivity and growth in all countries is a relevant national objective, but it is mainly a national one with national tools. There are few externalities, once nominal trends are in line with a sustainable internal exchange rate. The key issue is thus nominal trends, and more precisely the gap between nominal trends and productivity trends across Member States. In short, the convergence of labour productivities (or

[2] The data on Multi factor Productivity are provided by the OECD. See http://stats.oecd.org/Index.aspx?DataSetCode=PDB_GR#.

more generally total factor productivity) is important but it is not the main issue in a monetary union, which is about nominal trends.

As a consequence, there is a need for Country Specific Recommendations to explicitly discuss the nominal convergence process, integrating the outcome of the analysis of National Productivity Boards, in order to ensure strong domestic ownership.

Concerning financial sustainability, the initial focus of the European governance was on public finance (public deficit and public debt). The recognition that an understanding of the various components of private debt is necessary for financial stability in a monetary union has motivated a more general view of imbalances in the Macroeconomic Imbalance Procedures (MIP) introduced together with the European Semester. As we argued in Bénassy-Quéré and Ragot (2015), a useful statistical summary of financial imbalances is the current account (which is the borrowing or lending of a country to the rest of the world).

According to these statistics, one of the main imbalances in the euro are is the German current account, which is one of the highest in the world; at more than 8% of GDP, it is well above the MIP scoreboard threshold of 6% of GDP[3]. The current account is not a policy choice for government, and it is not affected simply by national economic policy. Nevertheless, there are some policies, which do obviously contribute to the reduction of the current account surplus, such as a higher *nominal* wage increase or higher investment.

3..2.2 National policies with no spill-over effects

A second type of recommendation is the set of CSRs concerning policies that have few externalities on other Member States, but which are obviously good advice for the country. These recommendations should not be put on the same ground as other recommendations necessary for the proper functioning of the EMU.

One example of such a recommendation is the 2017 CSR to Italy to reduce the trial length in civil justice. This would obviously be good for Italy, but it is hard to believe that it is a major concern for the EMU. One may argue that it would be efficient to help for the resolution of non-performing loans in Italy, which would help the Italian banking system, with some externalities in Europe. The issue of non-performing loans has to be tackled with banking regulation at the European level. Another example is the recommendation to France to improve access to the labour market for jobseekers, notably for less qualified workers. This is indeed a key issue for France, but it is hard to see a clear externality on other countries. Similarly, the recommendation to Germany to reduce disincentives to work for second earners and facilitate transitions to standard employment is excellent advice for increasing female participation in the labour market and reducing job insecurity (decreasing the share of mini-jobs), but it is mostly to reduce inequality on the labour market in Germany, without any clear externality on other Member States.

These remarks don't imply that these recommendations are not necessary or are illegitimate, but the compliance with these remarks is not on obvious requirement for the very existence of the EMU. As they concern specific countries, respect for the timing of the national political debate is necessary.

[3] The thresholds under MIP are reference values rather than "legally binding limits". For a given variable, a value exceeding the threshold (1) does not automatically indicate excessive imbalance in the sense of the MIP and (2) does not imply legally binding obligation on the part of a Member State concerned to implement a corrective action.

3..2.3 National policies with externalities

The last set of recommendations concerns policies with some *relevant* externalities on other Member States, acknowledging that this may be difficult to assess quantitatively. A first example is the reform of the fiscal system: The convergence of the tax base and tax rates on corporate income tax can improve cross-border investment (ACCIS project[4]). The improvement of vocational training (and convergence at the European level, see the idea of the proposition for a Spinelli Fund[5]) can increase labour mobility, and so on. Instead of trying to provide an exhaustive list, it is more interesting to focus on some key policies, which have a first-order impact in the EMU and the euro area, such as aggregate demand management.

There is an on-going debate about the externalities generated by national demand management. There is no clear proof of strong externalities in normal times (Blanchard, Erceg, Linde, 2014). Any externalities are likely to be much more relevant during a period of prolonged weak economic activity where the monetary policy reaches some limits (due to the zero lower bound, for instance). In addition, when some countries face some legal binding constraint to reduce the public deficit, the ability to manage aggregate demand nationally may be reduced.

As a consequence, the notion of an aggregate fiscal stance in the euro area is key to thinking about the coordination of fiscal policy during these periods. There are now CSRs about the euro area analysing the euro area fiscal stance. In addition, the creation of the European Fiscal Board is a good step in the direction of better coordination of fiscal policy. A clear assessment in the CSRs of the consistency of national fiscal policy and the desirable aggregate fiscal stance in the euro area is the next necessary step to ensure a proper European aggregate demand management.

These recommendations are necessary steps, but they are admittedly a poor substitute for a European stabilization tool, which would be much more efficient to cope with externalities. Stabilization tools, such as unemployment scheme are rule-based and very reactive to the business cycle, whereas coordination within the actual process involves common changes in the discretionary part of fiscal policy. Bénassy-Quéré, Ragot and Wolff (2016) show that the discretionary part of monetary policy has actually been pro-cyclical during the recent years (and thus mostly destabilizing) compared to the ruled-based part. An additional example of these stabilizing properties of automatic stabilizers is the recent study by Dolls and Lewney (2017) on unemployment insurance scheme. Simulating various types of European Unemployment scheme, they show that the GDP of Spain would have been higher by 1.6% for a well-defined scheme (without permanent transfers across countries). Finally, the insurance against country specific risk due to fiscal transfers in the EMU is low compared to the US (See Allard et al. 2012). This shows that there is some room for automatic stabilizers at the EMU level. The comparison between institutions allowing for risk-sharing in the US and the Euro area should nevertheless be carefully done. In Europe, labour mobility is a less important adjustment mechanism in response to country-specific labour demand shocks that cause stronger and more persistent reactions of the employment and the participation rate. Recent studies nevertheless find some convergence, as interstate migration in the US decreased recently (Beyer and Smets 2015). The Five Presidents' Report and the Reflection paper on the Deepening of the Economic and Monetary Union both discuss the necessity of a stabilization tool.

There is a very strong case for a European re-insurance scheme as a stabilization scheme. A discussion of the benefits of such a European tool is outside the scope of this paper. A side effect is that it would simplify the coordination of fiscal policies, which is necessary in the European

[4] See https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en
[5] See http://www.strategie.gouv.fr/english-articles/spinelli-fund-european-compact-skills

Semester in the CSRs. Along the same lines, a bigger and countercyclical EU or euro area budget would be useful.

3..3 The wage stance

The previous remarks concerning both nominal and financial imbalances point to the crucial role of price dynamics in a monetary union. Recommendations about policy action to affect both price and nominal wage dynamics are not adequately addressed in the CSRs. Recommendations address this issue very indirectly.

There is only an indirect mention of the need for an upward nominal adjustment in Germany in the 2017 CSRs. Although the current account imbalance is mentioned, it is analysed only through the lens of the difference between savings and investment, calling for more investment, which is only one view of the issue. Higher wages would reduce the savings rate of firms, which is very high in Germany, in addition to increasing demand.

In the German CSRs, the issue of wages is discussed, but only *real* wages, which should grow. But this real wage growth can be attained by a reduction in inflation, contributing to a further increase in nominal imbalances in the euro area. This CSR can thus be destabilizing, and it is an example of the lack of *nominal* analysis of euro area imbalances.

The CSRs for Italy don't discuss properly the need and possible tools for the Italian nominal adjustment.

An explicit focus of the CSRs on nominal and wage dynamics is thus part of the necessary condition to deliver proper advice for the euro area to survive. I label this nominal analysis a *wage stance.* It should be explicitly introduced in the European Semester. These recommendations would be useful during booms to warn countries about diverging trends. They would be useful as well during recessions to avoid asymmetric adjustment (asking countries to decrease wages without recommending to some countries to avoid reduction in wages).

The derivation of a relevant wage stance can be based on some analytical works on nominal trends in a monetary union. For instance, one can compute Real Effective Exchange Rate (REER) movements in the euro area, using standard as in Tressel et al. (2014) for instance. In OFCE (2016) a simple model is used to compute the nominal adjustments, which would restore the balance of the balance of payment (measured as the stabilization of the net international position of the country). More generally, the literature on equilibrium REER can be used to derive indication about the direction and the size of the adjustment. Salto and Turrini (2010) provide descriptions of the method and an application to the EU.

Although there is some uncertainty about the precise values (as in any economic estimation of equilibrium prices), the main conclusions of these estimations are robust. Germany's REER is undervalued by more than 10%, (and this gap is narrowing) whereas there is still some nominal adjustment to perform in Greece, for instance.

Comparing the robustness of the analysis of REER in Europe for different papers, there is not more uncertainty about these results compared to the computation of output gaps and cyclically adjusted public deficit, which are now widely used for the assessment of fiscal policy. As a consequence, there is no technical reason not to use these measures as a tool to help (without binding legal constraint) improve our understanding of nominal convergences or divergences.

3..4 Governance: Four types of relations between the Commission and the Member States

The CSRs include both fiscal requirements based on the preventive arm of the SGP and other requirements based on the MIP. In addition they include advices about a more "inclusive and sustainable growth" (high growth, low pollution, low inequality) and indication of potential externalities to be debated in national policy making. The legal basis is indeed both the SGP and the more general Europe 2020 strategy[6].

One cannot expect an ownership of these different types of reform to be the same. In addition, the tools to incentivize reform implementation cannot be the same for the three types of reforms, as their legal basis differs.

An alternative focus in the governance of policy advice is useful to think about the necessary distinction across recommendations in the European Semester.

Borrowing freely from Bertoncini (2013), one can define four types of regime for Commission/ Member State relationships. Economists would define the nature of governance as a principal-agent relationship, but one will observe soon that the nature of the principal or the agent should change according to the type of recommendation.

Table 2 presents the main characteristics of these four regimes. The legal basis is freely inspired by the contribution of Vanden Bosh (2014).

Table 2: Four regimes between the Commission and Member States for the CSRs

The regime	Goals	Type of recommendation	Tools	Formal basis
The "IMF" regime	Avoiding fatal imbalances	De facto binding	Strict macroeconomic conditionality, possible financial sanctions	SGP, MIP, TFEU Art. 121, 126, 136
The "UN" regime	Coordinating national policies	Advice (possible warning)	National understanding of European externalities	MIP, TFEU Art. 121
The "World Bank" regime	Improve national policy decision	Optional	Policy recommendations, conditional fiscal support	TFEU Art. 121, 148, 136
The "OECD"	Improve national policy decision	Advice	Non-binding recommendations	Europe 2020 strategy, TFEU Art. 121, 148, 136, 153

Source: Freely inspired from Bertoncini (2013)

In the first regime (the "IMF" regime), the Commission is the principal and the Member States are the agent. These latter must comply with the recommendations of the Commission. Typical examples are the recommendations within the SGP on the public deficit and public debt.

[6] See, for the formal legal basis:
http://www.europarl.europa.eu/RegData/etudes/ATAG/2014/528767/IPOL_ATA(2014)528767_EN.pdf

In the second regime (the "UN" regime), the goal is to improve coordination of economies policies. This is necessary due to the various potential externalities mentioned above. There is no clear legal basis for these recommendations; coordinating fiscal policies or wage policy is useful, but countries are free to choose a national fiscal stance independently of a desirable aggregate fiscal stance.

The "World Bank" regime is a third regime where the Commission could provide positive incentives to help national reforms in the interest of the countries or of the European Union. A financial aid conditional on the implementation of a given policy is a typical example of such incentives. This can be low interest on some loans or delayed expected fiscal adjustments. The legal basis for such incentives seems weak.

The fourth regime (the "hyper-OECD" regime) is a regime where the Member States are the principal and the Commission is the agent. One can expect the Commission to provide good and independent advice to Member States to implement good policies. There is no commitment to implement these reforms.

A clear example of this last regime is the recent creation of the Structural Reform Support Service (SRSS) to provide technical support to Member States on various issues.[7] Many recommendations in the CSRs can be read as falling into this last item. All type 3 recommendations (purely national policies, see Figure 3) may fall into this category.

[7] See the presentation at https://ec.europa.eu/info/departments/structural-reform-support-service_en

4. ISSUES IN THE IMPLEMENTATION OF THE EUROPEAN SEMESTER: ACCOUNTABILITY AND THE TIME HORIZON

4.1 Transparency and accountability of European institutions

A key point deserves to be carefully studied when observing the weak ownership of CSRs by Member States. It is not clear that Member States and the Commission or the Council have the same evaluation of the relevance of any single CSR. What is phrased "weak ownership" may simply be disagreement between the Commission and a Member State. This can be the case even if the Commission consults Member States in advance before the adoption of the CSRs. We have no measure of the extent of disagreement.

The process of interaction within the European Semester reduces these disagreements. In February, a country report published by the Commission is sent to each Member State before they elaborate their national reform programme and the stability and convergence programme. The final CSRs are adopted in July. Information thus circulates, but this is not only about information: There *can* be some disagreement between the Commission and the Member States about the relevance of some CSRs for type 1 and type 2 policies. It is hard to think that national policy makers will fully factor in externalities on other countries of their own policies. They may even not have the tools to assess those external effects. For instance, there are divergences about the usefulness of nominal wage moderation in France and a wage increase in Germany.

Disagreements on type 3 policies (mainly national) are interesting because they reveal a difference in economic analysis. Both parties (Commission and Member States) can make mistakes. Two types of mistakes are possible. The first type is advising bad policy. The second is not advising good policy. The first type is much more politically costly than the second one.

An example of the second type of mistake for France may be the lack of emphasis on housing prices and inefficiencies in public spending that can contribute to inflation in housing prices, which are socially and economically inefficient.

The general conclusion is that the *ex post* accountability of the Commission for the CSRs is key. Following Banerji et al. (2015), an independent evaluation process of the Commission monitoring and enforcement of the governance framework, which is governed by the European Parliament, with a public communication of evaluations and discussions, would be a useful tool. It can be based on the hearings in the Economic Dialogues framework[8]. This independent evaluation could be based on the analytical framework discussed here: The distinction between type 1, 2 and 3 policies, the typology of possible relationships to deliver the proper incentives, and finally the distinction between the two types of errors.

4..2 Is linking the disbursement of EU funds to progress in implementing the CSRs a good idea?

The previous typology of the governance regime is useful for thinking about new propositions to improve the implementation of CSRs by Member States.

A recent proposition is to link the disbursement of EU funds to certain advances in the implementation of CSRs.

[8] The competent committee organises regular hearings with the Commission and the President of the Euro group, i.e. Economic Dialogues:
http://www.europarl.europa.eu/RegData/etudes/divers/join/2014/528738/IPOL-ECON_DV(2014)528738_EN.pdf

First, conditioning the transfer of funds in the current EU budget on implementing CSRs concerning type 3 policy actions (purely national) should be excluded. This would appear as an "IMF" type regime (negative incentives in case of non-compliance) for policies which have little spill-over. There is no economic, political or legal basis for such a conditioning. More concretely, conditioning a transfer to Italy on the implementation of reforms in civil justice seems a bad idea.

Second, for recommendations with important European spill-overs, the goal is to increase the net gain for countries to implement the reform. If the reform is costly, it is then efficient for the EU to use a part of its own budget to provide incentives to the country to internalize the spill-overs (which may not necessarily cover the full cost of the reform, if it is too costly). This is the logical foundation for a "World Bank" type of regime to support reform within a country. As a consequence, positive incentives can be provided by the EU (on the EU budget, broadly speaking).

This last remark is consistent with some analysis of Banerji et al. (2015), who call for direct financial transfers from the EU (among other tools). They rightly point out that financial transfers have been used in many countries to help in implementing reforms at regional level. This is the case in Australia, Germany Italy, and the US, among others. These transfers help in supporting reform to increase skill levels, infrastructure investment, and health care.

To generate positive incentives, the current tools within the set of the European Structural and Investment Funds (ESIF) aren't appropriate. These funds include the European regional development fund, European social fund, Cohesion fund, European agricultural fund for rural development, and European maritime and fisheries fund. All of these funds have some special purpose based on an assessment of specific situations. Using these funds for additional goals (implementing reforms) would create some confusion: using one stone to kill so many birds is out of reach.

Instead, the design of positive incentives would require a bigger and better functioning EU budget. That said, the positive incentives require European money to help some countries to implement reforms, and thus this is a cost to other countries. As a consequence, a clear initial agreement on the types of reforms with externalities should be identified. This may be easier to write than to do. Once identified, these incentives would generate transitory financial transfers across countries, but the net gain for each country (including the spill-overs) has to remain positive.

Reforms concerning nominal adjustments on the labour market are an obvious important candidate. For instance, a European insurance scheme could be introduced, together with proper incentives to implement regulatory changes on the labour market.

4..3 "STRUCTURAL REFORMS" AND INEQUALITIES

I have avoided the term "structural reform" so far. As Gros and Alcidi (2015) note, out of 300 articles mentioning structural reforms between 2010 and 2015, only 120 give a definition and example of desirable reforms. Speaking about these reforms, we should be more precise about desirable policies for given objectives. In addition, as any policies may have complex redistributive effect. The proper analysis of the social impact of any policies should at least be addressed. A good example of the evolution of policy recommendations toward a broader concept of efficiency is provided by Chapter 2 of the 2017 *Going for Growth* report of the OECD, titled "Integrating inclusiveness in the Going for Growth framework". The chapter includes discussion of income distribution and inequality outcomes (called "inclusiveness"), together with more traditional concern about employment and productivity growth.

One must admit that the economic analysis of inclusiveness in the European Semester and in the CSRs may be developed further. They are present for some CSRs (e.g. 2017 CSR 2 for CZ, similarly HU, SK), but they are far from systematic. Such developments would help Member States to think about the political economy of reforms.

4..4 The timing of politics: Short-run versus long-run

The time dimension must now be introduced for the design of an efficient governance framework. Indeed, the European Semester is a repeated coordination period from November of year t-1 to July of year t. The outcome is the CSRs, which are repeatedly said to focus on “reform steps that can be implemented within 12-18 months”. As often noted, the assessment of the CSRs is done in February t+1, only 8 months later.

Reading the CSRs, the tension between the European agenda and timing and the implementation within Member States is obvious. In Appendix A, we provide the CSRs for France for 2015, 2016 and 2017, together with a summary of the Commission assessment for 2015 and 2016.

First, the Commission often refers to the announcement and planned action to deliver its assessment. In other words, anticipation of actions appears in the yearly evaluation.

Second, some recommendations are made repeatedly, but it is not clear whether they are referring to a specific decision or broad general guidelines. For instance, the 2016 recommendation for France “Ensure that the labour cost reductions are sustained and that minimum wage developments are consistent with job creation and competitiveness” could be made each year forever. The 2017 recommendation “Continue to lift barriers to competition in the services sector, including in business services and regulated professions” could also be made for some years.

For each recommendation, there should be a clear initial date of the initial formulation and expected date of achievement and final evaluation. This does not exclude yearly reports regarding the advancements, but these intermediate reports would not be included in the evaluation of the implementations of CSRs as done in summary statistics provided by the Commission.

The expected duration of the implementation of any recommendation should take into account both technical and legal issues in the implementation, but also relevant aspects of the national political agenda of the Member States. For instance, a year including general elections is not favourable to the implementation of a new recommendation.

5. THE REFORM OF THE EUROPEAN SEMESTER

The previous Sections presented analytical reflections to improve European economic governance. This Section now derives more practical suggestions to improve the European Semester.

Suggestion 1: Clearly ask National Productivity Boards to focus on nominal trends, across tradable and non-tradable sectors and on the labour markets. These institutions could provide suggestions to increase convergence without deflationary pressures.

In other words, it seems less useful to create institutions to help countries to increase their productivity, as many other national and international institutions are providing relevant advice.

Suggestion 2: Based on the inputs of National Productivity Boards and the Commission on analysis, define a nominal wage stance in the euro area (and more generally in the EMU) consistent with the target of the ECB, which is an inflation close to but below 2%.

Suggestion 3: Provide a hierarchy of CSRs. The recommendations could start with the ones with strong spill-overs or with injunctions based on legal requirements, then with recommendations with some spill-overs (such as the ones about fiscal stance) and then with recommendations with small or no spill-overs.

Suggestion 4: Systematically add CSRs about environmental issues and possibly energy policy, as these recommendations tackle issues with externalities.

Among these recommendations, a systematic assessment of the country regarding greenhouse gas emissions, renewable energy or more generally the assessment of progress for the achievement of the Paris agreement, would be useful.

Suggestion 5: Add a temporal dimension to recommendations, with a possible medium-run time horizon. This horizon does not exclude yearly assessment of the advances. It would help distinguish between intermediate steps and final goals.

Suggestion 6: Start the European Semester with an assessment of the European economic situation on key aspects: Fiscal aspects (fiscal sustainability and fiscal stance), social aspects, financial aspects (based on current account imbalances) and nominal aspects (nominal and wage stance).

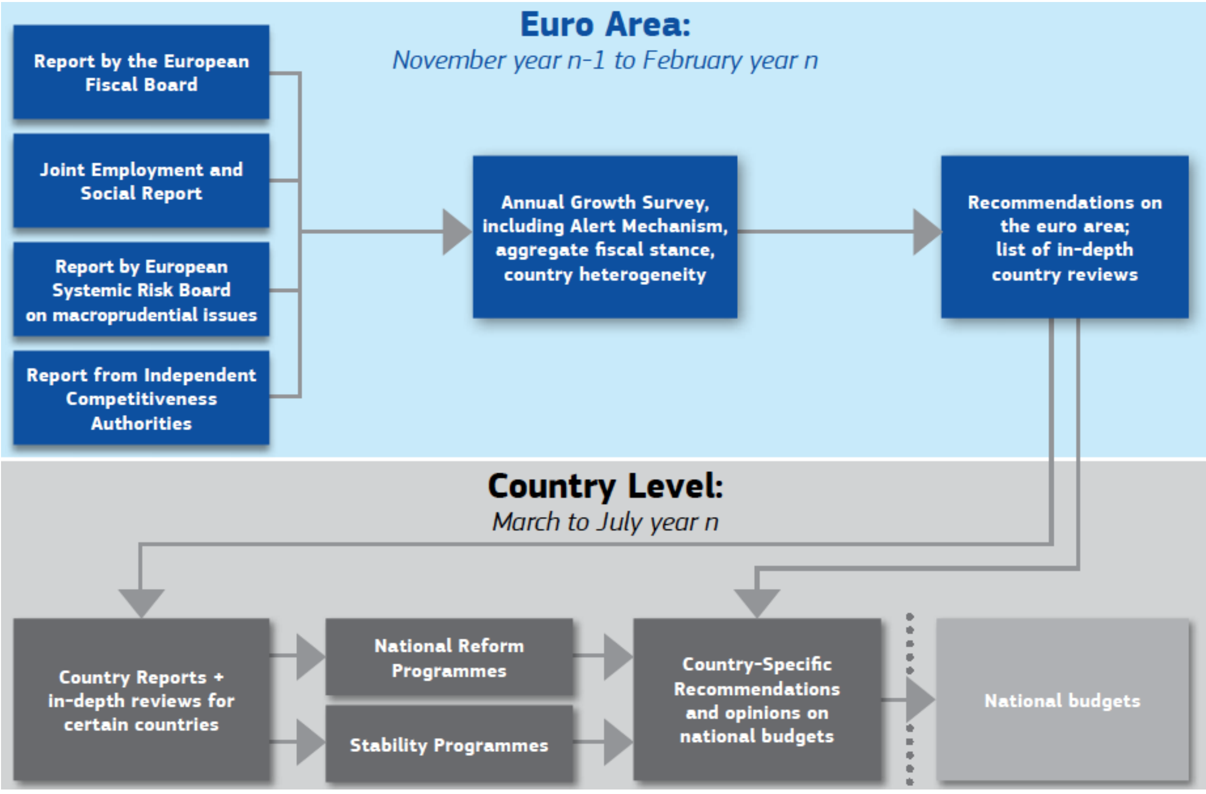
The Commission has a clear comparative advantage to make recommendations with European externalities. There are many analytical inputs that could be used.

For the fiscal stance, a report of the European Fiscal Board, nourished by national fiscal boards, is an obvious solid basis. For the wage stance, a similar report could coordinate and summarize inputs of National Productivity Boards. For the financial stance, a report from the European Systemic Risk Board (ESRB) and national agencies would be a main input.

A systematic treatment of policies for inclusive growth could be envisaged along the lines developed for instance in Chapter 2 of the OECD’s 2017 *Going for Growth*.

The next figure, taken from the Five Presidents’ report (Juncker, 2015), summarizes this last proposition.

Figure 5: The proposition of the organization of the European Semester



Source: Five Presidents' Report (2015)

Suggestion 7: To improve democratic debate, a systematic communication on recommendations with externalities would considerably increase national ownership, as it would be clear that the Commission has to be heard by the national parliament to factor in European externalities. An Annual hearing of the DG ECFIN by the national parliament should be systematic.

The European Parliament has an important role to scrutinize the EU policies and to contribute to help national parliament to consider externalities generated by national policymaking. For a long period, one can expect that we will need coordination of national policies.

6. CONCLUSIONS

The improvement of the European Semester is an on-going process, and some recent developments must be positively acknowledged. The European Semester was streamlined in 2015 to be more focused on key recommendations, in line with relevant macroeconomic and social priorities. The Five Presidents' Report proposes a close but better organization of the Semester. Rapid changes toward the implementation of the proposition of the Five Presidents' Report should be made.

This Briefing Paper contributes to the discussion on improvements of the European Semester by focusing on the aspect of economic policies within each Member State that have strong spill-overs on other countries. The proper definition of a *nominal stance* at the European level, based on wage and price analysis, would be an important tool to avoid either the divergence or deflationary convergence of Europe's economies.

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APPENDIX 1: SUMMARY OF CSRS FOR FRANCE

	CSR 2015	Summary of EC Assessment (as of Feb. 2016)
1	Ensure effective action under the excessive deficit procedure and a durable correction of the excessive deficit by 2017 by reinforcing the budgetary strategy, taking the necessary measures for all years and using all windfall gains for deficit and debt reduction. Specify the expenditure cuts planned for these years and provide an independent evaluation of the impact of key measures.	France has made limited progress in addressing CSR 1: **Limited progress** has been made in specifying the expenditure cuts planned up to 2017. Moreover, no independent evaluation of the impact of the key measures included in the draft budgetary plan for 2016 was provided, due to the existence of many evaluations.
2	Step up efforts to make the spending review effective, continue public policy evaluations and identify savings opportunities across all sub-sectors of general government, including on social security and local government. Take steps to limit the rise in local authorities' administrative expenditure. Take additional measures to bring the pension system into balance, in particular ensuring by March 2016 that the financial situation of complementary pension schemes is sustainable over the long term.	France has made **some progress** in addressing CSR 2: • **Some progress** has been made in making the spending review effective. • **Some progress** has been made on limiting the rise in local authorities' administrative expenditure. The spending norm (ODEDEL) for local authorities has been further specified in the draft budgetary plan for 2016. **Substantial progress** has been made on the long-term sustainability of complementary pension schemes.
3	Ensure that the labour cost reductions stemming from the tax credit for competitiveness and employment and from the responsibility and solidarity pact are sustained, in particular by implementing them as planned in 2016. Evaluate the effectiveness of these schemes in the light of labour and product market rigidities. Reform in consultation with the social partners and in accordance with national practices, the wage-setting process to ensure that wages evolve in line with productivity. Ensure that minimum wage developments are consistent with the objectives of promoting employment and competitiveness.	France has made some progress in addressing CSR 3: • **Substantial progress** has been made in pursuing measures to reduce the cost of labour. The 2016 budget leaves the tax credit for competitiveness and employment (CICE) unchanged and confirms the implementation of the second phase of reductions in employers' social security contributions planned in the Responsibility and Solidarity Pact, albeit with a three months' delay from the original timing. • **Some progress** has been made in reforming the wage-setting process. The law on social dialogue adopted in August 2015 enables companies, through majority agreements, to conclude wage agreements valid for up to three years instead of one year. Moreover, a reform of the Labour Code has been announced for 2016. • **Limited progress** has been made in ensuring that minimum wage developments are consistent with the objectives of promoting employment and competitiveness.
4	By the end of 2015, reduce regulatory impediments to companies' growth, in particular by reviewing the size-related criteria in regulations to avoid threshold effects. Remove the restrictions on access to and the exercise of regulated professions, beyond the legal professions, in particular as regards the health professions as from 2015.	France has made **some progress** in addressing CSR 4: • **Limited progress** has been made in reducing regulatory barriers to companies' growth. The measures taken or proposed to reduce barriers have limited impact (9 and 10 employee thresholds raised to 11) or are temporary (additional fiscal and social levies linked to reaching thresholds up to 50 employees have been frozen for 3 years). • **Some progress** has been made in removing unjustified restrictions on access to and the exercise of regulated professions, notably the legal professions. Overall, in regulated professions authorisation schemes persist and generally there is a lack of transparency and comparability.
5	Simplify and improve the efficiency of the tax system, in particular by removing inefficient tax expenditure. To promote investment, take action to reduce the taxes on production and the corporate income statutory rate, while broadening the tax base on consumption. Take measures as from 2015 to abolish inefficient taxes that are yielding little or no revenue.	France has made **limited progress** in addressing CSR 5: • **Limited progress** has been made to simplify and improve the efficiency of the tax system. • **Some progress** has been made to reduce the taxes on production (phasing out of C3S) but the effective average tax rate on corporations remains stable. • **Limited progress** has been made to raise the tax base on consumption, indirectly through the increase in environmental taxation.

		• **No progress** has been made in abolishing inefficient taxes. Out of the more than 100 identified by the Inspectorate-General of Finances (“Inspection Générale des Finances”) in 2014, the 2016 budget deletes two, for a total amount of EUR 10 million, and creates five new ones.
6	Reform the labour law to provide more incentives for employers to hire on open-ended contracts. Facilitate take-up of derogations at company and branch level from general legal provisions, in particular as regards working time arrangements. Reform the law creating the accords de maintien de l’emploi by the end of 2015 in order to increase their take-up by companies. Take action in consultation with the social partners and in accordance with national practices to reform the unemployment benefit system in order to bring the system back to budgetary sustainability and provide more incentives to return to work.	France has made **limited progress** in addressing CSR 6: • **Limited progress** has been made in reducing labour market segmentation. Higher social contributions for very short-term contracts have failed to provide more incentives for employers to hire on longer-term contracts, while the overall effect of the measures contained in the French Small Business Act announced by Prime Minister Manuel Valls on 9 June 2015 and adopted as part of the 2016 budget is unclear. • **Limited progress** has been made in facilitating the take-up of derogations at company and branch level from general legal provisions. • **Some progress** has been made in reforming the employment conservation agreements (“accords de maintien de l’emploi”).

	CSR 2016	EC Assessment (as of Feb. 2017)
1	Ensure a durable correction of the excessive deficit by 2017 by taking the required structural measures and by using all windfall gains for deficit and debt reduction. Specify the expenditure cuts planned for the coming years and step up efforts to increase the amount of savings generated by the spending reviews, including on local government spending, by the end of 2016. Reinforce independent public policy evaluations in order to identify efficiency gains across a	**Limited progress** • Limited progress in reinforcing and identifying savings and efficiency gains generated by the spending reviews and public policy evaluations. (1)
2	Ensure that the labour cost reductions are sustained and that minimum wage developments are consistent with job creation and competitiveness. Reform the labour law to provide more incentives for employers to hire on open-ended contracts. (MIP relevant)	**Substantial progress** • **Substantial progress** in ensuring that labour cost reductions are sustained. • **Some progress** in ensuring that minimum wage developments are consistent with job creation and competitiveness. • **Substantial progress** in reforming the labour law to provide more incentives for employers to hire on open-ended contracts.
3	Improve the links between the education sector and the labour market, in particular by reforming apprenticeships and vocational training, with emphasis on the low-skilled. By the end of 2016, take action to reform the unemployment benefit system in order to bring the system back to budgetary sustainability and to provide more incentives to return to work. (MIP relevant)	**Limited progress** • **Some progress** in improving the links between the education sector and the labour market. • **No progress** in reforming the unemployment benefit system.
4	Remove barriers to activity in the services sector, in particular in business services and regulated professions. Take steps to simplify and improve the efficiency of innovation policy schemes. By the end of 2016, further reform the size-related criteria in regulations that impede companies' growth and continue to simplify companies' administrative, fiscal and accounting rules by pursuing the simplification programme. (MIP relevant)	**Some progress** • **Some progress** in easing access to and exercise of activity in the services sectors. • **Limited progress** in improving the efficiency of innovation policy schemes. • **No progress** in reforming the size-related criteria in regulations that impede companies' growth. • **Some progress** in pursuing the simplification programme.
5	Take action to reduce the taxes on production and the corporate income statutory rate while broadening the tax base on consumption, in particular as regards VAT. Remove inefficient tax expenditures, remove taxes that are yielding little or no revenue and adopt the withholding personal income tax reform by the end of 2016. (MIP relevant)	**Limited progress** • **Limited progress** in reducing taxes on production and the corporate income tax while broadening the tax base on consumption. • **Some progress** in modernizing the tax system, mainly through adopting the withholding personal income tax. The phasing out of tax expenditure and taxes yielding little or no revenue is progressing very slowly.

	CSR 2017
1	Ensure compliance with the Council recommendation of 10 March 2015 under the excessive deficit procedure. Pursue a substantial fiscal effort in 2018 in line with the requirements of the preventive arm of the Stability and Growth Pact, taking into account the need to strengthen the on-going recovery and to ensure the sustainability of France's public finances. Comprehensively review expenditure items with the aim to make efficiency gains that translate into expenditure savings.
2	Consolidate the measures reducing the cost of labour to maximise their efficiency in a budget-neutral manner and in order to scale up their effects on employment and investment. Broaden the overall tax base and take further action to implement the planned decrease in the statutory corporate-income rate.
3	Improve access to the labour market for jobseekers, in particular less-qualified workers and people with a migrant background, including by revising the system of vocational education and training. Ensure that minimum wage developments are consistent with job creation and competitiveness.
4	Further reduce the regulatory burden for firms, including by pursuing the simplification programme. Continue to lift barriers to competition in the services sector, including in business services and regulated professions. Simplify and improve the efficiency of public support schemes for innovation.

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