The European Semester for economic policy coordination: A reflection paper
The European Semester for economic policy coordination: A reflection paper

Abstract
This paper provides an overview of the current EU economic governance framework, in particular of the so-called EU ‘rule-based’ surveillance framework of national budgetary, economic and social policies. It raises some broad questions on the lessons learned and proposes some reflections for the future.

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<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>CSR</td>
<td>Country-specific Recommendation</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>EFSF</td>
<td>European Financial Stability Facility</td>
</tr>
<tr>
<td>EMU</td>
<td>Economic and Monetary Union</td>
</tr>
<tr>
<td>ESM</td>
<td>European Stability Mechanism</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>MIP</td>
<td>Macroeconomic Imbalance Procedure</td>
</tr>
<tr>
<td>SGP</td>
<td>Stability and Growth Pact</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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EXECUTIVE SUMMARY

This paper provides an overview of the current EU economic governance framework, in particular in view of assessing the experiences gained from the EU ‘rule-based’ surveillance framework of national budgetary, economic and social policies (i.e. the European Semester for economic policy coordination).

Section 1 sets out the main features of the EU economic governance framework, compares the EU economic governance framework to the one of the United States and presents a number of topical questions. This section also notes that two principles are inherent to the EMU governance design: (1) fiscal responsibility lays ultimately with the Member States (“no bail out clause” and the “no monetary financing clause”) and (2) a ‘rule-based’ surveillance framework that aims at ensuring sound public finances and setting ceilings for budget deficit and debt levels. The section also provides an overview of the evolution of these principles since the start of the monetary union. In particular, it shows how the main principles have recently been complemented with (1) additional EU-level governance instruments (e.g. for macro-economic imbalances, banking union legislation) and institutions (e.g. permanent backstop for sovereign debt, banking supervision and resolution) and (2) the introduction of new instruments at national level (e.g. balanced budget rules) and institutions (e.g. independent fiscal councils and productivity boards).

Section 2 provides a short overview of the main characteristics and functioning of the European Semester, in particular the so-called Country Specific Recommendations.

Section 3 presents a reflection on the overall design of the European Semester, with special attention to the relationship between its policy objectives and the surveillance tools to achieve them. It poses questions on the respective objectives and instruments that can be used to pursue a sustainable growth strategy for the EU and the specific needs for the well-functioning of the Euro Area.

Section 4 looks at some aspects of the EU fiscal surveillance system (the Stability and Growth Pact) and highlights a number of questions on its functioning that have been raised in the public domain and may be part of any debate on a future review.

Section 5 does the same for the Macroeconomic Imbalance Procedure.

Finally, section 6 draws general conclusions.
1. AN EVOLUTIONARY DESIGN OF THE EMU GOVERNANCE

1.1. From Maastricht until today: two complementary approaches?

The Maastricht Treaty introduced two main principles that Member States are bound to observe when deciding their economic and fiscal policies: that the final fiscal responsibility lays with the Member States (i.e. the “no bail out clause” and the “no monetary financing clause”) and that of an EU surveillance framework aimed at avoiding excessive budget deficit and debt (coupled with strict quantitative thresholds). Since, the latter has become the main building block of an EU “rule-based fiscal surveillance system”, the Stability and Growth Pact (SGP).

The dichotomy between these two governing principles, i.e. giving to the EU level a role to steer national policies and at the same time expecting Member States to take full final responsibility (economic, fiscal and political) for their national policies, has been part of the overall design of the Economic and Monetary Union (EMU) since its inception. In principle, one could argue that one of these principles should, if fully effective, be a sufficient condition for the smooth functioning of the single currency union. Nevertheless, by looking at the unique design of the EMU, it was considered necessary to introduce both these principles into the EMU governance framework as mutually reinforcing (a sort of ‘belts and bolts’). It is open to debate which one of them has been more effective, in relative terms, for the stability of the euro.

Box 1: Why an EU-level economic governance framework?

The institutional framework for economic policy making in the European Union is unique. Fiscal, economic and social policies are national competences, while the EU Treaties oblige Member States to coordinate them at the EU level in various forms. This is, in particular, the case for the Member States that have adopted the euro and are therefore fully sharing the single monetary policy (and currency exchange rates) inside the EMU. This unique design is rooted in a number of reasons.

Firstly, as learned from the first decade of the single currency area, economic growth may not always be supported by the economic fundamentals. For instance, nominal wages may develop in a way that is not compatible with the growth potential. In some cases, strong nominal growth in one country may even be fuelled by diverging real interest rates among the participating Member States, possibly resulting in “assets bubbles” in one or more Member States.

Secondly, countries inside a monetary union cannot rely on individual monetary policy and nominal exchange rate to absorb adverse country-specific shocks, country-specific effects of common shocks, or different country specific economic developments. These constraints place a greater burden on other mechanisms, such as fiscal, labour and product market policies, to compensate shocks and facilitate adjustments. According to the IMF, in order to ensure the long-term viability of the EMU, member countries’ resilience to shocks – whether temporary or permanent – must be improved (see e.g. IMF Staff Discussion Note No. 19/05 June 2019).

Thirdly, the importance of avoiding procyclical fiscal policies (both during upturns and downturns) may be of even more importance for members of a monetary union. A fiscal framework that supports the building of fiscal buffers in good economic times could help to avoid a detrimental fiscal consolidation during economic recessions that would undermine sustainable growth.

Finally, inside a monetary union, unsustainable national economic and fiscal policies (or the absence of some policies) in one Member State may, if not addressed in time, have strong externalities (or spill over effects) on other Member States.

During the sovereign debt crisis, both principles came under stress and their effectiveness to safeguard the smooth functioning of the EMU was questioned. Neither of them was able to detect or prevent the crisis from emerging in the first place and, once the crisis installed, both principles had to adjust to the reality in a rather flexible way. Because of the crisis, public debt levels rose dramatically in many
Member States and the “no bail out clause” had to be applied in a rather pragmatic way in order to safeguard the financial stability of the euro area.

Debates on how to reform the governance of the EMU started immediately and are still ongoing. The unique design of the EMU governance framework has rendered difficult to find a common vision for a long-term “steady-state” governance framework. Policies to strengthen EMU governance have instead gone ahead step-by-step on various fronts.

The first, most urgent and immediate policy response focused on crisis management. It included the establishment of a sovereign debt backstop, namely the European Stability Mechanism (ESM) and its predecessor, the European Financial Stability Facility (EFSF), and a more dynamic approach of the European Central Bank (ECB) in terms of monetary policy. Those policies were complemented by clear steps to better supervise and resolve banks inside the euro area (through the setting up of the Banking Union). The establishment of the ESM (and its predecessors) and the rulings of the European Court of Justice allowed providing financial assistance to a Member State of the euro area under strict conditionality, without breaching the “no bail out clause”.

As a follow-up to the sovereign debt crisis, the EU surveillance system of national economic policies has been enhanced. Today, it is a rather comprehensive framework, extending well beyond surveillance of mere rules of public finances. The current EU surveillance framework covers many policy areas, and is aimed at preventing unsustainable economic developments beyond fiscal targets, such as those that occurred in several euro area Member States before the sovereign debt crisis. The extent and the format of this EU level guidance - or steering framework - have evolved, depending on the nature of the policies targeted, the most far reaching being the ones for national budgetary policies.

Recently, policies aimed at making also the principle of “no bail out” of a Member State’s finances more effective have also been discussed and gradually developed. These included policies trying to weaken the doom-loop linking sovereigns and their banks, inter alia by moving banking supervision and resolution to the EU-level (i.e. establishing the Banking Union for the euro area), introducing “collective action clauses” in sovereign debt issued by euro area Member States and emphasising the conditionality attached to any financial assistance granted (namely by stressing the importance of a debt sustainability analysis and of “voluntary” debt restructuring). The possibility to introduce some limits to the holdings of sovereign debt by banks and the introduction of some kind of “safe asset” have also been discussed.

1 For an overview of the various ways to strengthen the EMU governance framework, see a previous EGOV document: “An evolutionary approach to a genuine Economic and Monetary Union” (September 2017).
2 Analysing EMU reform proposals may be complemented with a better understanding of how policies are formed during non-crisis times at national level in relation to EU affairs, in particular Euro Area governance and reform. For some interesting papers on national policy formation in EMU during crisis times, please see recent papers published by the EMU Choices research project funded by European Union’s Horizon 2020: https://emuchoices.eu/.
3 For a recent ESM Discussion paper on the Banking Union, please see “Completing the banking union to support the Economic and Monetary Union” (October 2019).
4 See in particular the Pringle case.
5 See, for instance, two papers commissioned by the EP on “Debt Sustainability Assessments: The state of the art” by C. Alcidi and D. Gros (November 2018) and G. Corsetti (November 2018).
6 Reforms in this direction are included in the revised draft ESM Treaty; a recent report by the Chairman of the High-level Working Group on a Common Deposit Guarantee Scheme mentions further initiatives in this domain, in order to reach a “steady-state Banking Union”. See also two papers commissioned by the EP: E. Jones (May 2019) and S. Rossi (May 2019).
8 See EGOV paper on sovereign bond backed securities for an overview of this discussion.
9 See for example the report by the Chair of the high-level group on the European Common Deposit Insurance.
10 Relying on a stronger role of “market forces” in the current institutional set-up of the EMU may also have its limitations, at least in practice. Based on the experience of the first decades of the euro, the role that financial markets can play in giving
Enhancing the capacity at the EU (or at the Euro Area) level to provide some kind of *macro-economic stabilisation function* in case of major shocks in one or more Member States has also been discussed. Various options have been suggested in this respect, such as a Euro Area budget for fiscal stabilisation (“rainy day fund”), funds to support national reforms and investments, and unemployment reinsurance schemes, among others. On some of these, formal proposals have been already made.\(^{11}\)

Finally, there have also been policy initiatives to introduce *“self-imposed” national rules and institutions*, aimed at limiting the fiscal and economic policies of the Euro Area Member States. Examples of these are the contractual obligation\(^{12}\) for the Member States to introduce so-called *balanced budget rules* into national law, as well as the establishment of independent fiscal institutions and national productivity boards.

These various policy initiatives to strengthen the governance of the EMU do not necessarily conflict with each other. Instead, in an optimal situation, they should aim at reinforcing each other.\(^{13}\)

In order to complement the overview of the EU economic governance framework, the following section provides a simplified outline of the “economic governance framework” in the United States (US) compared, in particular, to the Euro Area (EA). The objective of the comparison is to better frame the uniqueness of the EMU design and facilitate a broader discussion in relation to its reform agenda.

\(^{11}\) For budgetary support for national reforms, a budgetary instrument for convergence and competitiveness (BICC) for the euro area and ERM II Member States on a voluntary basis and a possible instrument for the non-euro area Member States, the Convergence and Reform Instrument (CRI), are under discussions. The CRI would aim at supporting the convergence of non-euro area Member States towards the euro area, by providing financial support for structural reforms. The CRI would draw on the coordination mechanisms of the European Semester, including the country-specific recommendations (see letter from the President of the Eurogroup of 10 October 2019). Furthermore, in her political guidelines as Commission President candidate, Ursula von der Leyen committed to proposing “(...) a European Unemployment Benefit Reinsurance Scheme. This will protect our citizens and reduce the pressure on public finances during external shocks.” See a paper by B. Miroslav and L. Karolien (2017) on the “Feasibility and added value of a European unemployment benefit scheme”. A recent paper on possible lessons from unemployment insurance schemes in US, see C. Luigjes, G. Fischer, F. Vandenbroucke, October 2019: “The US Unemployment Insurance Scheme: A Model for the EU?”. They caution against an oversimplified comparison between the American system and a possible European re-insurance scheme. However, some lessons may be learned from the US experience.

\(^{12}\) This obligation stems from the so-called “Fiscal Compact” (the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)), an intergovernmental agreement aimed at introducing a balanced budget rule in domestic legal orders. Out of the 25 Contracting Parties to the TSCG, 22 are formally bound by the Fiscal Compact (the 19 euro area Member States plus Bulgaria, Denmark and Romania). It was formally concluded on 2 March 2012, and entered into force on 1 January 2013.

\(^{13}\) Many proposals have been raised by academics and EU institutions to establish a comprehensive ‘roadmap’ for EMU reform. For instance, the Five Presidents’ Report on completing the EMU of June 2015 suggested a road map covering the following policy domains: “Towards an Economic Union”, “Towards Financial Union”, “Towards Fiscal Union” and “Democratic accountability, legitimacy and institutional strengthening”. A paper by seven French and seven German economist on “Reconciling risk sharing with market discipline: A constructive approach to euro area reform” (CEPR January 2018) argues that that market discipline and risk sharing should be viewed as complementary pillars of the euro area financial architecture, rather than as substitutes. For instance, they argue that: ‘Creating such incentives requires a credible application of the no bailout rule of the European treaty. Countries with unsustainable debt levels should not expect, and not be expected, to receive fiscal assistance – whether through the European Stability Mechanism (ESM) or any other mechanism — unless they restructure their debts. But this requires an environment in which debt restructuring becomes feasible without large collateral economic damage. In turn, this necessitates more effective euro area-level protection of the viable part of the financial sector, re-walls, stronger macroeconomic stabilisation, more predictable liquidity support when needed, and more risk sharing – through both private and fiscal channels.’ Recently, M. Draghi (October 2019): “All this should make it clear that deepening public insurance by completing the banking union and strengthening fiscal union is not about creating a transfer union. It is about creating a euro area in which there is less need for public risk-sharing in future, because we have the instruments in place to stabilise crises more quickly, and because we have the right framework to allow private sector risk-sharing to develop more sustainably.”
1.2 The EU and the US economic governance frameworks: comparing apples and pears?

In the US, there is no “American Semester for economic policy coordination” covering the economic policies of the constituent States nor an “American Stability Fund” to act as a possible backstop to individual states during crisis times (see also Box 2 below). Why not? There are many institutional differences between the two systems, and the obvious one is that the US is a federal country, while the EU is not. That, in turn, has many consequences for the design and functioning of the economic governance framework.\(^{14\,15}\)

In the US, a supranational (centralised, or in the US terminology, federal) surveillance of the constituent states’ economies may not be warranted because of the relative size of the public sector at the state level, including their outstanding debt stock. On average, state and local level budgets in the US account for around 15 - 25% of their GDP (average in 2016: 19.8%), while in the EU national budgets range from 26 to 56% (the average in the Euro Area, in 2018, was 47%). The aggregate US budget (federal, state, and local) amounts to around 36% of US GDP. In other words, half of the total public budget is controlled by the federal level, and half by the state and local level. Therefore, potential “contagion effects” from one state to another may be less severe (than in the Euro Area) in times of distress in a specific state. This is also due to the fact that the federal government has direct taxation rights and provides some public services directly to the US citizens (e.g. defence, foreign affairs, and justice to some extent) and indirectly through federally funded programmes. Due to the division of taxation rights between state and federal level, the use of debt financing is very different in the two. The aggregated public debt level for EA Member States was 85.1% of GDP in 2018 (ranging from 8.4% in Estonia to 181% in Greece), while the aggregated public debt level of the US states was 14.6% in 2018 (ranging from 4.6% in Wyoming to 23.5% in New York). In the EA, the supranational debt level is minimal (the EU budget is not allowed to be in deficit), while in the US the federal debt level is around 104.2% of GDP.

Moreover, in the US, the states act as sovereign entities, with their own financial/budgetary responsibilities, as defined in the US Constitution. The common understanding, based on historical experience, is that the federal level (or another State) should not “bail-out” a state in distress. Instead, a state is expected to save under economic good times (e.g. via rainy day funds) and to adjust its expenditures to revenues, or to get extra funding from the markets during times of distress. This has implied also major economic and social consequences for the states concerned. Nevertheless, some services provided by the federal level would be guaranteed even during times of distress.\(^{16}\) The Federal Reserve (FED) does not have the right to buy or keep bonds issued by the states on its balance sheet (only bills with a maturity shorter than 6 months).\(^{17}\) This means that the FED cannot play a lender of last

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\(^{14}\) In some respect, one can argue that the objective of the EU economic governance surveillance framework is to be a surrogate of federal economic and budget policies.

\(^{15}\) See also “Fiscal rules in the euro area and lessons from other monetary unions” by N. Leiner-Killinger and C. Nerlich (ECB Economic Bulletin, Issue 3/2019).

\(^{16}\) In early 2009, the Congress adopted an American Recovery and Reinvestment Act (ARRA) with the purpose to stimulate the national economy. As part of that legislation the federal government provided $223 billion for three years of fiscal relief for state and local governments to support core state services. (see R. P. Inman (June 2010): “To get money into the national economy, the federal government must use existing government agencies and government programs. States are effectively federal “agencies” for the purpose of spending federal money, and education aid to states, Medicaid funding, and highway construction grants are three prominent federal programs. Education aid is the most important component of ARRA assistance called “stability aid.” Together these three spending categories – stability, Medicaid, and highway aid – account for just over two-thirds of all state ARRA funding”.


resort role for the individual states. This has the advantage that, in case of a possible default of a single state, the financial consequences for the FED would be very limited. Again, this feature of the US system is a consequence of the federal governance structure of US. The FED uses Treasury bonds issued by the federal government for its monetary policy interventions. Furthermore, one may notice that the federal government bonds attract a 0% risk weight in banks supervisory/regulatory rules, while individual states and municipalities bonds are 20% risk-weighted in the US implementation of the Basel 3 Accord\(^{18}\).

Furthermore, the implicit link between the states’ budget and the financial sector is smaller in the US than in the EA, and has therefore potentially fewer financial consequences for an individual state during a financial crisis. In the US, capital markets play also a larger role in the intermediation between creditors and debtors and thereby in private risk sharing and the federal institutions play a stronger role in supervising and cleaning up banks (and providing deposit insurance). In the EA, the Banking Union is making progress in this direction.

The above-described specific features of the US governance structures limits the potential systemic risk in the US as a whole in the case of financial distress in one or more states.

### Box 2: A simplified comparison of EA and US economic governance frameworks

<table>
<thead>
<tr>
<th></th>
<th><strong>EA</strong></th>
<th><strong>US</strong></th>
<th><strong>State Level</strong></th>
<th><strong>Surveillance of fiscal and economic policies (“prevention”)</strong></th>
<th><strong>Fiscal policy (provision of “public goods”, “transfers” and “stabilisation”)</strong></th>
<th><strong>Principle of “no bail-out” of other sovereign states</strong></th>
<th><strong>A permanent public back-stop for sovereign debt</strong></th>
<th><strong>Principle of no monetary financing of fiscal policies</strong></th>
<th><strong>Government bonds eligible in central bank’s open market operations</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Supranational instruments</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>No/Limited (only the EU budget)</td>
<td>N.A. (incl. assistance subject to strict conditionality)</td>
<td>N.A.</td>
<td>Yes/N.A. (EU not allowed to be in deficit)</td>
<td>N.A. (no real supranational level debt instrument - even if ECB buys ESM and EIB bonds)</td>
</tr>
<tr>
<td><strong>Targeting supranational policies</strong></td>
<td>Yes (“European Semester”)</td>
<td>Yes (“balanced budget rules”, “IFIs”)</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes (incl. assistance subject to strict conditionality)</td>
<td>N.A.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Supranational instruments</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>No/Limited (only the EU budget)</td>
<td>N.A. (incl. assistance subject to strict conditionality)</td>
<td>N.A.</td>
<td>Yes (incl. assistance subject to strict conditionality)</td>
<td>N.A. (no real supranational level debt instrument - even if ECB buys ESM and EIB bonds)</td>
</tr>
<tr>
<td><strong>Targeting national policies</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Surveillance of fiscal and economic policies (“prevention”)</strong></td>
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<td>Yes</td>
<td>Targeting national policies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td><strong>Fiscal policy (provision of “public goods”, “transfers” and “stabilisation”)</strong></td>
<td>No</td>
<td>Yes</td>
<td>Targeting national policies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td><strong>Principle of “no bail-out” of other sovereign states</strong></td>
<td>Yes (incl. assistance subject to strict conditionality)</td>
<td>Yes</td>
<td>Yes</td>
<td>N.A.</td>
<td>Yes (de facto)</td>
<td>Yes (de facto)</td>
<td>No (no permanent mechanism)</td>
<td>N.A.</td>
<td>N.A.</td>
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<td><strong>A permanent public back-stop for sovereign debt</strong></td>
<td>N.A.</td>
<td>Yes</td>
<td>N.A.</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<td><strong>Principle of no monetary financing of fiscal policies</strong></td>
<td>Yes/N.A. (EU not allowed to be in deficit)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td><strong>Government bonds eligible in central bank’s open market operations</strong></td>
<td>N.A.</td>
<td>Yes</td>
<td>N.A.</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

1.3 Some broad questions on lessons learned and possible ways forward

This section proposes broad questions on the experience gained from applying the two main economic governance principles described in section 1.1. The questions look backwards and ask how well the governance framework has worked in practice. The questions also aim at reflecting on what role and weight such principles should play in the future. This could contribute to a wider reflection on the broad governance principles, before undertaking a more detailed discussion on whether and how the relevant EU rules themselves could be revised.

Optimally, policy makers would first agree on the desired design of the governance of the EMU and then identify the gradual steps to reach it. The following questions provide a frame of reference for the subsequent sections, which discuss the current legal framework of the European Semester, the SGP and the Macro Imbalances Procedure (MIP).

What role for the EU surveillance framework?

Is there a general trust that an EU rule-based system has provided and should provide pro-active useful “preventive” policy guidance (beyond expert advice) for national policy-making, even if it cannot, by itself, prevent a financial crisis from occurring in an individual Member State?

If this is the case, one could broaden the questions to other aspects that could make the EMU surveillance framework more effective in its preventive nature:

In general, how broad should the scope of the European Semester be? Which specific national policies should the EU economic surveillance framework cover? Is it possible to identify a selection of national developments and policies that are core for the stability of the euro? Could EU recommendations be made more effective at an early stage, notably during “good economic times”? How exactly could fiscal buffers be build up? How could the risk of emerging macro-economic imbalances be prevented?

And more specifically, how could the political acceptance of EU policy recommendations be improved? How could policy recommendation stemming from the Semester be better integrated into national policymaking? How would the legitimacy and democratic control over the economic and political cycles be improved at EU and national level? What should the balance between discretion and automaticity be in the formulation of the rules? What role should sanctions in the case of non-compliance play? What role could financial incentives linked to the policy recommendations play?

If the actual impact of the EU level policy recommendations seems doubtful, one can expand the scope of questions above to other polices that could facilitate the “adjustment capacity” of the Euro Area Member States, in view of avoiding and/or adjusting to economic shocks. In other words: inside a monetary union there are basically only two ways for national policy makers - prevention of unsustainable policies and enhancing resilience \textit{ex ante} or internal adjustment \textit{ex post} to an economic shock.

What role for other policies beyond the EU surveillance framework?

What other EU or national instruments could improve the capacity for Member States to adjust to a crisis? Which EMU reforms would support each other over time? What priority should be given to other policy initiatives such as the completion the Banking Union and/or Capital Markets Union? Are there ways to enhance to the role of the “no bail out clause” in order to steer the policies of Member States? Would a stronger fiscal stabilisation instrument or common insurance mechanism at the EU/EA level be useful as a tool to assist Member States to adjust to crisis, including in the case of a sovereign debt crisis/debt restructuring? What role can the ESM play in assisting a Member State in adjusting to crisis/shocks?

It may also be reflected upon the relative weight given to the EMU governance principles and how they should evolve over time - i.e. having an EU surveillance system aiming at preventing and improving
resilience and adjustment capacity *ex ante* - and/or an EU crisis management mechanism, aiming at supporting adjustment *ex post* or during a crisis. And therefore, what kind of EMU governance reforms should be pursued that would improve the feasibility and actual functioning on the available instruments over time?

The next sections will give a short overview on how the EU rule-based surveillance framework, i.e. the European Semester, has worked in practice and present some ‘food for thought’ in view of the assessment of the current economic governance regime.

19 The Regulations currently detailing the economic governance rules (namely the so-called “six pack” and the “two pack”) require periodic reports evaluating their application. Such assessment takes place every five years and aims to evaluate, *inter alia*, the effectiveness of the regulations and progress made to ensure closer coordination of economic policies and sustained convergence of economic performances. The first review took place at the end of 2014 and concluded: “The ability to draw conclusions on the effectiveness of the regulations is limited by the short experience of their operation, with the six-pack entering into force in end-2011 and the two-pack only in mid-2013. Not only is this time period short, but it has also been characterised by a severe economic crisis. This leaves the rules untested in normal economic times.”.
2. THE EUROPEAN SEMESTER AT A GLANCE

2.1. A rule-based coordination and surveillance framework

Today, the EU economic governance tools are integrated in the European Semester for economic policy coordination (hence “European Semester”)
20, which mainly results in multilateral and bilateral surveillance at EU-level of Member States fiscal policies under the SGP, economic and structural policies under the MIP, and employment policies under the so-called Employment Guidelines 21. Under the European Semester framework, and based on these EU economic governance instruments, on the national reform programmes and planned fiscal policies by the Member States, the Commission proposes and the Council adopts every year policy recommendations (the so-called Country Specific Recommendations) addressed to the Member States.

In addition to these Country Specific Recommendations (CSRs), the Commission proposes recommendations on the economic policy of the Euro Area as a whole, based on Article 136 of the TFEU; since the 2016 European Semester, these proposals are published at the start of the Semester cycle (in November) to better integrate the Euro Area dimension into the national dimension 22.

There is a number of actors involved in the European Semester at the EU-level, the most relevant being the European Commission, that proposes the priorities of each annual economic cycle (mostly through the Annual Growth Survey) and the Member States in Council and in the Eurogroup, that are responsible for approving the EU policy orientations and recommendations. The Eurogroup has become de facto the forum for political discussion on Semester related matters 23.

The European Parliament is involved in the Semester through its political resolutions and in particular through the Economic Dialogues. These dialogues allow Parliament to be informed on the results of the multilateral surveillance and to scrutinise European institutions involved in setting the priorities and policies: the presidents of the Council and of the Eurogroup and the Commission are due to appear before Parliament to provide information and answer questions. The Parliament can also invite a Member State to an exchange

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20 The concept of the European Semester was introduced by EU Regulation 1175/2011 as part of the 2011 revision of the Stability and Growth Pact (a new Section 1-A of EU Regulation 1466/97, see also Annex of this paper). For an overview of the European Semester and its main actors, see EG0V paper “The European Semester: Main steps at the EU level”.

21 Each year the Council updates employment guidelines.

22 See a separate EG0V note on the Euro Area recommendations for more details.

23 See, for instance, the “Term sheet on the budgetary instrument for convergence and competitiveness (BICC)” as agreed by the Eurogroup on 10 October 2019. The role of the Eurogroup in economic policy coordination has been analysed by E. Enderlein et al (September 2016).
of views in specified circumstances. The underlying EU rules of the SGP and the MIP are also co-decided with the EP.  

One could ask what the difference is between the EU policy recommendations provided under the European Semester (see section below on CSRs) and similar recommendations provided to by OECD or IMF to the respective Members. The main difference from a procedural point of view is that the CSRs are partly based on EU primary and secondary legislation (i.e. the TFEU, the SGP and the MIP) and are adopted by the Member States themselves in the Council (even endorsed by the heads of state in the European Council). In addition, the Member States have agreed in EU-legislation that in case of non-compliance they can ultimately impose financial penalties. In this respect, the EU policy recommendations are formally clearly different from policy advice provided by independent institutions, such as the OECD and the IMF.

For these reasons, the Semester framework is often called an EU “rule-based” governance system. However, it cannot replace economic policy making at the national level. It can, at most, provide a more or less intrusive framework, within which Member States are expected to conduct their policies in view of respecting the common objectives set in the EU Treaties.

While being a surveillance system based on commonly agreed EU rules and procedures, the framework inevitably relies for its application on a degree of discretionary elements, by the Commission and the Council and - on its actual implementation - by the concerned Member States. The deeper and wider scope of the EU surveillance framework that followed the euro crisis has, in parallel, required more room for interpretation in its day-to-day application. This has been a consequence of a reality check that the rule-based framework faced both in economic and political terms.

One may note that M. Draghi, as President of the ECB, has advocated the need to move from a “rule-based system” towards an “institutions based system” also in the area of EU economic governance.

This EU rule-based economic governance framework was revised last time in 2011-2013, following the sovereign debt crisis in the Euro Area. Considering the severity of the euro debt crisis, the hardest in
many decades, it is difficult to assess whether it could have partly been avoided, had the Semester been in place the decade before the crisis. Now, nearly ten years after the introduction of the Semester, the rule-based economic governance framework is up for an assessment and review in the coming months\textsuperscript{28, 29}.

2.2. The role of the Country Specific Recommendations

The CSRs, adopted annually as part of the European Semester, provide policy guidance to EU Member States on macro-economic, budgetary and structural policies in accordance with Articles 121 and 148 of the Treaty on the Functioning of the EU (TFEU). These recommendations aim at attaining the economic objectives of the EU, namely, boosting economic growth and job creation, while achieving or maintaining sound public finances and preventing excessive macroeconomic imbalances. The content and scope of the recommendations have evolved over the years, depending on economic developments and priorities. The CSRs provide guidance for national policies over the following 12-18 months.

Table 1: Distribution of CSRs from a legal basis perspective

<table>
<thead>
<tr>
<th>European Semester</th>
<th>SGP + Integrated Guidelines</th>
<th>MIP + Integrated Guidelines</th>
<th>Jointly SGP and MIP</th>
<th>Exclusively Integrated Guidelines</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>18 (13%)</td>
<td>31 (22%)</td>
<td>5 (4%)</td>
<td>84 (61%)</td>
<td>138 (100%)</td>
</tr>
<tr>
<td>2013</td>
<td>18 (13%)</td>
<td>50 (35%)</td>
<td>6 (4%)</td>
<td>67 (48%)</td>
<td>141 (100%)</td>
</tr>
<tr>
<td>2014</td>
<td>19 (12%)</td>
<td>58 (37%)</td>
<td>8 (5%)</td>
<td>72 (46%)</td>
<td>157 (100%)</td>
</tr>
<tr>
<td>2015</td>
<td>11 (11%)</td>
<td>48 (47%)</td>
<td>10 (10%)</td>
<td>33 (32%)</td>
<td>102 (100%)</td>
</tr>
<tr>
<td>2016</td>
<td>13 (15%)</td>
<td>36 (40%)</td>
<td>9 (10%)</td>
<td>31 (35%)</td>
<td>89 (100%)</td>
</tr>
<tr>
<td>2017</td>
<td>12 (15%)</td>
<td>27 (35%)</td>
<td>8 (10%)</td>
<td>31 (40%)</td>
<td>78 (100%)</td>
</tr>
<tr>
<td>2018</td>
<td>11 (15%)</td>
<td>27 (37%)</td>
<td>5 (7%)</td>
<td>30 (41%)</td>
<td>73 (100%)</td>
</tr>
<tr>
<td>2019</td>
<td>9 (9%)</td>
<td>35 (36%)</td>
<td>5 (5%)</td>
<td>48 (50%)</td>
<td>97 (100%)</td>
</tr>
</tbody>
</table>

Source: EGOV calculations based on the European Commission. See also EGOV database on CSRs. Note: Share of CSRs by secondary legal base for a given Semester cycle in brackets.

As to the process, CSRs are proposed by the European Commission in May each year and discussed by the various Council formations. As a rule, the Council is expected to follow the Commission proposals or explain its position publicly (i.e. the “comply or explain” principle)\textsuperscript{30}. Every year, after being endorsed

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\textsuperscript{28} The wording of the review clauses in the relevant Regulations (473/2013 and 472/2013, amended by 1175/2011 and 1177/2011, and 1173/2011, 1174/2011, 1176/2011), are identical and require revision by 14 December 2019. The review of Directive 2011/85 was due in 14 December 2018 but has been postponed to better fit the review of the remainder economic governance framework. The Commission is generically asked to assess the effectiveness and the progress in ensuring closer coordination of economic policies and sustained convergence of economic performances.

\textsuperscript{29} See the autumn 2019 work programme of the Eurogroup and the discussions of the informal ECOFIN of September 2019. Already in December 2017, J. Dijsselbloem, as the President of the Eurogroup, concluded after the Eurogroup meeting that: “As regards fiscal governance, there was broad agreement that the credibility of our fiscal framework should be enhanced by making it more effective, less complex, and by increasing shared ownership while some have been advocating a stronger reliance on developing market-based fiscal discipline mechanisms. In my view, a possible way forward, which could merit further discussions, could be to ask a high-level working group of independent experts to provide advice along those criteria.” However, no working group was established, while the European Parliament published in spring 2018 three expert papers on ways to simplify the SGP (see Section 4 of this paper).

\textsuperscript{30} One may note, as an example, that the Council did very limited modifications to the draft 2019 CSRs as proposed by the Commission (see separate EGOV comparison table). This may have reflected the uncontentious analyses of the economic challenges of the respective Member States, a close consultation of the respective Member States’ authorities during the
by the European Council and formally adopted by the ECOFIN Council, CSRs are to be taken into account by Member States in their national decision making process, namely when preparing the national budgets and the national reform programmes.

A failure to implement the recommendations might result in further procedural steps under the relevant EU law and ultimately in sanctions under the SGP and the MIP. These sanctions might include fines and/or suspension of European Funds. The Commission has proposed, as part of the Multiannual Financial Framework 2021-2027, to strengthen the link between the policy recommendations of the Semester and the use of the EU budget.

Based on the regular annual assessment published by the COM in its Country Reports, more than half of CSRs (53%) were implemented, on average, with at least some progress over the period 2012-2018. The annual implementation rate of the CSRs followed a downward trend over the period 2012-2016, before showing first signs of improvement in 2017 and a decline again in 2018. The implementation record has been uneven across policy areas and countries (for further information, see separate briefing: “Overview of the Country Specific Recommendations, September 2019”.

preparatory stage, and/or that the annual recommendations, due to their generic nature, have attracted less political attention over time.

31 The European Commission proposed the establishment of the Reform Support Programme (RSP) and Investment Stabilisation Function to strengthen Europe's Economic and Monetary Union on 31 May 2018, as part of the package for the upcoming multiannual financial framework for 2021-2027. RSP will provide financial and technical support for Member States to implement reforms aimed at increasing the resilience of their economies and modernising them, including priority reforms identified in the European Semester. On 24 July 2019, the Commission made a proposal for a Council and Parliament Regulation on the governance framework for a budgetary instrument for convergence and competitiveness for the euro area (BICC). The Eurogroup agreed on the main features of the BICC on 10 September 2019. The need for a “euro area budget” has long been debated, see e.g. H. Enderlein et al (September 2016) who argued that a “small but flexible investment fund used to incentivise reforms” could help reinforcing the role of the Eurogroup in economic policy coordination.

32 Recognising that a number of CSRs relate to long-term structural issues, the Commission included in its Communication on the 2018 European Semester an assessment of CSRs implementation from both yearly and multiannual perspectives (including progress on compliance with the SGP). The latter approach was introduced in 2017 and according to this yardstick “more than two thirds of CSRs have been implemented with at least “some progress”” over the period 2011-2017, leading therefore to a somewhat more favourable picture of the CSRs’ implementation record, when compared with the year-by-year assessment. However, the Commission has not published the methodology underpinning their multiannual assessment and this renders the link between the annual recommendations and their multiannual assessment by the Commission unclear.

33 H. Enderlein et al (September 2016) argues that CSRs are not efficient benchmarking instruments to measure progress on converging and implementing economic policies (“Benchmarking could help in monitoring reform progress if CSRs were formulated in a way that makes progress measurable, and the convergence process was defined clearly. Currently, these elements are still missing.”).

34 See a recent working paper by IMF staff (October 2019) on “The Political Costs of Reforms: Fear or Reality?”). In the paper it is argued that structural reforms are motivated by multiple policy objectives. They can foster medium-term economic prospects and living standards by raising productivity and employment, improving debt sustainability, and enhancing the resilience of the economy to shocks. The results of the empirical analysis suggest that, while on average reforms are associated with electoral costs, specific effects depend on the type of reform and on when in the electoral cycle reforms are implemented.
3. SOME REFLECTIONS ON THE EUROPEAN SEMESTER FRAMEWORK IN GENERAL

3.1. What relationship between policy objectives and underlying tools?

The current main EU economic governance tools (mainly the SGP, the MIP and the Integrated Guidelines) are all part of the annual Semester cycle of economic policy coordination.

However, the objectives to be achieved (namely, sustainable public finances and reforms for sustainable growth, but more recently, additional socially oriented objectives) and their relationship to the underlying governance tool may not always be clear for policy makers and citizens. Such disconnect may hamper their effectiveness in practice. The number of policy objectives that can be realistically attained within one governance framework would also need to be taken into account.

In the event that the Semester remains the main framework for economic policy coordination and surveillance, it would be useful to be as clear as possible in what concerns the link between each specific EU tool and the objectives to be achieved. This could help the public understanding and legitimacy of these EU tools and, thereby, the effectiveness of the related policies pursued under the Semester.

As a general remark, the objective of the main EU economic governance tools, the SGP and the MIP, is to try to “prevent” unsustainable fiscal, economic and social policies, while the objectives of the policies under the integrated guidelines are more targeted to “promote” sustainable policies and practices. For instance, the integrated policy guidelines are mostly targeted to promote “best practices” under the so-called “open method of coordination” (e.g. the EU2020 targets, see Box 4).35

However, today, only a few annual policy recommendations are adopted by the Council under a single EU instrument (e.g. SGP or MIP or Integrated guidelines). Instead the CSRs are underpinned by a joint legal basis (e.g. SGP and the integrated guidelines or MIP and the integrated guidelines, see separate EGOS briefing). This risks rendering unclear the assessment of compliance with the recommendations under the respective EU instrument. Trying to separate better the underlying surveillance tool in accordance with its core objective (e.g. “try to prevent” versus “try to promote” certain policies) could make the framework more transparent.

3.2. A reinforced EU coordination framework for sustainable growth and jobs?

One option would be to transform the European Semester into the main policy coordination framework, supporting a comprehensive EU strategy for sustainable (and inclusive) growth, with corresponding annual and/or multiannual policy recommendations (hence “renewed Semester”).36

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35 The open method of coordination (OMC) may be described as a form of ‘soft’ law. It is a form of intergovernmental policy-making that does not result in binding EU legislative measures and does not require EU countries to introduce or amend their laws. It provided a new framework for cooperation among the EU countries, whose national policies can thus be directed towards certain common objectives. Under this intergovernmental method, the EU countries are evaluated by one another (peer pressure), with the Commission’s role being limited to surveillance. The European Parliament and the Court of Justice play virtually no part in the OMC process. The OMC takes place in areas, which fall within the competence of EU countries, such as employment, social protection, education, youth and vocational training (Glossary of summaries, EU LEX).

36 The European Parliament emphasised in its resolution of 10 October 2019 that “the Union’s social and economic goals should have equal priority and secured financial resources within the next budget, and that the European Semester should be enhanced to include a social dimension all throughout its cycle involving the competent bodies of the EU and Member States which deal with social policies; urges the Commission to enhance the CSRs for Eurozone members by creating a matrix framework where social policies related to the European Pillar of Social Rights, such as inclusive access to education, health, nutrition, employment and housing, and the preservation of social rights, are analysed by social segment, for example children, young people, older people, minorities, migrants and people with disabilities, thereby creating a much more accurate image of the economic and social health
The reviewed framework would be based on the “open method of coordination” (e.g. “peer support and peer pressure”) and possibly, in some cases, linked to the use of EU funds. This would enable positive peer pressure based on best practices on a wider set of policies. It could be built on the integrated guidelines as set out in the TFEU in order to be backed by an EU legal framework.

It could take the form of an EU act framing the respective roles of the competent bodies at the EU and national level, developed on the basis of the current legal definition of the Semester (see Annex to this paper). This upgraded coordination framework could include a set of long-term objectives (i.e. beyond the EU2020 strategy), indicators to measure progress, and annual or multi-annual policy recommendations on a variety of policy objectives (e.g. green investments, social inclusion, education system, public administration, labour productivity etc.). For instance, in the 2019 CSRs proposed by the Commission in June 2019, recommendations on how to address possible “investment gaps” have been included. Policy measures to promote private and public investment will surely remain high priority in the coming years, notably as part of modernising and greening of the European economies.

This renewed Semester framework would aim for policy recommendation targeting “upward convergence” among and inside the Member States. The Social Rights Pillar could be fully integrated into this new EU policy guidance framework.

The upgraded framework should build on the lessons learned from the current European Semester. However, it would be useful to better frame the relationship between the policy recommendations and the expected timeframe and deliverables to achieve them, in view of reaching the long-term objectives (as explained above under 3.1). This may become even more relevant with the introduction of EU budgetary resources linked to the implementation of some national reforms under the guidance of the Semester.

Also, some attention would be needed on the timeframe of the recommendations issued under the European Semester. In some cases, it may be more relevant to have annual recommendations and targets, and in other cases, a multi-annual approach could provide more tangible results. In this respect, the reviewed framework would be based on the “open method of coordination” (e.g. “peer support and peer pressure”) and possibly, in some cases, linked to the use of EU funds. This would enable positive peer pressure based on best practices on a wider set of policies. It could be built on the integrated guidelines as set out in the TFEU in order to be backed by an EU legal framework.

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it would also be important to ensure that policy initiatives proposed by Member States (in their “national programmes”) and the recommendations adopted at the EU-level be well integrated into the concrete work programmes of each national government.

3.3. Specific policy instruments aiming at preventing unsustainable policies inside the monetary union

As clearly identifiable instruments of the “renewed Semester”, the policy recommendations under the SGP and the MIP would focus on those national developments and policies that may need specific attention due to the fact of belonging to a common currency area (or planning to join it). This should not be seen as downgrading the importance of other Semester related objectives that need also to be addressed as a “common concern”, such as tackling climate change as part of any sustainable economic policies.

Those core EMU economic governance tools would aim to target economic policies that, if not addressed in time, could potentially have a significant negative impact on the stability of the euro (“common concern for the Euro Area as a whole”), and are essentially due to the loss of monetary and exchange rate policies at country level (see also Box 1 on the specific features of the monetary union).

These EU policy guidance tools of “preventive nature” could be clearly identified as part of the broader Semester framework. Policy recommendations should only be made based on country specific analyses and target potentially large or lasting “policy mistakes” from a joint Euro area perspective. This approach would need a strong common understanding of the policies that would deserve special attention. In this respect, the policy recommendations for the Euro Area would be targeted to specific needs of the Euro Area and its Member States and would aim at refraining Member States from certain policies that could in the longer run jeopardising financial stability.

Therefore, any decisions to trigger policy action in the concerned Member State would need a broad support both at the national and EU level before any final decision is taken at the EU level, notably by the Commission and the Eurogroup/Council. This broad consultation, as part of the preparatory phase, could involve opinions of various competent bodies at the EU level (e.g. the European Fiscal Board (EFB) for public finances and the European Systemic Risk Board (ESRB) for potential macro-prudential risks).

39 For an overview by the Council of lessons learned from the 2019 Semester cycle, see the note prepared by the EPC and EFC-altarnates (Council document 12465/19). For example, they conclude: “When addressing less severe challenges or addressing challenges where Member States have shown decisive reform action in previous years, the CSRs could be less prescriptive. While allowing for more room for the Member States to tailor their response to country specificities, they should remain sufficiently specific to be amenable to an ex-post evaluation. At the same time, if a Member State has not responded to recommendations with decisive reform action in previous years, new recommendations could be more prescriptive. Some CSRs could be formulated as multi-annual due to the expected length of their implementation.”

40 Article 1 of the Regulation (No 1466/97) on the preventive arm of the SGP: “(...) sets out the rules covering the content, the submission, the examination and the monitoring of stability programmes and convergence programmes as part of multilateral surveillance by the Council and the Commission so as to prevent, at an early stage, the occurrence of excessive general government deficits and to promote the surveillance and coordination of economic policies thereby supporting the achievement of the Union’s objectives for growth and employment.”

41 Article 1.1 of the MIP-Regulation (No 1176/2011): “(...) sets out detailed rules for the detection of macroeconomic imbalances, as well as the prevention and correction of excessive macroeconomic imbalances within the Union.”.

42 See for instance, a working paper by IMF staff (January 2018) on “Economic Convergence in the Euro Area: Coming Together or Drifting Apart?”.

43 See D.J. Bokhorst (May 2019) on “Governing imbalances in the Economic and Monetary Union”.

44 See recent Commission technical note on “Competitiveness and external balances, Main drivers and challenges ahead”: “The building up of current account imbalances and price competitiveness divergences in the euro area before the financial crisis was followed by their abrupt unwinding. Current account reversals were accompanied by major recessions and soaring unemployment in countries with large current account deficits; euro-area convergence came to a halt. With hindsight, the potentially harmful implications of current account imbalances and price competitiveness divergences at euro area level were underestimated in the first EMU decade.”
and similarly at the national level (e.g. national fiscal councils and national productivity boards). An EU level independent body, mandated to coordinate the work of the national productivity boards, could be envisaged. As today, these policy recommendations with “preventive nature” would be adopted by the Member States in the Council based on a proposal of the Commission.

These preventive tools would still be assessed in light of not endangering the long-term objectives of the renewed Semester framework. In other words, the broader Semester framework should aim to upward convergence among the EU Member States, while the SGP and MIP should aim at avoiding major divergence or imbalances in the Euro Area Member States. Under these procedures, the right balance between “peer support”, “peer pressure”, “financial benefits” and “financial penalties” should be sought. In addition, some kind of “positive consequences” could be established for the reforms and measures undertaken by the Member States under the revised European Semester framework. Some form of “negative consequences” could also be envisaged, in particular if there would be a solid case of repeated non-respect of policy recommendations aimed at avoiding certain policies that could ultimately endanger the “shared responsibility” for the stability of the euro.

3.4. How to go beyond the rules in the Semester framework?

Today, the regular assessment by the Commission of CSR implementation per Member State gives indications on how the Semester is contributing to steer, notably in a preventive manner, the fiscal, economic and social policies in the EU.

The effectiveness of these EU rule-based recommendations depends largely on Member States willingness and ownership of the recommendations and the shared belief that the commonly agreed policies are the ones appropriate for the EU and each of its Member States. Therefore, a debate around reforming the Semester - in view of making it an integral part of national policy-making - may need to go well beyond the underlying legal instruments of the Semester, in order for the related policy recommendations to be politically accepted and implemented over the economic and political cycles in the EU and its Member States.

At the EU level, one could consider ways to anticipate and make more transparent the debate on the EU policy recommendations, to increase peer support and pressure. One option could be to give more prominence to the Country Reports prepared by the Commission services as the underlying tools for discussing and assessing country specific challenges. Nowadays, these reports are mostly discussed at technical level in the preparatory bodies of the Council and, before that, bilaterally with Member States at administrative level. Increasing the public knowledge and debates of these reports could also

45 E.g. S. Sapir and G. Wolf (February 2015) on “Euro-area governance: what to reform and how to do it”.
46 For possible definitions of convergences in the EMU and the policy tools to achieve them, see also two papers commissioned by the EP: J. Creel (2018) and M. Dolls, C. Fuest et al. (2018) on “Convergence in the EMU: what and how?”. Convergence can be analysed from many perspectives, amongst others, real convergence addresses convergence in income levels and living standards, nominal convergence covers nominal indicators such as interest rates and inflation rates, and cyclical convergence focuses on the synchronicity of business cycles across Member States.
47 See, as an example, what X. Ragot (November 2017) argues: “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.”
48 See, as an example, C. Alcidi and D. Gros (November 2017), “emphasis of the European Semester should shift from economic policy coordination (...) to a stronger national ownership. Coordination of national policies may be essential at times of crisis, when cross-country spillover effects tend to be large, but it may not be very effective when economic conditions return to normal, as spillovers tend to be small and the incentives for governments to coordinate lessen. Stronger national ownership should lead to better enforcement of commonly agreed rules, regardless of economic conditions and should take away the perception that rules are hierarchically imposed.”.
49 There has been a discussion on how to best safeguard the analytical independence of the relevant Commission services.
support the acceptance of the EU policy recommendations that will stem from their analyses and consultation.

Content and format wise, the Country Reports could be differentiated according to the country specific challenges and risks for the Euro Area as a whole.

For all EU Member States, the annual Country Reports could cover the objectives of the reinforced Semester strategy for sustainable growth and jobs (“upward convergence”).

Additionally, the annual Country Reports for Euro Area Member States (and ERM-II countries, on a voluntarily basis) could include three more separate sections: one related to potential macroeconomic imbalances, one related to the sustainability of public finances and one related to country specific developments in relation to the Euro Area. At the national level, the national productivity boards and the independent fiscal councils could also be invited to prepare and publish an annual report on the developments and challenges in their jurisdiction by year-end. These reports could be presented in national parliaments and the Commission would be invited to take them into account in its analysis of the Country Reports and in the preparations of the Euro Area recommendations.

Euro Area countries assessed at risk of excessive macroeconomic imbalances could, in addition, be provided with a specific report. Similarly, Euro Area Member States at risk of a significant deviation from their obligation under the SGP would be addressed with a specific report on sustainability of their public finances (risks in short, medium and long term). These specific reports, as prepared by the Commission whenever necessary, could then be discussed and analysed in the Eurogroup and the respective governments could be invited to a public dialogue in the competent Committee of the European Parliament. In addition, the Commission could be invited to present and discuss such a report in the concerned national parliament.

This differentiation could facilitate the public policy discussions (ahead of possible more intrusive EU policy recommendations, such as the opening of an excessive imbalances procedure or excessive deficit procedure) and concentrate attention where peer pressure and support is more necessary, in view of the risks to the Euro Area as a whole. Faced with a more focused set of policies and challenges to analyse, the Eurogroup could render its discussions more effective in coordinating economic policies.

Currently, work is also ongoing to see whether the recommendations could be made more relevant, by linking them to possible EU budgetary instruments50.

Other possible routes would be to find ways to better integrate the policy recommendations (as adopted by the governments at the EU level in the Council) into the national policy-making (aiming at increasing a common and shared “political ownership” of the process). This could take various forms:

- taking better into account the election cycles in the respective Member States (e.g. after elections, a new government would be invited to send an updated national reform programme in order to reflect the priorities of the new government and EU commitments stemming from the Semester framework);
- trying to better target the policy recommendations with short and long-term country specific policy objectives and progressively more detailed and intrusive (as already underlined above);
- re-inventing ways to enhance the involvement of the national parliaments during the various stages of the Semester at the national level (in order to be able to scrutinise their governments’ EU commitments and related actions);

50 See, notably the “Term sheet on the budgetary instrument for convergence and competitiveness (BICC)” as agreed by the Eurogroup on 10 October 2019. C. Alcidi and D. Gros (November 2017) argue against linking CSRs and budgetary instruments: “Moreover, strengthening the Semester by further linking the EU budget to reforms undertaken in the Member States is fine in theory but very difficult in practice. Reforms cannot be ‘bought’ as such and it would be extremely difficult to measure the implementation of the CSRs precisely enough to make implementation a condition for funds.”.
- establishing a common understanding of how stakeholders are consulted during the Semester process; and
- giving a stronger role of the respective national institutions (e.g. independent fiscal institutions and productivity boards) during both the preparatory and implementation stages of the EU policy recommendations.

Another possible avenue to explore is to reinforce the role of the Eurogroup in economic policy coordination at the Euro Area-level. For instance, there has been a debate for some time on making the role of the President of the Eurogroup a full-time job.

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51 Based on an EGOV survey on the degree of the involvement of national parliaments in the Semester varies in the EU Member States. The EP services and national parliament administrations have hence established a network to strengthen technical co-operations on the European Semester process. Some researchers have even proposed minimum standards for the participation of national parliaments in the European Semester and the creation of an inter-parliamentary working group in order to increase national ownership and democratic control (V. Kreilinger, January 2019).

52 H. Enderlein and J. Haas (September 2016) argue that the Eurogroup could fill a gap in economic policy coordination by “officially assuming the responsibility for achieving the euro-area CSRs, following up on country-level CSRs and possibly taking up an active role in the MIP.” and propose a number of avenues to reach such objective.

53 This was recently also proposed by the European Fiscal Board: “EFB is convinced that the functioning of the Eurogroup could be improved if it was chaired by a full-time president, who is neither a national Finance Minister nor a member of the Commission. Considering the relatively high turnover of Finance Ministers in the Eurogroup this would improve continuity and the governance of the euro area as a whole.” For an overview of the role of the President of the Eurogroup, please see separate EGOV briefing.
4. THE FISCAL SURVEILLANCE FRAMEWORK

4.1. A detailed EU rules-based fiscal surveillance framework

Today, the surveillance of Member States’ budgetary policies is based on the rules of the SGP, as enshrined in primary and secondary EU law and in agreed underlying methodologies. Its design has evolved over time since the Maastricht Treaty. The primary objective of the SGP is to ensure the sustainability of public finances of the Member States, in the interest of the stability of the EMU. It consists of two main building blocks: the preventive arm and the corrective arm (see Box 5). The rules aim also at preventing pro-cyclical national fiscal policies that may have negative consequences on the economic situation or on the sustainability of public finances.

Box 5: The SGP in a nutshell

The preventive arm of the SGP endeavours to ensure that fiscal policy is on a sustainable track over the economic cycle. It requires Member States attaining a country-specific medium term objective (MTO) for their budgetary position. This is set in structural terms, i.e. excluding effects of the economic cycle and any one-off and other temporary measures. For Member States that are not at their MTO, an appropriate adjustment path towards it is defined and should adhered to. By setting a budgetary target in structural terms, the preventive arm of the Pact aims to ensure that the underlying fiscal position of Member States is conducive to medium-term sustainability, while allowing for the free operation of automatic fiscal stabilisers. Today, compliance with the requirements of the preventive arm is assessed using a two-piller approach. The assessment of the structural balance, which constitutes one pillar, is complemented by an analysis of the growth rate of an expenditure aggregate net of discretionary revenue measures (i.e. an assessment of compliance with the so-called expenditure benchmark), which constitutes the other pillar.

The corrective arm of the SGP governs the Excessive Deficit Procedure (EDP).

The EDP is triggered by:

• the deficit breaching the 3% of GDP threshold or
• the debt being above 60% of GDP and not diminishing at a sufficiently rapid pace as defined by the debt reduction benchmark stipulating that the distance to the 60% threshold should be reduced by 5% on average per year (over the past 3 years or in the next 2 years), also taking the economic cycle into account.

If the Council decides, on the basis of a Commission recommendation, that a deficit is excessive, the Council issues a recommendation to the Member State concerned to correct the excessive deficit and gives a time frame for doing so. In its recommendation, the Council shall request that the Member State achieve annual budgetary targets (‘fiscal effort in structural and/or nominal terms’) which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement of the structural balance of at least 0.5 % of GDP as a benchmark, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation.

This EU rule-based fiscal surveillance framework was revised in 2005 and again in 2011 (as part of the so-called “Six pack”), after the sovereign debt crisis in the euro area; it was then complemented with an annual early warning surveillance of draft national budgets of the Euro Area Member States (as part of the so-called “Two pack” in 2013) and an intergovernmental agreement on the introduction of national balanced budget rules. In 2016, the Council (ECOFIN) endorsed Commission proposals relating to the use of “flexibility” in the application of the SGP (notably of its preventive arm) and to a stronger focus on the expenditure benchmark. Today, the SGP is the most granular or fine-tuned surveillance

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54 Treaty on Stabilisation, Cooperation and Government (TSCG) whose fiscal component is called Fiscal Compact and on whose basis a Member State can bring another Member State to the European Court of Justice in case it considers that the latter has failed to comply with specific provisions of the Treaty.

55 “Commonly agreed position on flexibility within the SGP: Flexibility for cyclical conditions, structural reforms and investment” was endorsed by the ECOFIN Council in February 2016 and was annexed in May 2017 to the code of conduct on
instrument of the European Semester framework, but has been criticised by many academics and policy-makers for being too complex.

The European Fiscal Board (EFB) in its report of August 2019 “Assessment of EU fiscal rules - with a focus on the six and two-pack legislation” (EFB August 2019) analyses Member States’ compliance with the various fiscal rules in place within the EU from an evolutionary and broad approach. It concludes that compliance has been mixed and differs markedly depending on the concrete fiscal rule considered and the periods of comparison and notes that evidence of what would have happened if the EU had continued to rely on the pre-crisis rulebook is not available, so conclusions are necessarily tentative.

4.2. What are the underlying reasons for the complexity?

According to a paper produced by Commission staff, it would be useful to understand the root causes of the complexity of the SGP and reaching a shared view would be crucial before embarking on reforming the EU fiscal framework. They conclude:

“In order to capture all kinds of possible situations while maintaining a sufficient degree of predictability, the tendency has been to put in place incremental, detailed ex ante specifications in an elusive quest for a ‘complete contract’. The need to take into account evolving economic realities and policy preferences entailed the repeated introduction of new sub-rules and/or exceptions to the rules. This was a recognition that the rules must be at the same time predictable and adaptable to circumstances. Even then, this approach disregarded the fact that no system could eliminate or template the necessary role of economic and political judgement in unusual circumstances or in borderline cases. Moreover, the lack of simplicity generated by this over-specification turns against its proclaimed objective of predictability.”

Fundamentally, the dilemma faced by EU fiscal rules and mentioned above is actually a trilemma between adaptability, enforceability and simplicity (see Figure 1). The absence of a single authority for adjudicating on compliance, consistent with the multi-level governance characterising the EU, exacerbates the tensions between the three elements. It is also a reason for doubting that a state-of-the-art design of the rules would be sufficient to ensure a smooth working of the system.”

the implementation of the SGP; the new elements include: (a) a matrix specifying the ‘good times’ and ‘bad times’ and the corresponding appropriate fiscal adjustments; (b) specifications on the “structural reform clause” and the “investment clause” allowing temporary deviations from the adjustment path towards the MTO; for each of both clauses the allowed temporary deviation does not exceed 0.5 % of GDP and the cumulative temporary deviation granted under the both clauses shall not exceed 0.75 % of GDP. The Code of conduct contains since November 2016 also annex which puts a stronger focus on the expenditure benchmark.

56 This document was requested by the President of the Commission, J.C. Juncker, in January 2019, who specified also the broad terms of references. The assessment was carried out against three main criteria: (1) ensuring the long-term sustainability of public finances; (2) stabilising economic activity in a counter-cyclical fashion; and (3) improving the quality of public finances.

57 See, notably: “An empirical analysis of numerical fiscal rules at the EU level shows that, following the six and two-pack reforms, compliance has generally increased even though it is difficult to establish a clear causality. Compared to the pre-crisis period, average compliance across all EU numerical rules has marginally improved from 57% to 63%. However, the compliance rates of individual rules differ widely when comparing the periods 1998-2007 to 2011-2018. Compliance with the structural balance rule increased from 44% to 63%, while compliance with the debt rule declined from 83% to 59%. In practice, compliance with the debt rule has been waived by referring to other relevant factors (i.e. compliance with the preventive arm and structural reforms) in the assessment. In high-debt countries that made use of flexibility within the SGP, the medium-term sustainability of public finances has weakened.”

58 See S. Deroose et al, “EU fiscal rules: Root causes of its complexity” (14 September 2018) in VOX.
In the last years, the complexity of the rules has also been subject of Eurogroup and ECOFIN discussions. In this regard, the President of the Eurogroup in function at that time noted in November 2017:

"On the rules themselves, the returning issue is that they are complex, they are not predictable, they are sometimes not based on observable criteria. That makes it difficult for national ministers to design their budgets, to explain what happens to their electorates, and that is an issue that keeps coming back. On the other hand, we all know why the rules are complex: because we want to take into account all different circumstances that may arise and we have allowed for a number of flexibilities. This has also made the rules more complex. I think we have to be realistic there: when people say let’s make rules much more simple, I am not sure that they want accept that they could also become much more harsh, in difficult circumstances. So that is a trade-off that we must realise.”

4.3. The debate on structural balances

The structural budget balance is the nominal budget balance adjusted by the cyclical component, excluding one-off and temporary policy measures. A significant part of the complexity of the rules stems from their reliance on the structural balance and on the indicators underlying it, namely the potential output and output gap.69. Given that the output (and therefore the structural balance) is an unobservable variable, a stronger focus has been put since 2016 on the observable indicator “budget expenditure growth”.60.

The EFB (EFB August 2019) expresses the same criticism and further adds: “The sources of unnecessary complexity include: (i) an excessive reliance on unobservable indicators; (ii) badly timed use of flexibility encouraging pro-cyclical fiscal policy; (iii) a tendency towards postponing fiscal adjustments to the outer years of the stability and convergence programmes.”

Commission staff defended recently the EU methodology to calculate potential output, output gaps and structural balances, inter alia by highlighting that the Commission is far away from using a “rigid, mechanical approach based solely on an evaluation of output gaps”, but includes in its assessments of national budgetary plans “constrained judgement” and flexibility.61.
However, large revisions, notably concerning the level of structural balances, remain a matter of concern. Experience has shown that these estimations include a lot of uncertainty, in particular following a long period of rather high level of nominal growth or after an economic and financial crises.

Any reform of the SGP that aims to avoid pro-cyclical national fiscal policies (see following section) would need to take into account the “economic cycle” and reflect that in the related policy recommendations. This means that an element of uncertainty linked to the estimation of the current economic situation in relation to the potential output of the country in question would always remain, at least to some extent. As such, the estimation of the potential output of an economy would remain part of such a reform.

4.4 The debate on pro-cyclical fiscal policies

Automatic fiscal stabilisers refer to expenditures and revenue items in government budgets that operate in ways that smooth the economic cycle. These are found to have played their role to a considerable extent in the first two decades of the EMU, possibly halving the amplitude of the cycle. However, discretionary fiscal policies have frequently overruled the working of the automatic stabilisers, thus muting their smoothing impact on the economic cycle, both in good and in bad times.

Box 6: External experts’ papers for the EP: “Are the current automatic stabilisers in the Euro Area Member States sufficient to smooth economic cycles?” (May 2019)

M. Dolls, C. Fuest, A. Peichl, F. Schleef conclude that while automatic stabilisers have played an important role in the early phase of the financial and economic crises in 2008/2009, their countercyclical effect was partly offset in some Member States by a pro-cyclical fiscal stance in other years, in particular throughout the period 2011-2016. The report concludes that Euro-area fiscal governance needs to be improved and that it is key to build up fiscal buffers in good economic times so that automatic stabilisers can operate freely in prolonged downturns.

P. Van Den Noord assesses that automatic stabilisers have possibly halving the amplitude of the cycle – in the first two decades of the EMU. However, he shows that in the context of the financial crisis many Member States again failed to abide by the spirit of the EU rules letting automatic stabilisers play freely (while respecting the 3% deficit ceiling). The standard policy prescriptions to prevent such a chain of events from repeating itself is for governments to consolidate their budgets so as to allow the operation of ‘automatic stabilisers’ within the limits set by the fiscal rules. However, it may well prove difficult for governments to resist the temptation to resort to fiscal leniency when cyclical fiscal windfalls re-emerge in good times, thus adding fuel to the cycle and sowing the seeds for a return to fiscal distress in bad times. In some sense this invalidates the consensus view that the Euro Area, owing to the comparatively large size of its Member States’ public sectors, would benefit from stronger automatic stabilisers than e.g. the United States. Indeed, by extension, the perverse incentives for governments to ‘spend’ cyclical windfalls in good times and vice versa in bad times may well also be stronger in the Euro Area than in the United States.

He also notes that many observers have argued – even prior to the creation of the euro – that such incentives could be mitigated if the windfalls and shortfalls stemming from the operation of the automatic stabilisers would be used as cyclical buffers in a pan-European buffer fund, to which Member States contribute in good times and can draw on in bad times. However, while the economic rationale for such a device looks strong on paper, the operational challenges may be substantial and the political appetite for it is low.

A. Fatas argues that, since 2008, and as the result of central banks reaching the zero-lower bound, fiscal policy has come back as a potential, possibly primary, tool to stabilise business cycles. He shows that European countries have historically relied on automatic stabilisers for counter-cyclical policies, while discretionary fiscal policy has been pro-cyclical (unlike in the US). Pro-cyclical fiscal policies became so strong in the years 2010-14 that they completely eliminated the benefits of automatic stabilisers. He argues that automatic stabilisers should be strengthened and that the reasons behind the pro-cyclicality of discretionary policy should be addressed.

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62 See, as an example, the recent paper by Z. Darvas “Why structural balances should be scrapped from EU fiscal rules”.
In fact, the relative large size of the automatic stabilisers may give “pervasive” incentives for “overspending” through discretionary fiscal measures in good economic times (see Box 6 above).

Some economists show that the use of structural balances within the SGP rules can have (and has had) pro-cyclical impacts, notably due to surprises in GDP growth and their impact on potential output and fiscal policies; they argue that the impact is due to the way potential output is calculated by the Commission (via a method agreed with Member States).

One way to try to avoid too pro-cyclical fiscal policies would be to try to avoid the potentially counterproductive role of discretionary fiscal policies, both during good and bad economic times. The framework could aim to restrict too expansionary discretionary fiscal policies during times of economic growth and instead lean to the more cautious side when deciding on any new discretionary fiscal initiatives during good times. For instance, as regards windfall gains or higher tax revenues during good times, some of them could be automatically transferred to rainy day funds or to reduce outstanding public debt. For instance, Ireland adopted legislation on a “rainy day fund” (Reserve Fund for Exceptional Contingencies) in June 2019. By moving from pure rules to the establishment of national rainy day funds and some new Euro Area resources (e.g. BICC), the EU economic governance framework would take some steps from purely “rule-based” towards “institution-based” governance of the EMU as advocated many times by the President of the ECB (see Section 1).

4.5 The debate on simplification

There have also been many proposals in recent years on how the SGP could be reformed, many of them try to find ways to simplify the underlying rules (see Box 7 below).

<table>
<thead>
<tr>
<th>Box 7: External experts’ papers for the EP on “The simplification of the SGP” (April 2018)</th>
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<tbody>
<tr>
<td><strong>C. Cottarelli</strong> proposes (i) removing some margins of flexibility, without changes in the legislation; (ii) a legal simplification, including relaxing some of the SGP long-term parameters or reconsidering the coexistence of the MTO rule and the expenditure benchmark; and a more radical solution (iii) by shifting to a single rule in which an “operational target” responds to deviations of public debt from its long-term objective;</td>
</tr>
<tr>
<td><strong>F. Heinemann</strong> reflects on a number of possible amendments where (i) the greatest potential for simplification would result from a shift of discretionary power to an independent fiscal institution; (ii) the preventive and corrective arms could be integrated into one procedure, the integrated procedure would be centred on a net expenditure rule combined with a debt feedback mechanism and a memory for expenditure overruns; further fiscal indicators (headline deficit rule and structural balance) would be downgraded to non-binding reference values and the planned transposition of the Fiscal Compact into European law should follow SGP reforms, in order to promote consistency between European and national fiscal rules;</td>
</tr>
<tr>
<td><strong>G. Kopits</strong> offers three options for future reform: (i) the structural balance and the debt convergence targets are replaced with a debt-stabilizing or -reducing primary surplus target, while retaining the expenditure benchmark; (ii) to consolidate all current rules into a single operational debt rule by setting a limit on the discretionary budget deficit, derived from the debt reduction target; (iii) a market-based approach which is essentially an autonomous regime of rules, in contrast to coordinated or centralised regimes.</td>
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The EFB proposes in its recent publication (EFB 2019) to overcome the complexity of the current EU fiscal framework by simplifying the EU fiscal rules and by improving the governance of the fiscal framework and advocates for a reformed SGP, which would be based on:

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63 See e.g. Zsolt Darvas: “Why structural balances should be scrapped from EU fiscal rules”, October 2019.

64 See: [https://www.oireachtas.ie/en/bills/bill/2018/116/?tab=full-text](https://www.oireachtas.ie/en/bills/bill/2018/116/?tab=full-text). See note by the Irish Fiscal Council: “An additional tool, such as a rainy day fund, may be useful to set savings aside in good times providing room for fiscal stimulus when needed. Another potential benefit of a rainy day fund is that it could be used to save potentially transient revenue sources (e.g., unexpected surges in corporation tax receipts) rather than using these to fund permanent expenditure increases (...) Contributions to and withdrawals from a rainy day fund should be linked to the economic cycle and should not be capped or time limited.”
• one single target (sustainable public debt), which could be made country-specific and cover a seven-year cycle;
• one single instrument (controlling net expenditure growth, to be linked to potential growth);
• one general escape clause, triggered based on independent economic judgement

In that context, the EFB proposes the introduction of a limited “golden rule” to protect public investment, while avoiding overburdening the EU fiscal rules with too many conflicting objectives; more concretely, the proposed golden rule would exclude some specific growth-enhancing expenditure (notably national top-up expenditures to projects already identified by the EU budget) from the net primary expenditure growth ceiling. The purpose of the proposal is to reduce the risk that governments unduly classify certain expenditure items as public investment.

Any approach to give more prominence to public investments would require a clear understanding and agreement on what kind of public investments could be given a special treatment under the SGP, considering all potential aspects related to effectiveness, efficiency, feasibility, measurement and timeliness. In that regard, any reform protecting public investments within the SGP would need to take into account the ongoing broader discussion on financial instruments allowing Member States to further pursue the policies that are commonly agreed in the context of the proposal for the BICC65.

Today, some attention is already given to the role of public investments within the rules of the SGP, notably in view of the adjustment path for Member States reaching their MTO under the preventive arm 66. Under the corrective arm, public investment may only be implicitly protected, since the Commission stated in its Communication on flexibility that it may take into account public investments as “relevant factors” (under “structural reforms”) when it assesses the existence of an excessive deficit or debt (or compliance with the required adjustment).

Finally, from a broader perspective (going beyond the element of investment), due to the SGP split into a preventive arm and a corrective arm, the policy recommendations when moving in or out of one of the arms have not always been consistent and the recommendations have been driven on the grounds of the artificial distinction above or below a nominal budget deficit of 3 percent of GDP. This is partly due to the fact that the policy objectives (e.g. the MTO) and the policy recommendations (fiscal effort) under the preventive arm have been designed in structural terms, while the objectives and the recommendations under the corrective arm (EDP) have been designed in nominal terms in order to correct the 3 percent deficit or the reduction of excessive debt (not yet used as part of EDP). In any reform of the SGP, this distinction into prevention and correction may not be a necessary part of the framework, at least from a methodological point of view.

65 See key features of BICC as agreed by the Eurogroup on 10 October 2019.
66 Notably those national investments which are co-funded by the EU under the Structural and Cohesion policy, Trans-European Networks and the Connecting Europe Facility, and the co-financing of projects also co-financed by the EFSI.
5. THE MACRO-ECONOMIC IMBALANCES FRAMEWORK

In the first decade of its existence, the EMU experienced major macroeconomic imbalances, excessive private and public indebtedness, asset bubbles and divergences in competitiveness (reflected in diverging real effective exchange rates) that exacerbated the negative effects of the global financial crisis.

From the euro’s launch until the Euro Area sovereign debt crisis, there were big capital flows from core nations (like Germany, France, and the Netherlands) to periphery nations (like Ireland, Portugal, Spain and Greece). A major share of these capital inflows were spent on consumption or invested in non-tradable sectors – especially housing and infrastructure investment. This meant that not sufficient productive assets were being created to pay off the borrowing and thus rebalance the balance of payments. Foreign financed domestic spending tended to drive up wages and costs, in a way that harmed the competitiveness of the receivers’ export earnings and encouraged further worsening of their current accounts67.

In 2011, the EU agreed to set up the Macroeconomic Imbalance Procedure (MIP), a new surveillance and enforcement procedure intended to facilitate the early identification and correction of such imbalances in Member States, paying specific attention to those imbalances with potential spill-over effects on other Member States. This surveillance system comprises both a preventive and a corrective arm (the Excessive Imbalance Procedure (EIP), possibly leading to sanctions, see Box 8).

The objective was to have a formal framework, aimed to better prevent excessive macroeconomic imbalances from emerging and to support Member States affected to take corrective actions, before imbalances become entrenched. Such broadening of the EU surveillance of economic policies was intended to take place in parallel with the deepening of fiscal surveillance.

Today, the MIP framework has improved the understanding of the potential risks caused by macroeconomic imbalances, in particular inside the Euro Area. This has been the result of the detailed analyses of economic developments, both in the annual Alert Mechanism Reports and - in particular - in the in-depth-reviews prepared by the Commission services, as part of their annual Country Reports.

Based on the outcomes of the in-depth review, the Commission identifies the Member States experiencing

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67 See a paper by set of economist on “Rebooting the Eurozone: Step 1 – agreeing a crisis narrative” (CEPR, November 2015).

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**Box 8: The MIP in a nutshell**

At the beginning of the each annual cycle of the European Semester, the Commission publishes a so-called Alert Mechanism Report (AMR), which is based on a scoreboard of indicators and thresholds used to facilitate the identification and monitoring of potential external or internal imbalances. Member States with indicators beyond these thresholds are submitted to an "in-depth review", i.e. a further economic analysis.

**Preventive recommendations**

If, based on the outcomes of the "in-depth-review", the Commission finds that "macroeconomic imbalances" exist, it informs the EP, the Council and the Eurogroup. The Council, on a recommendation from the COM, may then address a recommendation to the Member State concerned (in accordance with procedure set out in Art. 121(2) TFEU). These preventive MIP-recommendations form part of the annual Country Specific Recommendations (CSRs).

**Excessive Imbalance Procedure (EIP)**

If, based on the in-depth review, the Commission identifies "excessive imbalances" that warrant opening a EIP, it informs the EP, the Council, the Eurogroup, the relevant European Supervisory Authorities and the ESRB. The Council, on a recommendation from the COM, may establish the existence of excessive imbalance and recommend corrective action (in accordance with Article 121(4) TFEU). The Council’s recommendation sets out the nature and implications of the imbalances, and specifies the policy recommendations to be followed, as well as a deadline within which the Member State concerned must submit a corrective action plan. The EIP comprises the delivery of a corrective action plan, with a set of policy measures to be carried out within a pre-determined timeframe, and possible fines (for Euro Area countries).
macroeconomic imbalances or excessive macroeconomic imbalances and proposes some recommendations to the concerned Member States, as part of the Country Specific Recommendations (formally these recommendations fall under the preventive arm of the MIP). The Figure 2 below shows the rate of implementation (assessed on an annual basis by the Commission of the CSR adopted in the previous year) by the Member States that have received MIP-related CSR.

**Figure 2: Annual assessment of the implementation rate of MIP-CSRs**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total MIP-CSRs</th>
<th>Member States</th>
</tr>
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<tbody>
<tr>
<td>2012</td>
<td>36</td>
<td>12</td>
</tr>
<tr>
<td>2013</td>
<td>56</td>
<td>13</td>
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<tr>
<td>2014</td>
<td>66</td>
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<td>2017</td>
<td>35</td>
<td>12</td>
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<tr>
<td>2018</td>
<td>32</td>
<td>11</td>
</tr>
</tbody>
</table>

Source: EGOV based on European Commission assessments.
Note: The assessment grid of CSR implementation is as follows: full/substantial progress, some progress and limited/no progress.

In some cases, the Commission found that a Member State was experiencing excessive macro-economic imbalances and indicated that it might consider opening an EIP later on, depending on the degree of ambition of the reform plans (National Reform Programme) that the concerned Member State submits to the Commission and the Council as part of the regular Semester process. So far, the Commission has never proposed the opening of an EIP. This may reflect the fact that the Commission has either regarded the reforms planned or undertaken to be sufficient for not recommending an opening of the procedure, or considered that it would be politically unfeasible. The Council, the European Central Bank and the Court of Auditors have called several times for the procedure to be used to its full potential, with the corrective arm applied where appropriate.

For the future, one may need to consider which ways could render the full application of the EIP feasible from a political perspective. Possible avenues could be:

(a) to focus only on Euro Area Member States medium term challenges (major imbalances emerging inside an individual Member States and major divergences emerging among the Member States of the Euro Area);

(b) finding ways to increase the common understanding of macroeconomic developments, possibly by enhancing the role of national productivity boards (both in the preparatory phase of the specific policy recommendations and in the monitoring of their implementation).

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68 For example, as regards the Commission’s outcome of the in-depth-reviews in 2016: Fewer Member States than last year are considered to have imbalances. Of the 19 Member States retained for further analysis, the in-depth reviews have found that six Member States are experiencing no imbalances, seven Member States are experiencing imbalances and six Member States are experiencing excessive imbalances (Bulgaria, France, Croatia, Italy, Portugal, Cyprus). For Croatia and Portugal, the Commission will review its assessment in May, taking into account the level of ambition of their National Reform Programmes.

69 For further information on the implementation of the MIP, please see separate EGOV document.

70 See D. J. Bokhorst (May 2019) on “Governing imbalances in the Economic and Monetary Union”: “A reoriented MIP would focus on issues of macro-critical importance and would be used in a more focussed way so that escalation has a stronger signalling effect. A more precise mission statement for the MIP could be formulated and the numbers of headline indicators reduced: escalation within the procedure would occur strictly on the basis of higher values on flow indicators. Since the issues that are of macro-economic critical importance in the euro area are often financial in nature, the EU could considering incorporating macroprudential oversight mechanism into the MIP”.

71 This would imply that these bodies have a clear mandate, be independent from political interference and be well resourced. See Commission progress report from February 2019 on establishing national productivity boards in the EU. See also a separate EGOV document.
Furthermore, the activities of the national productivity boards could be coordinate at EU level, in order to exchange information, provide common analytical tools, identify best practices and improve their Euro Area perspective.72

In addition, the European Stability Risk Board (ESRB) could be given a more prominent role in identifying the macroeconomic imbalances from a macro-prudential viewpoint, in particular from a common currency union perspective.

As regards the implementation of the EIP, one possible longer term perspective could be to use the corrective action plans put forward by Member States under the EIP instead of the financial adjustment programmes, as set out in the EU Regulation 472/2013, and link such corrective action plan to the financial support from the ESM.73 This would be a way to further anchoring these programmes into the EU framework and thereby increase the legitimacy and transparency of the procedures used for setting up the programmes. It would also allow a Member State that has been granted financial assistance by the ESM to remain part of the European Semester framework.75

72 On the last point, see an article by a group of French economists on “Productivity and competitiveness in the euro area: A view from France”, VOXEU, 24 July 2019.

73 See Article 7/2 of regulation 472/2013: 2. The Council, acting by a qualified majority on a proposal from the Commission, shall approve the macroeconomic adjustment programme prepared by the Member State requesting financial assistance in accordance with paragraph 1.

74 It is important to note that compliance with the recommendations issued under the MIP (and the SGP) will, under the revised European Stability Mechanism Treaty being finalised, be eligibility conditions for a Member State to have access to the ESM precautionary financial assistance. For further information on the revision of the ESM Treaty see specific EGOV paper. For additional information on the relationship of the ESM and the EU fiscal surveillance framework, see specific EGOV briefing on ESM.

75 Today, a Member State subject to a macro-economic adjustment programme is exempted from the European Semester framework (see Article 12 of EU Regulation 472/2013). This might have consequences for their eligibility under the BICC (“The Commission will assess the Member States’ proposals on the basis of transparent criteria.” and that “Member States will report on the implementation of reform and investment commitments regularly, in the context of the European Semester” (BICC term sheet as agreed by Eurogroup).
6. WHAT CAN BE CONCLUDED?

Economic policy coordination at EU level is mainly conducted within the European Semester framework. This framework is underpinned by two self-reinforcing principles - that Member States bear ultimate fiscal responsibility for their economic and budgetary policies (enforced through the “no bail out” and “no monetary financing” clauses) and that of a shared common interest in coordinating, at EU level, their economic policies.

Since the financial and sovereign debt crises, these two principles have been complemented with economic governance national rules and institutions, as well as with some new EU surveillance instruments going beyond fiscal policies. Today, work is also ongoing to strengthen the EMU governance with new additional EU level resources, such as a budgetary instrument for convergence and competitiveness. In addition, major steps have been taken to establish a genuine banking union in the Euro Area, even if some core elements are still missing.

In order to put the EU economic governance framework in perspective and show how unique it is, the paper provides a short comparison with that of the United States. In drawing lessons from the United States model, one should bear in mind all the different elements in the broader institutional framework and not only focus on a couple of governance aspects, avoiding a piecemeal approach.

EU policy recommendations clearly differ from policy advice provided by independent institutions such as OECD and IMF. Member States play a fundamental role at the EU level in designing and applying the common economic governance framework: they co-decide the relevant legislation (i.e., the SGP and the MIP), adopt policy recommendations under the European Semester, and coordinate their policies in the Eurogroup and the Council. This surveillance framework includes enforcement mechanisms in case of repeated non-compliance with the related EU recommendations.

Both the SGP and the MIP are relevant and important instruments of the EMU governance and they are likely to remain, in any scenario, at the core of policy surveillance instruments for the EMU. Nevertheless, their implementation over time has raised questions, especially about their legitimacy and effectiveness in steering national economic, fiscal and social policies. In particular, there has been a broad debate in the public domain on the degree of complexity of the SGP and whether it has been able to sufficiently steer national policies, notably in avoiding pro-cyclical fiscal policies. Amending the relevant EU legislation may therefore not be sufficient in itself to render the EU level “rule-based” surveillance framework more efficient. The paper dwells on certain ideas (beyond amending the rules) that could support reinforcing the framework within the current institutional setting and raises some broad questions to take stock and reflect on how the EMU governance could be made more effective or whether additional instruments would be needed to complement the existing ones.

As possible contributions to the debate, one can consider:

- Trying to better distinguish each EU surveillance instrument according to its respective core objective (e.g. “try to prevent certain policies” versus “try to promote certain policies”);
- Clarifying the policies to be covered in the European Semester coordination framework, if it is to remain the core coordination framework, to allow targeting common EU longer-term objectives (and, in so doing, replacing and upgrading the EU2020 strategy). That could require reframing, and possibly redesigning, the European Semester as a standalone legal instrument, and to include indicators to measure progress, along with annual or multi-annual policy recommendations covering the full breath of policy objectives (e.g. green investments, social inclusion, education system, public administration, labour productivity etc.) in a “renewed Semester”;
- Without prejudice to general policy recommendations addressed to all Member States of the EU and covering all the objectives of the renewed Semester, focusing the policy recommendations under the SGP and the MIP on those national developments and policies of the Euro Area Member States that may need specific attention due to the fact of belonging to a common currency area (or planning to join it);
- Rendering the EU policy recommendations more operational, namely by introducing elements that allow better defining targets, measuring progress and setting timeframes for implementation, whenever possible, coupled with financial instruments allowing Member States to further pursue the policies that are commonly agreed;
- Clarifying the politically shared ownership of the EU rules-based surveillance framework, and better linking commonly agreed policies at EU level with national policy debates and implementation. In fact, the surveillance system may only be effective if all parties concerned take political ownership of the common rules and, in addition, governments of the Member States themselves do their utmost to integrate their EU level commitments into national policy making;
- Making better use of the Commission Country Reports, as an instrument for early and targeted political debate, including at the level of the Eurogroup and the European Parliament. Specific reports could be addressed to euro area Member States at risk of significantly breaching their SGP commitments or identified at risk of excessive macroeconomic imbalances, to better frame the discussions and underpin possible recommendations for correction;
- Consider proposals to simplify the SGP, while keeping the “trilemma” (simplicity, adaptability and enforceability) in mind, to better avoid pro-cyclical fiscal policies. There are various proposals available in the public domain, including making an “expenditure benchmark” the core operational instrument of the fiscal framework, the introduction of a “limited golden rule” protecting specific growth enhancing investments, and promoting instruments to build buffers in economic good times. In any case, one should note that any reform of the SGP aiming at avoiding pro-cyclical national fiscal policies, would need to consider the “economic cycle” and reflect that in the related policy recommendations. As such, an element of uncertainty linked to the estimation of the current economic situation in relation to the potential output of the country in question would always remain, at least to some extent;
- Rendering the enforcement of MIP more feasible from a political perspective, whilst bearing in mind that it was developed as a “early warning instrument”, able to measure, detect, prevent and correct macroeconomic imbalances that could pose risks to the stability of the euro area. That may entail (a) refocusing the MIP/EIP only on euro area member states; (b) increasing the common understanding of macroeconomic developments by enhancing the role of national productivity boards; (c) giving the ESRB a stronger role in identifying relevant developments, from a macro-prudential viewpoint, inside the common currency area; (d) linking the use of EU funds to the implementation of CSRs underpinned by the MIP; (e) replacing the MoU in financial assistance programmes with the corrective action plans as agreed under the MIP.
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ANNEX 1: DEFINITION OF THE EUROPEAN SEMESTER (ARTICLE 2-A OF REGULATION 1466/2011)

EUROPEAN SEMESTER FOR ECONOMIC POLICY COORDINATION

1. In order to ensure closer coordination of economic policies and sustained convergence of the economic performance of the Member States, the Council shall conduct multilateral surveillance as an integral part of the European Semester for economic policy coordination in accordance with the objectives and requirements set out in the Treaty on the Functioning of the European Union (TFEU).

2. The European Semester shall include:

(a) the formulation, and the surveillance of the implementation, of the broad guidelines of the economic policies of the Member States and of the Union (broad economic policy guidelines) in accordance with Article 121(2) TFEU;

(b) the formulation, and the examination of the implementation, of the employment guidelines that must be taken into account by Member States in accordance with Article 148(2) TFEU (employment guidelines);

(c) the submission and assessment of Member States’ stability or convergence programmes under this Regulation;

(d) the submission and assessment of Member States' national reform programmes supporting the Union's strategy for growth and jobs and established in line with the guidelines set out in point (a) and (b) and with the general guidance to Member States issued by the Commission and the European Council at the beginning of the annual cycle of surveillance;


3. In the course of the European Semester, in order to provide timely and integrated policy advice on macrofiscal and macrostructural policy intentions, the Council shall, as a rule, following the assessment of these programmes on the basis of recommendations from the Commission, address guidance to the Member States making full use of the legal instruments provided under Articles 121 and 148 TFEU, and under this Regulation and Regulation (EU) No 1176/2011.

Member States shall take due account of the guidance addressed to them in the development of their economic, employment and budgetary policies before taking key decisions on their national budgets for the succeeding years. Progress shall be monitored by the Commission.

Failure by a Member State to act upon the guidance received may result in:

(a) further recommendations to take specific measures;

(b) a warning by the Commission under Article 121(4) TFEU;

(c) measures under this Regulation, Regulation (EC) No 1467/97 or Regulation (EU) No 1176/2011.

Implementation of the measures shall be subject to reinforced monitoring by the Commission and may include surveillance missions under Article -11 of this Regulation.

4. The European Parliament shall be duly involved in the European Semester in order to increase the transparency and ownership of, and the accountability for the decisions taken, in particular by means of the economic dialogue carried out pursuant to Article 2-ab of this Regulation. The Economic and Financial Committee, the Economic Policy Committee, the Employment Committee and the Social Protection Committee shall be consulted within the framework of the European Semester where appropriate. Relevant stakeholders, in particular the social partners, shall be involved within the framework of the European Semester, on the main policy issues where appropriate, in accordance with the provisions of the TFEU and national legal and political arrangements.

The President of the Council, and the Commission in accordance with Article 121 TFEU, and, where appropriate, the President of the Eurogroup, shall report annually to the European Parliament and to the European Council on the results of the multilateral surveillance. These reports should be a component of the Economic Dialogue referred to in Article 2-ab of this Regulation.
This paper provides an overview of the current EU economic governance framework, in particular of the so-called EU ‘rule-based’ surveillance framework of national budgetary, economic and social policies. It raises some broad questions on the lessons learned and proposes some reflections for the future.

This document was prepared by the Economic Governance Support Unit of the European Parliament and the opinions expressed are the sole responsibility of the authors and do not necessarily represent the official position of the European Parliament.