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## Reforming EU economic governance: is 'more' any better?

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**March 2014**

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## **Reforming EU economic governance: is ‘more’ any better?**

**Renaud Thillaye (policy network), Ludek Kouba (MUAF),  
Andreas Sachs (ZEW)**

### **Contribution to the Project**

The paper tests three possible reforms of economic governance in the EMU (wage coordination, contractual arrangements and a cyclical stabilisation mechanism) which would help member states deal better with heterogeneity and facilitate the socio-ecological transition of their economies. It uses a multi-criteria analytical framework encompassing economic, political and institutional aspects.

### **Keywords:**

EU integration, European economic policy, European governance, European Monetary Union, Good governance, Institutional reforms, Labour markets, Macroeconomic disequilibria, Multi-level governance, Welfare reform

### **Jel codes:**

E02

## **Reforming EU economic governance: is ‘more’ any better?**

Renaud Thillaye, Ludek Kouba, Andreas Sachs\*

WWWforEurope policy paper (MS84)

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### **Abstract**

Despite significant measures to reinforce the EMU’s institutional set-up, there is widespread consensus that more needs to be done in order to better deal with cyclical and structural heterogeneity in the EU. Market-based adjustment mechanisms are necessary but not sufficient to advance convergence along more sustainable growth patterns. In that context, institutional reforms advancing integration in the Eurozone are often said to be desirable from an economic point of view, albeit fraught with political difficulties.

This paper seeks to provide a fresh outlook on this debate by bringing forward a third, overlooked dimension, namely the feasibility, or ‘implementability’, of governance reforms. Like national technocracies, the EU faces the risk of failure whereby the creation of institutions or the introduction of new policies do not always bring about the expected outcomes. The paper develops a multi-criteria analytical framework to assess three possible innovations of economic governance: rule-based wage coordination, contractual arrangements for reforms, and a stabilisation fund for the Euro area. The ‘robustness’ of any proposal seeking to increase the EU’s interference into national policy-making should start with a clear economic justification, while taking the dynamics of national preferences into account. However, the risks of moral hazard and institutional barriers should also be systematically internalised in the assessment.

After outlining the analytical framework (section 1), the paper assesses the three tentative reforms by using a wide range of data and analyses from existing EU documentation, academic and policy literature, and opinion surveys (sections 2 to 4). Each section ends with some recommendations on the desirable scope and design of reforms. Overall, the three case studies stress the need for a careful and reasoned approach to reforming EU governance. Beyond the predictable clash of economic rationales and political hurdles, reform ideas tend to overlook the difficulties arising at the implementation stage. Diverse wage-setting systems, low administrative capacities, and statistical uncertainty for instance all warn against ‘more EU money’ or ‘EU interference’. The paper, therefore, makes the case for experimental and small-scale innovations and for a much greater engagement of the public in the politics of EU coordination.

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## Introduction

After a few turbulent years, the Economic and Monetary Union (EMU) seems to have returned to stability. Emergency measures taken since 2010 have bought time and governance reforms have beefed up credibility. There is hope that painful adjustment measures will improve member states' resilience and competitiveness and, ultimately, put their growth models on a more sustainable trajectory. Yet the latter outcome is far from guaranteed. The ability to produce innovation-based, 'socio-ecological' growth in the long term might remain poorly distributed in EMU, both vertically (between member states) and horizontally (between different groups or areas across member states). Some voices continue to express doubt over the survival of a very heterogeneous currency area.

History and theory suggests that EMU does not only need market-oriented reforms and labour mobility, but also new institutions such as a central budget. Yet, although EU leaders are seemingly committed to advance integration (as illustrated by the 'Roadmap towards a genuine EMU' proposed by Herman Van Rompuy in December 2012), the speed of the journey and the final destination are unknown at this stage. In place of a brand new federal design, the current 'insurance-adjustment' strategy, whereby financial transfers are limited, temporary and submitted to strict conditionality, might be extended for years (Aiginger et al, 2012).

Arguably, the debate over further possible steps towards greater integration is stuck in the middle of two conflicting rationales. On the one hand, transfers of sovereignty and the pooling of resources are said to be economically desirable in order to safeguard the Eurozone's unity and to improve its optimality. On the other hand, everyone notices the 'elephant in the room', namely the political hurdle of presenting electorates with options they are manifestly not ready to accept. At a time when tax and solidarity are heavily disputed within several EU member states, it is hard to imagine the easy adoption of a Eurozone treaty setting up similar instruments at a higher level.

This paper tries to offer fresh insights into this debate by highlighting the overlooked dimension of feasibility, or ‘implementability’, of EU governance reforms. Even if one ignores political constraints, the effectiveness of greater EU interference into national policy-making remains to be demonstrated. EU mechanisms are often criticised for their complexity and their disconnection from very diverse realities. Some also argue that they create moral hazard and make matters worse by relieving national governments of their responsibilities. This set of arguments about the limits of governance chimes well with the broader critiques of technocracy and institutional solidarity in a national context. In the same way as the capacity of national governments to achieve specific goals is contested today, the EU may be facing a crisis of maturity whereby the creation of new institutions might not necessarily bring about the expected results.

To illustrate this argument, the paper assesses the desirability and feasibility of three governance innovations among those most discussed in the recent past: EU-wide coordination on wages; contractual arrangements between the EU and member states combining reforms and financial support; an EU cyclical stabilisation fund. The options for each of these possible reforms are tested against an analytical framework based on four questions:

- Do existing or potential spillovers justify EU intervention?
- Is the distribution of preferences conducive or adverse to EU intervention?
- What are the risks of moral hazard?
- What are the potential implementation costs and flaws?

The first part explains the choice of these analytical criteria by referring both to the arguments used in the EU political sphere, and to the theoretical insights of fiscal federalism. The second to fourth sections answer the questions for each of the three proposals. The analysis draws on a wide range of existing studies and data in EU documentation, political economy literature, and opinion surveys. Based on the analysis, we provide some recommendations on the design and conditions of such reforms.

## 1. Assessing the desirability and feasibility of EU action

### *1. A. An analytical framework rooted in the political debate*

Proponents and critics of new steps towards greater coordination or integration in the EU (and, in particular, in the Eurozone) use a range of arguments that broadly echo the categories used in this paper.

- Economic necessity: ‘there is no alternative’

The main driving force of governance reforms in the last few years has been economic necessity. The ‘there is no alternative’ (TINA) rationale has systematically pulled the trigger of institutional change. Assuming that Eurozone leaders see the rescue of the euro as a goal per se – the consequences of a collapse being seen as disastrous – they are ready to do ‘whatever it takes’ to make EMU work.

For instance, the first ‘Greek rescue package’ of May 2010 was presented as a ‘basic choice between collapse or salvation’ by the then Greek finance minister.<sup>1</sup> In Summer 2012, the launch of the ‘Open Monetary Transactions’ programme by the European Central Bank was also seen as critical at a time when the spread between German and Southern European bond yields put Spain and Italy under extreme pressure.<sup>2</sup> Economic necessity also contributed to institutional fixes, such as the creation of the ESM, the ex-ante coordination of fiscal and economic policies throughout the European Semester, and the Treaty on Stabilisation, Coordination and Governance. EU leaders have repeatedly argued that only more robust EU institutions would prevent fiscal or competitiveness imbalances from spiralling into damaging spillovers and new bail-outs.

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<sup>1</sup> ‘Eurozone approves massive Greece bail-out’, BBC News, 02/05/2010, <http://news.bbc.co.uk/1/hi/world/europe/8656649.stm>

<sup>2</sup> Mario Draghi, 06 September 2012: ‘OMTs will enable us to address severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro’



The diagnosis over the causes of existing or potential spillovers is nevertheless often disputed. An illustration of that is the new Macroeconomic Imbalance Procedure, which keeps national indicators such as the trade balance, private debt, the cost of labour and unemployment in check, and forces governments into preventive action in order to avoid divergences in economic conditions. The selection of indicators has proved a highly political matter, which trade unions and left-wing forces at EU level have been contesting. For instance, they recommend a strictly symmetrical approach to tackling current account deficits and surpluses, whereas the current thresholds are respectively -4% and +6%. The MIP's recent extension to various measures of poverty and social conditions (called the 'Scoreboard Additional') reflects however greater awareness of social spillovers. In any case, any proposal for a greater EU role in these matters should be based on a broad consensus in terms of what the real or potential threats are.

- Political constraints: 'people do not want it'

It has become common place to say that Europeans are not ready to accept new sovereignty transfers and resources pooling. As early as 2005, the 'No' vote at the French and Dutch referendums on the EU constitutional treaty highlighted the limits of the so-called 'permissive consensus' about a European integration: the 'choice for Europe' could not go on being made by economic and political elites on the back of voters. The Eurozone crisis has aggravated this further. Opinion surveys regularly inform the lack of appetite and the low level of confidence, both in EU institutions and among peoples themselves. According to Eurobarometer (European Commission, 2013), trust in the EU has steadily declined from 57% in 2007 to 31% in 2013.

This rather discouraging picture for anyone who wishes to see the EU play a greater role in the resolution of the debt and economic crisis needs to be qualified. First, attitudes towards EU integration and solidarity are highly heterogeneous among countries depending on their economic condition. Second, evidence suggests a growing understanding about the need for greater coordination in a highly interdependent EU. When faced with the choice of voting for pro- and anti-euro forces at the May 2012 general election, Greek voters sent a pro-EU

majority into their parliament despite the very harsh train of austerity measures imposed on the country by EU officials.

In any case, the heterogeneity of preferences across the EU is having a significant impact on the ongoing discussions over the form of possible governance innovations. Following the liberal-intergovernmentalist theory of EU interstate bargaining (Moravcsik, 1998) the outcome usually reflects the 'relative intensity of national preferences'. Those countries which have no unilateral alternative are in a position of weakness. Therefore, when Angela Merkel declares that she will not see Eurobonds as a risk-sharing tool 'as long as [she] live[s]', thereby reflecting the mood in German public opinion, she casts *de facto* a very long shadow over the process of innovating EU governance.<sup>3</sup>

- Moral hazard: 'beware unintended consequences'

A third type of arguments against the beefing-up of EU governance relate to possible unintended consequences, namely opposite effects from the one intended. Some prominent politicians and central bankers have argued that the breach of the no-bail-out clause and the creation of the ESM have already made markets' pressures less intense and weakened incentives for fiscal discipline and structural reforms. Angela Merkel has repeatedly insisted that 'more debt' was not the solution to the crisis.

Response to such criticism comes in the form of stronger conditionality and monitoring. For instance, the newly introduced 'ex-ante conditionality' of the EU budget foresees the possibility of halting disbursements if a member state does not respect its fiscal and reform commitments. Access to ESM and ECB support is strictly conditioned to signing up for an 'assistance programme' implemented under close supervision of EU and international experts. It is also interesting to note that political players, especially on the centre-left, have caught up with this new conditionality paradigm. François Hollande, for instance, puts forward the concept of '*intégration solidaire*' as a way to combine more solidarity at EU

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<sup>3</sup> 'The Coming EU Summit Clash: Merkel Vows 'No Euro Bonds as Long as I Live', Spiegel online, 27/06/2012 <http://www.spiegel.de/international/europe/chancellor-merkel-vows-no-euro-bonds-as-long-as-she-lives-a-841163.html>

level with greater control over national policy-making. Yet the effectiveness of such safeguards remains disputed.

- Institutional barriers: 'bureaucracy does not match reality'

In 2000, the European Commission released a 'White Book on governance' supposed to address growing criticism against the lack of transparency of EU institutions. This came after a series of scandals leading to the collapse of the Santer Commission, at a time when a stream in the EU academic literature highlighted the tendency of EU institutions and agencies to grow out of any control from their 'principal', namely the member states.<sup>4</sup> A decade later, attacks against 'Brussels eurocrats' and the overall complexity and opacity of EU decision-making have only become more intense. The British Prime Minister David Cameron stroke a chord across Europe in January 2013 when he called for greater flexibility and accountability.<sup>5</sup> This was quickly followed by a 'Subsidiarity review' conducted by the Dutch government, which compelled the EU to show more legislative restraint and to 'impose less administrative burden' on the member states'.<sup>6</sup>

Such criticism has particular resonance in the field of economic governance. In the last decade, poor ownership, complexity and a lack of visibility were identified as key problems crippling the effective implementation of the ambitious Lisbon Strategy. The inability of the Stability and Growth Pact to prevent the sovereign debt crises from happening also signalled the limit of decentralised economic governance based on national reporting and EU monitoring. EU leaders could have decided to 'get back to basics', namely by letting markets play their full role and allowing member states to default – or, conversely, to give the EU a veto right over national budgets. Instead, recent reforms add new rules (MIP), new timelines (European Semester) and new actors (ESM, constitutional courts) to the existing framework. For some critiques, these new bureaucratic processes will not deliver better.

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<sup>4</sup> For a discussion of the 'runaway-bureaucracy' thesis, see Pollack (1997)

<sup>5</sup> 'There is a growing frustration that the EU is seen as something that is done to people rather than acting on their behalf. And this is being intensified by the very solutions required to resolve the economic problems.' In 'David Cameron's EU speech - full text', Guardian, 23/01/2013, <http://www.theguardian.com/politics/2013/jan/23/david-cameron-eu-speech-referendum>

<sup>6</sup> Dutch government, 'NL subsidiarity review - explanatory note', 21/06/2013, <http://www.government.nl/issues/european-union/documents-and-publications/notes/2013/06/21/nl-subsidiarity-review-explanatory-note.html>

### **1. B. Testing subsidiarity and proportionality: theoretical insights**

The four type of political arguments outlined above have been reflected in the literature, especially in 'fiscal federalism' writings and in studies about 'subsidiarity' in the EU context. EU scholars often link the subsidiarity and proportionality principles to the insights of fiscal federalism. This line of thought was developed in the late 1950s in the US context (see summary by Lejour and Molle, 2011, p. 90-91). Fiscal federalism suggests a series of arguments for both centralising and decentralising functions of government. Roughly speaking, centralisation is justified if *economies of scale* can be obtained and negative *externalities* internalised at higher level. Decentralisation is desirable when significant *differences in needs and in preferences* have to be taken into account.

This basic formula has been enriched since the 1970s onwards by a 'second generation' of fiscal federalists coming from various backgrounds (Oates, 2005; Ederveen et al, 2006). They bring a series of qualifications which seek to avoid overly simplistic reasoning. Their contributions drop the assumption of benevolent governments; they integrate new dimensions such as moral hazard, asymmetric information and policy complementarities. The result is not to tip the balance in one or another direction, but rather to make the analysis more accurate.

In the EU context, Pelkmans (2006) suggests a five-step 'functional subsidiarity test' echoing strongly the fiscal federalism framework. The test should only be applied in the area of shared competences between the EU and member states (step 1). Despite heterogeneity in preferences, a high level of interdependence may justify the need-to-act at EU level (step 2). It must be proven that voluntary cooperation between member states will not deliver the expected results, i.e. that the task is not simple, repetitive and presents major enforcement problems (step 3). When steps 1, 2 and 3 are validated, the subsidiarity test on the need of EU action is passed (step 4). Step 5 raises the proportionality question: what should be the best instrument in order to keep implementation costs and enforcement issues as limited as possible? Hence, interestingly, Pelkmans makes of interdependence a sufficient trigger for common action, but he is also cautious regarding the form of it.

It should finally be noted that the Impact Assessment (IA) procedure developed by the European Commission over the last decade takes a similar approach. The IA Guidelines<sup>7</sup> impose a very detailed six-step ex-ante inquiry to any new legislative proposal. The subsidiarity question comes up as part of the first stage in the analysis ('identifying the problem'). Any proposal must pass the 'necessity' and the 'added value' test. In other words, it must be proven that member states fail to address a problem and that the Community can provide a response. Proportionality comes up at a later stage ('develop main policy options'), once the objectives of the proposal have been more narrowly defined. The Guidelines read as such: 'Community action should be as simple as possible and leave as much scope for national decision as possible, and should respect well established national arrangements and legal systems' (p.29).

This overview shows that a more systemic use of a multi-criteria approach to policy reform could help contrast and weigh various options of EU governance. In the following sections of the paper, we analyse three possible governance innovations – wage coordination (2), contractual arrangements for reforms (3), and a stabilisation mechanism (4) - by using the framework suggested above. For each proposal, we review the 'spillover rationale' (A), various possible designs (B), the distribution of preferences (C), risks of moral hazard (D) and implementation issues (E). Finally, we formulate some recommendations (F).

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<sup>7</sup> European Commission, 'IMPACT ASSESSMENT GUIDELINES', SEC(2009) 92, 15/01/2009, [http://ec.europa.eu/governance/impact/commission\\_guidelines/docs/iag\\_2009\\_en.pdf](http://ec.europa.eu/governance/impact/commission_guidelines/docs/iag_2009_en.pdf)

## 2. Coordinating wages at EU level

Werner Report (1970, p. 12): *'in order to avoid the emergence of excessive divergences, the trend of incomes in the various member countries will be studied and discussed at the Community level with the participation of the social partners.'*

Despite early warnings that EMU would require some form of wage coordination, only limited initiatives characterised the first 15 years from Maastricht to the 2008-2010 crisis. The momentum for a stronger push in that direction may have come back, but the discussion over its desirability and feasibility is arguably tainted with ideological considerations.

### 2. A. *Spillover rationale: economic and social imbalances*

The lack of wage coordination in the EU leads to two types of imbalances, which have potential negative impact for the whole Euro Area. Economic imbalances became visible when the sovereign debt crisis burst in 2008. Social imbalances have become prominent quite recently and are still a developing matter.

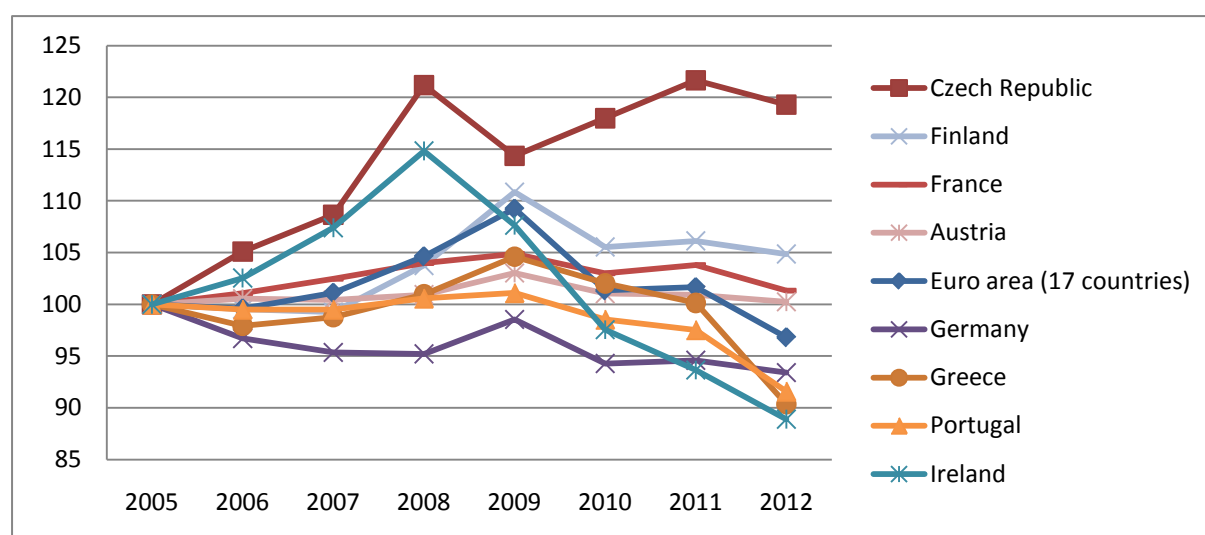
- Economic imbalances

On the economic side, uncoordinated wage developments played a role in the development of current account imbalances and in the resulting 'sudden stop', when credit institutions stopped lending to their public and private clients in 'deficit' countries. This is the situation which Eurozone leaders seek to avoid again.

A lot of studies have analysed the diverging competitiveness patterns that affected the euro area between 1999/2000 and 2007/2008. They all lead to reconsider the common wisdom according to which only Southern European countries and Ireland did not keep wages in check. Of course, nominal unit labour costs increased rapidly in Ireland, Portugal, Spain and Greece until 2009, while they were going down in Germany. However, divergence was much less pronounced when taking real unit labour costs into account, which decreased in most

Eurozone countries between 1999 and 2007, including Spain and Greece. This means that wages developments did not follow productivity, and it reflects an overall declining wage share noticeable in most EU and advanced economies for various reasons, not the least a weakening of labour's bargaining position (Bourgeot, 2013). When put in relation with productivity and the ECB's inflation target, most authors find that the size of wage restraint was not justified in Germany with respect to the monetary union's convergence requirements. Except in Italy and Spain, productivity increased at the same pace in most Eurozone countries; but inflation rose by 10% in Germany between 1999 and 2008 against more than 30% in Greece, Spain, Ireland and Portugal. As figure 1 shows, Germany stood out as the only country significantly improving its price competitiveness against other member states (as measured by the real effective exchange rate) until 2009.

Figure 1: Real effective exchange rates 2005-2012



Source: Eurostat

Explanations for these developments have mainly pointed to differences in wage-settings mechanisms and resulting diverging reactions to the single interest rate. A sectorial breakdown of wage development shows in particular that wages in the manufacturing sector fell well behind productivity gains in Germany. In 'coordinated' economies like Germany, wage developments were indexed on the exposed (manufacturing) sector, which had a deflationary impact on the sheltered sectors (Johnston et al, 2013). Such a consensus was possible in a context of low growth, when the ECB's high interest rates were felt

particularly constraining. By contrast, Southern European economies were facing a new context of relatively low interest rates and, as Marzinotto puts it, were lacking an export-oriented sector 'that was strong enough politically and institutionally to impose discipline on other sectors' (Marzinotto, 2013).

A further learning from the divergent patterns of the last decade is that unregulated labour-markets and decentralised wage-setting systems do not always outperform highly institutionalised ones in terms of wage moderation. Over 1999-2008, only in coordinated economies have wages increased at a below Eurozone average rate (Höpner and Schäfer, 2012). As Johnston et al (2013, p.38) put it, *'the economies that have performed well under EMU have been those that relied on wage moderation – but essentially of the type provided by a combination of strong labour unions, wage coordination, and skills-based export competitiveness – almost the exact institutional opposite of the flexible labour markets proposed by OCA protagonists.'* The authors' conclusion is that some coordination would be necessary, not only across the Eurozone, but, to start with, across sectors on a national basis.

- Social imbalances

A new strand of analyses focuses today on the consequences of the policies put in place to address current account imbalances after 2008-2009. They find that the wage restraint experienced in crisis-hit countries has significant social consequences with potential short- and long-term spillover effects for the whole euro area. In the short term, a cut in real wages increases the risk of 'in-work-poverty' and depresses domestic demand, which, in turn, risks translating into high unemployment and higher poverty. In the long run, if adequate policies are not in place to promote the reallocation of workers to growing competitive sectors, reskill the unemployed and address the consequences of poverty, human capital deteriorates. The only alternative is often for people to emigrate.

Some data hint at such social deterioration. According to Eurostat, in-work poverty in the Euro area has increased from 10.8% in 2010 to 13.6% in 2012 while the rate of people at risk of poverty has gone up from 19.9% to 21.4%. According to the European Commission, 'the



average rate of people neither in employment, education or training (NEETs) reached 22.4% in the south and periphery of the euro area, against 11.4% in the north'.<sup>8</sup> Some authors (such as Esposito, 2014) also stress that the poverty rate increased in Germany over the last decade, showing that the same medicine (wage restraint) may bring about the same results in the countries running a competitive adjustment today.

Of course, this signals a correlation rather than a causality link. For the European Commission, poor social performances have mainly to do with malfunctioning automatic stabilisers rather than with downward trends on wages and benefits.<sup>9</sup> Yet, it admits the collective damage of deteriorating social situations in individual countries. This goes through several channels such as weaker demand, eroding skills and hysteresis, negative perceptions in the financial sector and political instability.

## ***2. B. Proposed designs to address the lack of wage coordination***

They can be classified in two categories: those which seek to set across wage development guidelines, and those which focus on minimum wages.

- A 'golden wage rule'

EU institutions have issued soft guidance on wage-setting for more than a decade.<sup>10</sup> An implicit rule is already in place, according to which the development of *real* wages should follow productivity. The extent to which wages can follow inflation is restricted by the 2% inflation target of the ECB. In 2011, The 'Euro Plus Pact' urged member states to '*review the wage-setting arrangements, and, where necessary, the degree of centralisation in the bargaining process, and the indexation mechanisms*' and to '*ensure that wages in the public sector support the competitiveness efforts in the private sector*'. As part of the 2013 country-specific recommendations, the European Commission stated that '*the structural reforms*

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<sup>8</sup> European Commission, 'Social and Employment Quarterly Report', September 2013, p. 15, <http://ec.europa.eu/social/main.jsp?langId=en&catId=89&newsId=1974&furtherNews=yes>

<sup>9</sup> Ibid., p.14-15

<sup>10</sup> In 2000, the Broad Economic Policy Guidelines recommended for instance keeping 'nominal wage increases consistent with price stability' [...] and real wages to increase in relation labour productivity growth'.

*needed to link wage developments with productivity on a permanent basis are still missing*'.<sup>11</sup>

Yet, more than productivity, the problem identified during the last decade was an increase of nominal wages above the ECB's inflation target in several countries and below it in Germany. Several authors and organisations, therefore, have suggested new rules or guidelines to ensure convergence and avoid both excessive upwards and downward trends. In its 2012 resolution, the European Trade Union Congress argues for instance that 'wages should rise according to annual rates reflecting – among other developments – increases in inflation and gains in productivity'<sup>12</sup>.

In order to address *existing* divergences, Watts (2010) proposes a 'golden wage rule' according to which 'nominal wage growth in each country equals medium-run national productivity growth, *plus* the target inflation rate of the central bank, *plus/minus* a competitiveness correction in surplus/deficit countries'. Finally, Hancké (2013) hints at the need for a double-track rule. He argues for instance that Spain would regain competitiveness against its trading partners if 'costs in the sheltered sector in Spain (adjusted for productivity) grew at a rate that was considerably slower than in the sector that is exposed to trade; two, if costs, including wages, in the Spanish export sector grew, again adjusted for productivity, at a slower pace than those of their main trading partners in the same sectors.'

- A minimum wage rule

Some authors for simplicity reasons focus on a rule limited to minimum wages, given their 'signalling' role, and also as a way to halt deflationary pressures and combat in-work poverty. The difficulty is that universal minimum wages does not exist in all EU countries, and that levels are very heterogeneous (see table 1).

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<sup>11</sup> European Commission, '2013 EUROPEAN SEMESTER: COUNTRY-SPECIFIC RECOMMENDATIONS: MOVING EUROPE BEYOND THE CRISIS' COM(2013) 350 final, 29/05/2013, [http://ec.europa.eu/europe2020/pdf/nd/2013eccomm\\_en.pdf](http://ec.europa.eu/europe2020/pdf/nd/2013eccomm_en.pdf) p. 15

<sup>12</sup> ETUC, 'Collective bargaining: The ETUC priorities and working program (Resolution)', 12/04/2012, <http://www.etuc.org/a/9872>

Table 1: wage bargaining systems and minimum wage (MW)

	Bargaining coverage (%) in 2010	Main level of bargaining	MW as percentage of median wage (2012), if relevant	Percentage points evolution of MW in real terms (inflation deflated) between 2010 and 2013	Monthly Minimum wage level in euro (2013)
Belgium	96	Centralised	51	1	1502
France	92 (2008)	Intermediate	62	1	1430
Germany	61	Intermediate			
Greece	65 (2008)	Centralised	43	-20	683
Ireland	42	Decentralised	48	-4	1462
Italy	85	Intermediate			
Netherlands	85	Intermediate	47	-4	1469
Poland	29	Decentralised	47		393
Portugal	32	Intermediate	58	-4	566
Spain	73	Intermediate		-4	753
Sweden	91	Intermediate			
UK	31	Decentralised	47		1264

Source: own adaptation from Independent Annual Growth Survey 2014 (OFCE-IMK-ECLM, 2013) and Eurostat

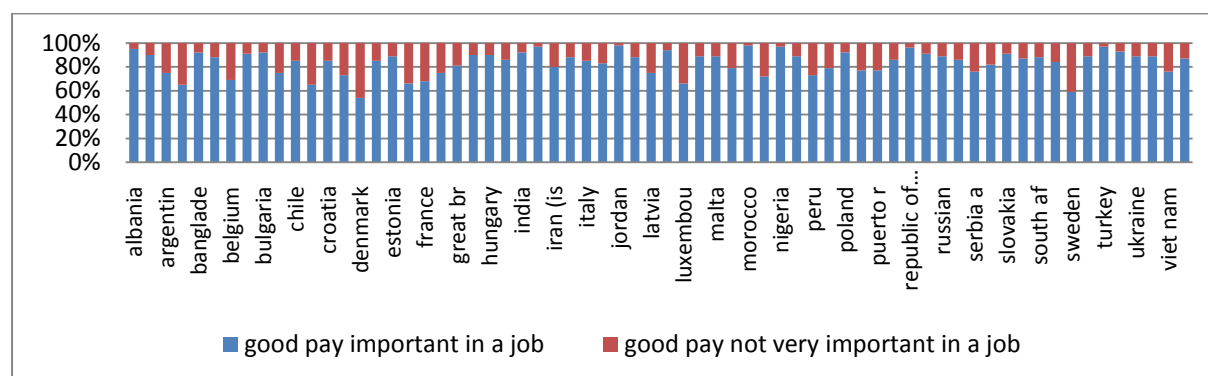
The extension of minimum wage coverage is a precondition of EU coordination. A second pre-requisite is the possibility, for the EU, to legislate or coordinate member states policies effectively in this field. Vandenbroucke (2013, p. 243) argues for instance that ‘minimum standards (e.g. with regard to the universal application of minimum wage floors, or the quality of minimum income protection) should ideally be introduced by European legislation’. However, if enforcing standards in terms of wage floors (be it in absolute or relative terms) is not possible, EU or Eurozone funding could be conditioned to improving the quality of member states’ social protection systems.

## 2. C. Distribution of preferences: expectations and wage-setting venues

Besides generally prevailing enthusiastic or sceptical attitudes to EU common policies within individual countries, some data and trends are particularly relevant to the question of potential wage coordination.

First of all, diverging expectations might derive from differences in living standards. One can assume that there is a relatively higher emphasis on wage increase in lower-income countries than in higher-income ones. In the former, the desired catch-up process is naturally accompanied by faster increases in both real and nominal variables. These diverging attitudes are visible in the data on the ‘importance of good pay’ from the World Values Survey (WVS)<sup>13</sup>. For only ten percent or less of the people in Bulgaria, Greece, Latvia, Lithuania, Poland, Slovakia and Romania, ‘good pay is not very important in a job’. On the contrary, this answer is chosen by 46 % of respondents in Denmark, 41 % in Sweden, 35 % in Austria, 34 % in Finland and in Luxembourg. Hence, presumably, people in high-income countries could be relatively more willing to consider wage coordination proposals at EU level. Those in the former group could be more sceptical to any measure potentially slowing down the wage dynamics there.

Figure 2: Preferences for good pay

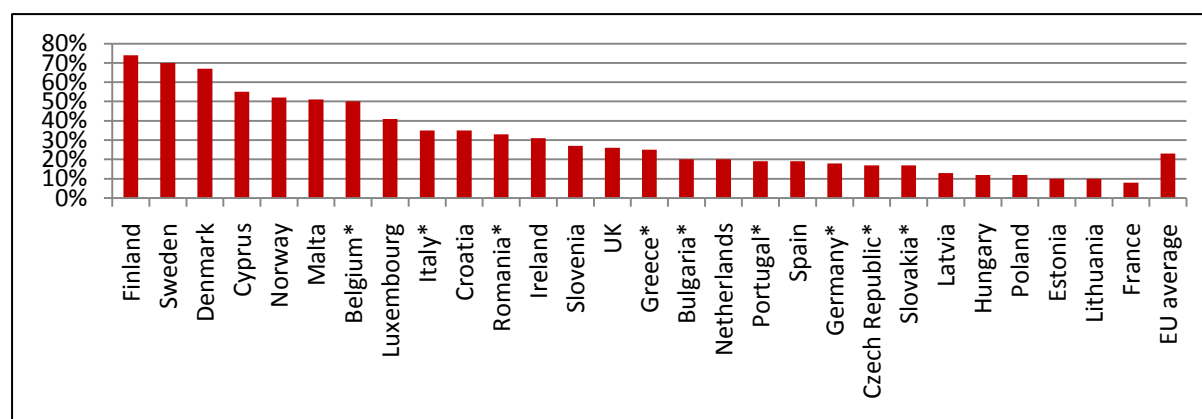


Source: own calculation based on WVS (1999-2004)

<sup>13</sup> WVS and EVS (European Values Survey) is a vast, long-lasting, cross-national research program, including 102 countries/regions in a few survey waves that have been conducted between 1981 and 2010. WVS/EVS contain data on how respondents think about family, work, religion, politics, and society.

Secondly, the significant differences in labour market institutional arrangements need to be taken into account. A proxy for attitudes in this area is membership in labour unions, which is also called trade union density. For the last three decades, there has been a decline in trade union membership across most Western European countries. Also, since 1989, trade union density in the Central and Eastern European countries has collapsed at an even more dramatic rate. This trend is reflected by current picture (see Figure 3): except in the Nordic countries, which still enjoy above 50% trade union membership, union density in EU countries is relatively low. Other sources<sup>14</sup> talk about six to eight EU member states where more than half of the employed population members of a trade union. The EU's four most populated states all have modest levels of unionisation, with Italy at 35%, the UK 26 %, Germany 18% and France at only 9%.

Figure 3: Proportion of employees in unions (%) – \*2013 figures



Source: [www.worker-participation.eu](http://www.worker-participation.eu) (\*extracted from Database on Institutional Characteristics of Trade Unions, Wage Setting, State Intervention and Social Pacts in 34 countries between 1960 and 2012, Amsterdam Institute for Advanced Labour Studies)

On the other hand, De Caju et al (2008) note that, although union membership is relatively low in many countries, trade union coverage (i.e. employees covered by collective agreements) is usually significantly higher (see table 1 above). Nevertheless, they highlight large variations in the degree of trade union density across sectors. Such complexity is also well reflected in a recent report for the European Trade Union Institute (Kampelmann et al, 2013). The authors highlight that the EU minimum wage debate is caught between those

<sup>14</sup> See in particular Waddington J. (2005) and Federation of European Employers, 'Trade unions in Europe', <http://www.fedee.com/labour-relations/trade-unions-in-europe/>

countries with a statutory minimum wage and those with satisfying collective bargaining coverage (such as the Nordic countries). The latter think that unions are better placed to obtain wage increases in a sectoral bargaining system, and fear downward harmonisation.

## ***2. D. Moral hazard: adverse consequences***

There are two types of adverse consequences which could result from wage coordination as outlined above. Firstly, in a Keynesian perspective, the upward trends that such coordination would unleash might change households' expectations about inflation and, therefore, foster inflation. A rise in the ECB's interest rate would be necessary to tame the inflationary pressures in surplus countries. This could 'kill' investment and employment, thus overshooting the initial objective of rebalancing. Higher interest rates would also become a drag on the less dynamic economies.

Secondly, in the realistic hypothesis of non-binding guidelines, wage coordination would face a collective action problem. In the absence of a central authority to enforce individual decisions, member states would have the temptation to extract a competitive advantage from not abiding by the rules. This problem is particularly acute in the EMU, where public goods such as the inflation rate, growth and employment are exclusive rather than inclusive. Access to them cannot be barred to any participant. As Collignon puts it (2008, pp. 76-78), 'deviating behaviour by individual governments might yield partially higher benefits' since they benefit anyway from others' compliance.

These critiques reflect the limits of half-way solutions in this field. Only if wage coordination is centralised, can individuals' and countries' expectations be managed at EU level. This corroborates Calmfors and Driffil (1988), for whom, from a macroeconomic point of view, either highly centralised or fully decentralised wage bargaining is superior to intermediate positions. In the former case, unions internalise the macroeconomic effects of their claims; in the latter, wages reflect marginal productivities of individual workers.

## ***2. E. Implementation issues: low transparency and statistical challenges***

The main risk faced by wage coordination at EU level is that it would add another layer of complexity and bureaucratic control onto EU economic governance. In that respect, implementing a 'golden rule' might be easier if limited to minimum wages and based on simple criteria such as inflation and current accounts. A general rule targeting the aggregate development of wages would trigger much more significant statistical challenges, especially if export-oriented and other sectors are to be differentiated. Past experiments of cross-sectoral, cross-border coordination (such as the Doorn group bringing together Belgian, Dutch, German and Luxemburgish union confederations in the late 1990s and early 2000s) have proved short-lived although they have been conducted on a small-scale basis.

## ***2. F. Recommendations***

If EU policy-makers want to go down the route of wage coordination, the analysis leads us to consider the following options:

- EU soft guidance linking wage developments with productivity should incorporate convergence towards the ECB's inflation target as a second objective. The Macroeconomic Dialogue between the ECB, EU institutions and social partners should be established as a more permanent forum in which such common understanding can be developed.
- Voluntary member states should develop a common understanding of what a minimum wage is about by using the Open Method of Coordination. This is a prerequisite for any further and more binding action.
- An indirect, but simpler way to tackle imbalances is for the EU to deal with current account deficits and surpluses in a more symmetric way as part of MIP. This leaves to national governments and social partners the freedom to adjust the real exchange rate by other means than wages (for instance, by modifying the tax burden).

### 3. Contractual arrangements – the case of labour markets reforms

Werner Report (1970, p. 25): *'It will also be necessary to envisage measures bearing on structural problems [...] In this context the Community measures should primarily concern regional policy and employment policy. Their realization would be facilitated by an increase in financial intervention effected at Community level.'*

The idea of 'contractual arrangements' underpinning domestic reforms has been discussed at EU meetings since 2012. President Van Rompuy's 'Roadmap' put forward 'arrangements of contractual nature' between the EU and member states aimed to 'address the roots of imbalances at an early stage' (p. 14). Such a proposal rests on two assumptions: first, that the coordination of supply-side reforms needs to be strengthened in the euro area; second, that financial incentives are necessary to buy member states' consent. We start by assessing this two-fold rationale before turning to the actual proposal, its strengths and its limits.

#### 3. A. Rationales for coordinated reforms and associated financial incentives

- Coordinated labour market reforms

Although the Macroeconomic Imbalance Procedure (MIP) might have increased pressures on member states, the EU's ability to influence national labour market reforms is limited to non-binding country-specific recommendations as part of the European Semester. Yet diverging rates of aggregate, youth and long-term unemployment as well as of labour market participation call the status-quo into question. There are at least three reasons why these national phenomena also matter for the EU as a whole.

First, large or growing disparities in social efficiency are a danger to the legitimacy of the European Union and to the proper functioning of the Eurozone. Vandenbroucke et al. (2013) take the example of heterogeneous child poverty rates in the EU to explain this spillover in detail. But the argumentation works similarly for other social phenomena like youth or aggregate unemployment. Substantial differences in unemployment erode mutual trust between member countries since they tend to classify themselves as successful and failing



countries. This will give room for national-oriented positions especially in successful countries, where public support for the idea of a common union with shared interests and responsibilities loses traction.

Secondly, while heterogeneous welfare systems and types of regulatory frameworks may lead to the same economic and social outcomes, this is probably not valid in the case of an asymmetric shock. Such a shock can put national arrangements under severe pressure if the reallocation of resources and the employment shifts from shrinking to growing sectors are hampered by wage inflexibility or low geographical mobility (Rothstein, 2012). The reduction in aggregate demand in 2009 has shown that labour market arrangements in some countries did not exhibit a sufficient level of resilience to a severe macroeconomic shock. For instance, unemployment increased substantially in Spain while Germany's labour market proved to be largely unaffected because of a combination of below-capacity employment before the crisis, wage moderation and working time accounts (Burda and Hunt, 2011).

Thirdly, spillovers can be occasioned by national social policies required by a detrimental social condition. If, for instance, high unemployment rates force the national government to carry out reforms which are targeted at reducing unemployment, other countries could be affected through trade or financial market interlinkages. A rapidly growing literature deals with the theoretical explanation as well as the empirical identification of international spillovers stemming from social policy reforms. Dao (2013) show that such spillovers can emerge through a change in relative prices which impact on terms of trade. For instance, a reduction in labour taxation leads to lower domestic labour costs and a rise in competitiveness due to falling export prices relative to the foreign competitors. The domestic export economy therefore gains market shares while foreign exporters are detrimentally affected. Nevertheless, improved terms of trade for the foreign economy (through cheaper import prices from the domestic economy) are expected to push foreign firm profits and labour demand.

In this context, Seymen and Busl (2013) discuss the spillover effects of two central components of the German 'Hartz IV reforms', an increase in the matching efficiency and a

reduction in the unemployment benefits, which have been carried out between 2003 and 2005. They show that this reform package had small negative short-run but small positive long-run employment effects on the euro area. In terms of output, consumption, investment and wages, the long-run spillover effects are positive and economically more relevant than the labour market effect. Nevertheless, the literature emphasizes that these types of spillovers depend crucially on other factors like the country-specific trade elasticity, openness or the country size.<sup>15</sup> A reform can produce either a positive or a negative spillover. The described potential supranational consequences of national reforms provide a justification for a greater EU involvement into national social policy.

- Rationale for financial incentives

While the need for structural reforms in economically suffering countries is widely acknowledged, it is questionable under which conditions reforms are likely to be implemented. Mabbett and Schelkle (2007) discuss two conflicting arguments regarding the ideal economic conditions for reforms. On the one hand, the ‘back against the wall’ or ‘TINA’ rationale defended by several authors stresses that the context of lost monetary and fiscal sovereignty provides, de facto, a strong incentive for reform. On the other hand, The ‘need for bribes’ rationale defends the idea of sequencing reform and fiscal adjustment since fiscal room for manoeuvre is needed in the short term, not only to compensate potential ‘losers’ – and avoid adverse effects such as rent-seeking demands on the back of reform - but also to finance the costs associated with systemic change.

It is not perfectly clear which of these theoretical rationales is true, although institutions like the IMF tend to defend the idea of sequencing. In the EU, the Stability and Growth Pact includes provisions according to which the medium-term budgetary objective (MTO) of a member state can be revised (i.e. delayed) when a ‘structural reform significantly impacting its public finances’ has been implemented. Furthermore, evidence points to a plausible link between reforms and EU financial support. Zartaloudis (2013) shows that reforms of ‘public employment policies’ in Greece and Portugal between 1995 and 2009 were not so much the

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<sup>15</sup> See Dao (2012), Dao (2013), Felbermayr et al. (2013), Coenen et al. (2008) and Schwarzmüller and Stähler (2011)

result of ‘policy learning’ under the European Employment Strategy than of ‘policy entrepreneurs’ on the one hand, and of the European Social Fund’s financial conditionality on the other. The latter aspect tends to confirm that financial incentives from the EU level can play a role in domestic reforms.

Hence, even if it is not clear whether money is needed to compensate ‘losers’, the ‘bait’ of more room for fiscal manoeuvre, or of additional money that would go into the central budget, make a strong case for financial incentives.

### ***3. B. Possible designs of the ‘contractual arrangement’ proposal***

In March 2013 The European Commission published a detailed proposal for a ‘convergence and competitiveness instrument’ made of ‘mutually agreed contracts’ and a ‘solidarity mechanism’.<sup>16</sup> A recent European Council’s working document gives an indication of the state of play of the discussions.<sup>17</sup> Table 2 synthesises the main features of the proposal, specifying the points left open to discussion.

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<sup>16</sup> European Commission, “Towards a Deep and Genuine Economic and Monetary Union, The introduction of a Convergence and Competitiveness Instrument” COM(2013) 165 final , 20/03/2013, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0165:FIN:EN:PDF>

<sup>17</sup> “Annotated agenda of the Sherpa meeting, Main features of Contractual Arrangements and Associated Solidary Mechanisms”, 21/11/2013, <http://blogs.ft.com/brusselsblog/files/2013/11/Sherpa.pdf>

Table 2: Possible design of ‘contractual arrangements’

	Contractual arrangement	Solidarity mechanism
<b>WHO</b>	<p><b>Commission:</b> open to all member states but mandatory for those under the ‘preventive’ and ‘corrective’ arms of the Macroeconomic Imbalance Procedure</p> <p><b>E. Council:</b> Mandatory in euro area (but failure of negotiation possible) and voluntary for other member states. A ‘politically binding commitment’</p>	<p><b>Commission:</b> consistent with EU structural funds, in particular the ESF</p> <p><b>E. Council:</b> only optional, but an agreement of ‘legally binding nature’</p>
<b>WHAT</b>	A set of reforms drawing on country-specific recommendations (CSR) and, if relevant, on the preventive and corrective action plans for member states with excessive imbalances	<p>A financial incentive rather than the cost coverage of a reform</p> <p><b>Commission:</b> Grants from EU budget as ‘external assigned revenues’ (EC)</p> <p><b>E. Council:</b> in the short term, long-term loans, possibly from ESM. In the long run, a euro area financing capacity</p>
<b>HOW</b>	Embedded in the European Semester, with ‘ex-ante’ involvement of national parliaments, social partners and all relevant stakeholders. The European Council signs off the contract (and the financial aid) negotiated between the EC and member states.	<p>Disbursement in tranches, conditional to actual implementation</p> <p>Suspension of payments and reimbursement in case of a breach</p>

Key questions remain open: should contracts be mandatory for all Eurozone members, or voluntary? Should financial support come in the form of loans or grants? Heated debates at the December 2013 European Council’s meeting revealed deep-seated disagreements over the proposal.<sup>18</sup>

### ***3. C. Distribution of preferences: ‘welfare attitudes’ across the EU***

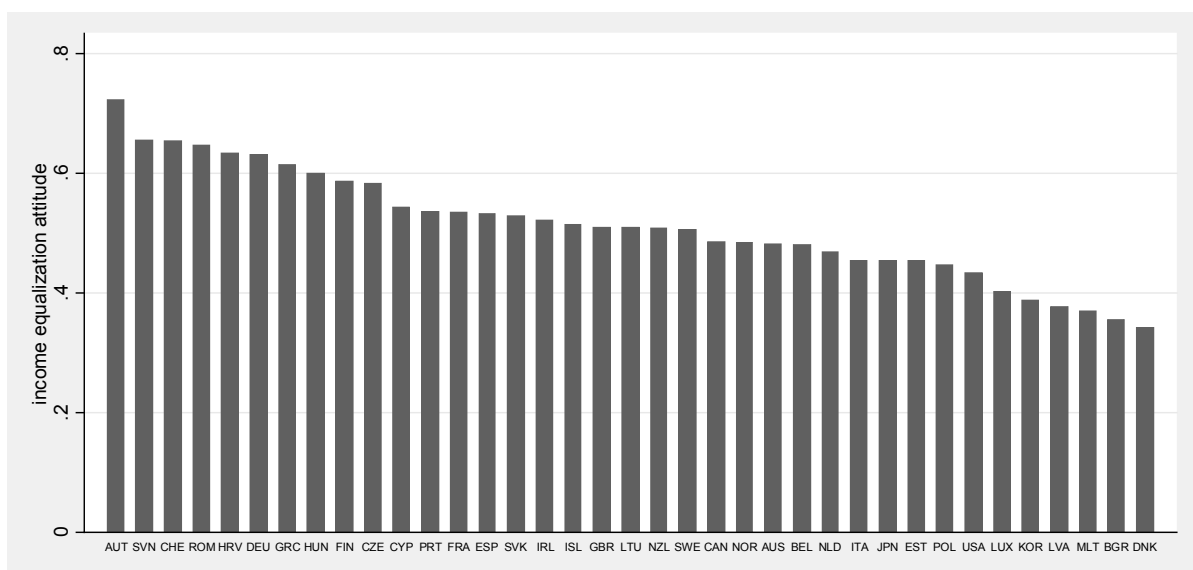
The hypothesis of EU contractual arrangements featuring labour market reforms means that the EU’s clout would significantly increase in an important area of modern welfare states. Understanding national preferences regarding the welfare state and welfare state reforms is therefore relevant to such a project. Dealing with this question, Pitlik and Kouba (2013) suppose that the acceptance of welfare state reform relates significantly to informal

<sup>18</sup> Ricard, P. ‘Angela Merkel : « Tôt ou tard, la monnaie explosera, sans la cohésion nécessaire »’, *Le Monde*, 22/12/2013

institutions and to the perceived quality of formal national institutional framework in individual countries. Based on World Values Survey and European Values Survey (EVS), they highlight preferences related to welfare states by using two key dimensions: attitudes to government intervention and income equalization (cf. figures 4 and 5 below).

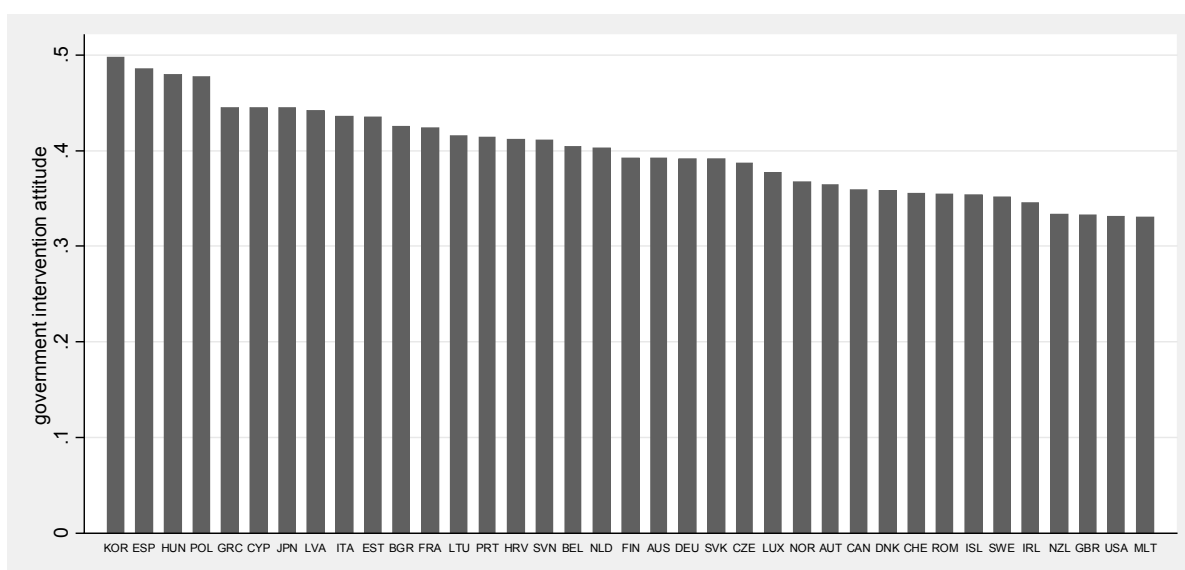
Unsurprisingly, these figures show ‘welfare state attitudes’ differing substantially across European countries. In the 2000s, the highest scores for income equalization are observed for Austria (0.72), the lowest scores for Denmark (0.34). Concerning government intervention attitudes in European countries, the highest scores are observed in a mixed group of countries consisting of Southern and Eastern countries – Spain (0.49), Hungary and Poland, the lowest scores in Malta and United Kingdom (0.33).

Figure 4: Welfare State attitudes in the 2000s: Income equalization



Source: Pitlik, Kouba (2013); 0-1 scale, higher values indicating stronger preferences

Figure 5: Welfare State attitudes in the 2000s: Government intervention



Source: Pitlik, Kouba (2013); 0-1 scale, higher values indicating stronger preferences

Yet, as such, these findings do not prove much. In many cases, they are even in discrepancy with an a priori intuition: for instance, there are relatively low preferences for government intervention in the Scandinavian countries, and Denmark has the lowest score in terms of income equalization attitudes. Similarly, within a priori expected clusters of countries (e.g. Central and Eastern European countries or Southern Europe), heterogeneous attitudes can be identified. Hence, the EU should show particular caution when getting involved in the politics of welfare reform. The temptation to impose one single ‘flexicurity’ model – as visible in the European Employment Strategy and in country-specific recommendations – runs inevitably against various traditions and expectations.

### 3. D. Moral hazard: who decides about the quality of reforms and spending?

Conditionality is the bulk of the ‘reform contracts’ proposal, thus explicitly designed to ward off risks of moral hazard. It relies on two main tools: the ‘legally binding nature’ of any contract providing financial support, and the ‘instalment’ logic of disbursement. History shows, however, that these guarantees might not be strong enough.

First, making sovereign states respect their commitments is very difficult. In the 2003-2005 dispute over the Stability and Growth Pact (SGP), Germany and France avoided sanctions by the Council and managed to have the rules recalibrated to their advantage. As part of the main executive institution deciding upon sanctions, member states are 'judge and jury' and they are reluctant to sanction each other.<sup>19</sup> Recent reforms in EU economic governance have tipped the balance towards more 'automaticity': financial sanctions under the corrective arm of the SGP and the MIP can only be outvoted by 'reverse-majority-voting'.<sup>20</sup> Nevertheless, this does not equate to a clear distinction between the 'insurer' and the 'insured'.

If contractual arrangements were introduced, the most populated member states would uphold substantial leeway in deciding when commitments have been breached. EU officials are manifestly aware of these concerns and defend a robust monitoring benchmark. The working note for the November 2013 'Sherpa meeting' goes as such: 'conditionality and monitoring based on observable milestones are essential. Financial support could be conditional on the implementation of a set of mutually agreed specific benchmarks' (p. 6).

Another source of uncertainty is how financial support is spent. As Rubio (2013) puts it, crisis-hit countries have had an impressive record at implementing reforms to deregulate markets and liberalise specific sectors, which, in themselves, cost more political than financial capital. However, they have been much less encouraged to improve the size and the quality of their training and placement services. Would contractual arrangements address this missing link? The risk is that focusing on one single set of objectives overlooks policy complementarities.<sup>21</sup> If, for instance, a country reforms its labour market in order to boost employment participation and spends EU money to compensate specific categories rather than to boost the efficiency of its active labour market programmes, this might result in a drop in the employment participation. Therefore conditionality needs to be broadly

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<sup>19</sup> See Wyplosz (2010)

<sup>20</sup> Though the initial steps of opening an excessive deficit or imbalance procedure still require a positive majority voting

<sup>21</sup> See Pisani-Ferry J., 'Distressed Europe should not be bribed for reform', *Financial Times*, 05/02/2013, <http://blogs.ft.com/the-a-list/2013/02/05/distressed-europe-should-not-be-bribed-to-reform/>

defined. They need to be connected to EU long-term objectives as set by the Europe 2020 Strategy and supported by the EU budget.

In that respect, it would make sense to merge 'reform contracts' with the new 'macroeconomic conditionality' provision of the EU budget, as Verhelst (2013) suggests. This would merely necessitate extending to all member states the financial incentives already available in the EU budget for countries under financial assistance. Conditionality would move from a punitive to a more positive approach: member states would not only be threatened with a suspension of EU funding in case of non-compliance with macroeconomic recommendations. They would also be offered additional guidance and support to make reforms pay over the long term.

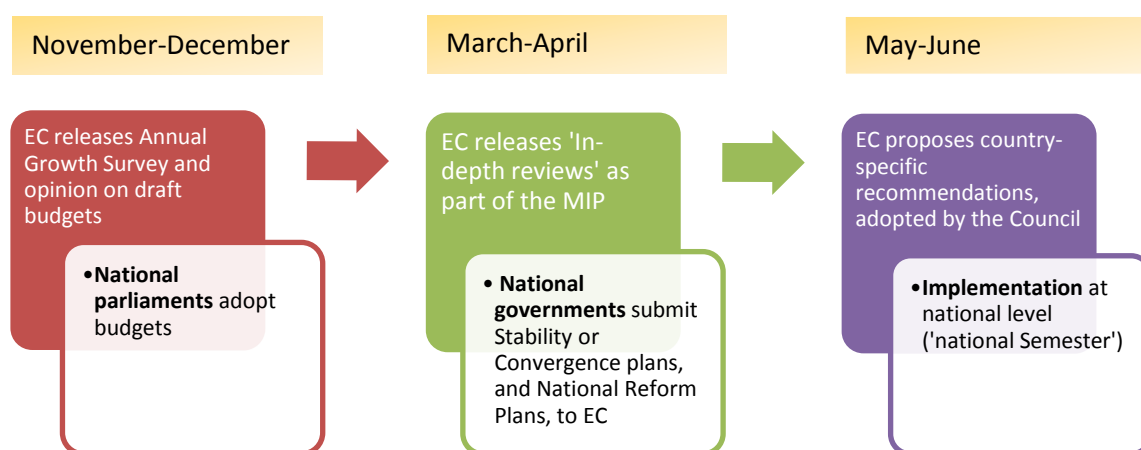
### ***3. E. Implementation issues: EU and national policy processes***

The introduction of contractual arrangements, especially if they were legally binding, would require a significant adjustment in national decision-making procedures, and the beefing up of EU monitoring capacities.

In terms of decision-making procedures, reform contracts would add another brick to the already complex European Semester's wall. National governments, parliaments and relevant stakeholders (such as social partners) have had to adapt the new regime of ex-ante coordination in the last few years. Figure 6 gives an idea of the different deadlines when national governments and parliaments have either to submit fiscal and national programmes, or to discuss and implement EU recommendations. Logically, contracts would be agreed upon after the adoption of the CSR by the Council.



Figure 6: the European Semester- simplified timeline



Source: own adaptation from [http://ec.europa.eu/europe2020/making-it-happen/index\\_en.htm](http://ec.europa.eu/europe2020/making-it-happen/index_en.htm)

The prospect of binding contracts would make discussions at an earlier stage only more intense. National parliaments and social partners might not have sufficient time to agree on the broad lines of a necessary reform before CSR are adopted. Clashes between EU and national policy processes cannot be excluded. It is therefore hard to argue that contractual arrangements offer a template in good governance. As reflected by the critiques against the 'Troika model', the lack of accountability of an over-intrusive European Commission could backfire.

The lack of administrative and monitoring capacity should also be another reason for caution. If poorly managed, reforms do not bring about the expected results. The EC is aware of the challenge: since 2012, 'modernising public administration' is one of the five priorities of the Annual Growth Survey, and it plays an increasing role in country-specific recommendations.<sup>22</sup> Furthermore, Institutional capacity building (ICB) was an objective in the 'Strategic Guidelines for Cohesion policy in 2007-2013'. It received only 1.1% of the ESF and the ERDF total amounts, although additional specific lines were available on labour-

<sup>22</sup> In the document introducing the 2013 country-specific recommendations, the Commission writes: 'From the need to overhaul certain public employment services to a lack of analytical capacity to design and implement structural reforms, to improve the management and increase low level of absorption of EU structural funds, the needs to modernise member states public administrations is clear'. "Moving Europe beyond the crisis" COM(2013) 350 final, [http://ec.europa.eu/europe2020/pdf/nd/2013eccomm\\_en.pdf](http://ec.europa.eu/europe2020/pdf/nd/2013eccomm_en.pdf), p.19

market reforms and e-government.<sup>23</sup> In Greece, for instance, 10% of the ESF allocation was dedicated to the Public Administration Reform Operational Programme. Mutual learning has a major role to play in improving administrative capacity, as illustrated recently by the dialogue between public employment services on the introduction of youth guarantee schemes.

Having a robust institutional framework in place is also paramount in order to both absorb and make the most of EU funding. Up to June 2013, Romania and Bulgaria had absorbed only 26 and 40% of available EU funds for the period 2007-2013. The EC had to freeze payments to Romania at the beginning of 2013 for reports of corruption.<sup>24</sup> Ederveen et al (2006) find that ‘for countries with a ‘proper’ institutional framework, structural funds are effective. The latter result is obtained for a wide range of conditioning variables, such as openness, institutional quality, corruption and indicators for good governance’. This finding should not lead the EU to ‘transplant’ best-performing institutional set-ups from a country or a region to another. As Rodríguez-Pose (2009) argues, a good balance between quality guidelines and local specificities is necessary given the extent of ‘informal institutions’. These observations should also lead to taking a much more ambitious approach to the quality of government in the accession process of candidate countries to the EU.

### **3. F. Recommendations**

The analysis above leads to the following recommendations:

- Contractual arrangements should be conceived as a tool improving both member states’ resilience to shocks and their social systems’ robustness.
- EU financial support should be targeted at improving the quality of national administrations to a much larger extent than today.
- The ‘ex-ante conditionality’ existing in the EU budget should be experimented before considering any new mechanism.

<sup>23</sup> European Commission, ‘Cohesion policy: strategic report 2013, Factsheet: Institutional capacity building’, [http://ec.europa.eu/regional\\_policy/how/policy/doc/strategic\\_report/2013/factsheet13\\_inst\\_capacity\\_building.pdf](http://ec.europa.eu/regional_policy/how/policy/doc/strategic_report/2013/factsheet13_inst_capacity_building.pdf) p. 2

<sup>24</sup> Source: European Commission via [www.insideurope.eu](http://www.insideurope.eu), a blog on EU structural and cohesion funds managed by the *Deutsche Gesellschaft für Internationale Zusammenarbeit* (GIZ)

## 4. A stabilisation mechanism for the Eurozone

Marjolin report (European Commission 1975, p. 33): *'As regards the stabilisation function in particular, experience shows the inadequacy of mere voluntary co-ordination of national budgetary policies. In order to take the first steps towards a common demand management policy, a stricter discipline of governments in their budgetary decisions is thus indispensable. In the longer term, this approach must stress the development of the proper stabilisation function of the Community budget.'*

### 4. A. Rationale: improved cyclical convergence or aggregate output?

'Cyclical insurance fund', 'automatic transfers', 'shock-absorbing capacity' are all different names behind an idea dating back to the early drafts of EMU, namely a stabilisation mechanism that would help member states cope with cyclical shocks. In Van Rompuy's Roadmap and in the EC communication on the social dimension of EMU<sup>25</sup>, this instrument is presented as a desirable prolongation of the EU budget and of the tentative solidarity instrument which would go along contractual arrangements. It is important to distinguish three main rationales behind a stabilisation mechanism.

The first rationale of a stabilisation mechanism is to prevent spillovers from cyclical variations. As the Roadmap puts it (p. 10), 'in order to protect against negative fiscal externalities, it is important that fiscal risks are shared where economic adjustment mechanisms to country-specific-shocks are less than perfect'. Despite market integration and fiscal convergence, structural heterogeneity in terms of economic development and specialisation explains the persistence of asymmetric shocks. Amid barriers to labour mobility and limits to internal devaluation strategies, the Eurozone lacks convincing adjustment mechanisms. In a downturn, a stabilisation tool would prevent member states from being exposed to financial markets, from implementing overly harsh austerity

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<sup>25</sup> European Commission, 'STRENGTHENING THE SOCIAL DIMENSION OF THE ECONOMIC AND MONETARY UNION', COM(2013) 690, 02/10/2013, [http://ec.europa.eu/commission\\_2010-2014/president/news/archives/2013/10/pdf/20131002\\_1-emu\\_en.pdf](http://ec.europa.eu/commission_2010-2014/president/news/archives/2013/10/pdf/20131002_1-emu_en.pdf)

measures and from unsettling the productive basis<sup>26</sup>. It would also, in theory, give space for structural reform. In 'good times' it would force surplus countries to 'recycle' their savings.

A second, commonly heard rationale is that a stabilisation mechanism would improve the policy mix in the Euro area. By smoothing cyclical variations, the aggregate output of the Euro Area would end up higher than in the absence of such a tool. On the one hand, the ECB's interest rate would fit diverse national positions better and foster less upward or downward pro-cyclicality. On the other hand, it would avoid countries experiencing downturns from slipping into too severe recessions, thereby making sure that member states come close to realising their growth potential and consolidating aggregate demand. The latter argument is however dependent on the fund's design (see below). It also starts from the disputable principle that member states share a common objective in terms of aggregate output. As such, it departs from a mere spillover rationale.

Finally, some argue that a stabilisation tool would significantly beef up the stability and, therefore, the credibility of governance in EMU. The current 'insurance-adjustment' strategy relies on a wide range of ad hoc measures, the coordination of which is fraught with moral hazard. As Puetter (2012) argues, coordination in EMU has created a new 'deliberative intergovernmentalism' which departs hugely from the law-based Community method. For many commentators, this regime of permanent uncertainty is not sustainable. It puts national leaders under conflicting pressures from their peers and their electorate, and it does not reassure financial markets. Having a permanent stabilisation tool organising automatic transfers among member states would, according to its proponents, resolutely move EMU from a flawed 'disciplinary device' to a credible insurance arrangement.<sup>27</sup>

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<sup>26</sup> Aghion and Howitt (2006, pp.301-309) argue for instance that macroeconomic instability prevents firms from reaching an optimal level of research and development. Counter-cyclical fiscal policy should be seen as a complement to structural, supply-side policies.

<sup>27</sup> See for instance Schelkle (2005)

#### **4. B. Possible designs**

Pisani-Ferry et al outline four different possible designs for a Eurozone stabilisation tool.<sup>28</sup> We focus here on the two options which have received all the attention in the recent past.

- Option 1: a cyclical shock insurance

Enderlein et al (2013) put forward a ‘cyclical shock insurance’ that would ensure symmetric stabilisation across the euro area. Payments from and to individual countries are linked to the difference between the domestic output gap and the EMU output gap, but the fund has no possibility to borrow. Thus, the scheme seeks an objective of cyclical convergence among EU partners rather than one of aggregate stabilisation. It requires a very limited budget and is said to be compatible with EU treaties.

Delbecq (2013) takes this approach further by devising a stabilisation fund across space and time. Member states would get a payment when their real GDP growth forecast is below their estimated long-term real GDP, but not in relation to the output gap with the EMU average. They would contribute in form of an ‘insurance premium’ in good times. In adverse circumstances for a majority of member states, the fund would have the possibility to borrow and, thus, to address euro-area wide shocks.

- Option 2: a euro-area budget for stabilisation

The contractual arrangement proposal (see section 3) might lead to pool further resources into a euro-area financial capacity. However, ad hoc and conditional payments to member states would not mean the same thing as automatic tax and spend. The latter is the logic behind the mutualisation of automatic stabilisers advocated by Dullien and Schwarzer (2009) and in a recent paper by the French Treasury (2013). Built upon cyclical revenues (corporate tax) and spending (unemployment benefits), such a budget could have

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<sup>28</sup> A euro-area budget ; an automatic transfer scheme offsetting output deviations; GDP-indexed bonds ; jointly guaranteed bonds (“eurobonds”), cf. Pisani-Ferry J., Vihriälä E., Wolff G.B., “Options for a euro area fiscal capacity”, Bruegel Policy Brief, January 2013, <http://www.bruegel.org/publications/publication-detail/publication/765-options-for-a-euro-area-fiscal-capacity/>

discretionary spending capacity and the ECB's financial backstop. This would necessitate some significant sovereignty transfer to the EU level and, optionally, the common issuance of Eurozone bonds.

#### ***4. C. Heterogeneity of preferences: solidarity and mutual trust***

The setting-up of an automatic stabilisation fund questions attitudes towards cross-EU solidarity and mutual support. Existing opinion polls touching upon the topic<sup>29</sup> should be treated with caution since results are highly volatile depending on the context. Furthermore, answers to different questions within the same survey can often look contradictory. Yet a few important trends have been noticeable in the last few years, which say a lot about the constraints faced by EU policy-makers.

In general, there have been both significantly diverging attitudes to EU integration, in particular between the North and South, and growing scepticism of the benefits and future of the European Union overall (Figure 7). This can however be contrasted with Eurobarometer findings according to which Europeans support 'stronger economic coordination' as a response to the crisis. 76% of them think this would be effective, with Belgium, Germany, Spain and the Netherlands well above 80% and the UK closing ranks with a still approving 59%.<sup>30</sup>

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<sup>29</sup> Such as Eurobarometer surveys, Pew Research Centre studies, and general opinions poll institutes

<sup>30</sup> European Commission, Standard Eurobarometer 80, Autumn 2013, Table of results, p.120, [http://ec.europa.eu/public\\_opinion/archives/eb/eb80/eb80\\_anx\\_en.pdf](http://ec.europa.eu/public_opinion/archives/eb/eb80/eb80_anx_en.pdf)

Figure 7: Overall support to the EU

<b>Decline in Support for the European Project</b>						
	<i>Economic integration strengthened economy</i>			<i>Favorable of EU</i>		
	2012	2013	Change	2012	2013	Change
	%	%		%	%	
Germany	59	54	-5	68	60	-8
Britain	30	26	-4	45	43	-2
France	36	22	-14	60	41	-19
Italy	22	11	-11	59	58	-1
Spain	46	37	-9	60	46	-14
Greece	18	11	-7	37	33	-4
Poland	48	41	-7	69	68	-1
Czech Rep.	31	29	-2	34	38	+4
<b>MEDIAN</b>	<b>34</b>	<b>28</b>	<b>-6</b>	<b>60</b>	<b>45</b>	<b>-15</b>

PEW RESEARCH CENTER Q9f & Q31.

Source: Pew Research Centre (2013)

These data do not provide any clear-cut indication regarding potential support to solidarity measures such as a stabilization mechanism, but they imply that EU citizens expect their leaders to find common solutions to collective problems without pooling sovereignty and resources further. Some other figures by Pew Research reveal that only 49% of German, 44% of French, and 34% of British citizens agree their country should give financial assistance if another EU country is in troubles. There is medium support in the CEE countries that are not currently in the Eurozone – 55% in the Czech Republic and 63% in Poland; while there is very high support in the Southern countries which currently have major financial problems – 91% in Greece, 90% in Spain and 79% in Italy.

A final trend worth noticing are the unique attitudes in Germany, as shown on Figure 8. On the one hand, the impressively optimistic and confident attitudes of German people can be beneficial to the whole European economy. On the other hand, the extreme discrepancy between attitudes in Germany and in the rest of Europe poses serious limitations to any reform process. Hitherto, the German government has enjoyed a relatively high level of public support in its steps and proposals to tackle instability in the Eurozone. Nevertheless, public opinion in other European countries has been increasingly critical. The ambiguity over how other European nations perceive Germans is evidenced by the fact that Germans are

perceived to be the most trustworthy EU nation on the one hand, and the most arrogant and least compassionate on the other hand (Pew Research Center, 2013). European policy-makers need to take these sharply divergent public opinions into account.

Figure 8: German perceptions

<b>Germans on Different Continent</b>			
	<b>EU median*</b>	<b>Germany</b>	<b>Diff.</b>
	<b>%</b>	<b>%</b>	
Economy is good	9	75	+66
Own country's leader is doing good job**	26	74	+48
Country strengthened by EU integration	26	54	+28
Personal economic situation is good	51	77	+26
EU favorable	43	60	+17
Economy improve in next 12 months	15	27	+12

\* Excludes Germany.

\*\* Leaders asked about include: Britain: PM Cameron; France: President Hollande; Germany: Chancellor Merkel; Spain: PM Rajoy; Italy: PM Monti; Greece: PM Samaras; Poland: PM Tusk; Czech Republic: PM Necas.

PEW RESEARCH CENTER Q4, Q5, Q6, Q9f, Q31 & Q32a-d.

Source: Pew Research Center (2013)

#### **4. D. Moral hazard: gaming the system?**

EU policy-makers are wary of automatic transfers going systematically 'one way', from the most to the least competitive countries, as it has been the case on a cross-regional basis in Italy, Belgium and Germany for decades. Are any of the options outlined above more desirable than another in that respect?

The 'cyclical insurance' option could see member states tempted to 'game the system' by reducing the size of their automatic stabilisers and letting their output deteriorate intentionally. As such, they do not have any incentives to make reforms improving their growth and adjustment capacities as they would soon become net contributors to the system. Addressing this risk demands strict conditionality. The existing fiscal and macroeconomic surveillance frameworks, and the ex-ante conditionality of EU funds,



already provide ample safeguards. Linking any stabilisation device with contractual arrangements, as suggested in the Roadmap, would make ‘free-riding’ even less likely.

Uncertainty about how money is spent ‘ex-post’ is another source of moral hazard. ‘Earmarking’ would be necessary in order to make sure that resources are targeted at the purpose they are supposed to serve, namely stabilisation. As Enderlein et al. (2013) suggest, it would be logical to cover the surge in social security expenditure.

Arguably, the ‘budget’ option faces even greater moral hazard issues given that it would rely directly on economic agents. In the absence of sufficient harmonisation of unemployment benefits and labour law, some countries with high structural unemployment could become permanent net recipients. Moreover, the EU or any euro-area authority in charge would be confronted with the same problems of tax fraud and benefit abuse than any national government does.

#### ***4. E. Implementation difficulties: statistical and institutional challenges***

While option 1 raises statistical questions, option 2 requires building a new institution on the back of a massive transfer of resources. In both cases, making it simple and transparent is a huge challenge.

Calculating payments on the basis of the output gap (option 1) questions the reliability of this indicator. The output gap is meant to estimate a country’s position in the business cycle by measuring the difference between the potential long-term output and the actual level of production. A positive output gap reflects an inflationary boom, while a negative output gap reveals growth below potential. This indicator plays already a central role in the Stability and Growth Pact’s procedures.<sup>31</sup> In a 2010 European Commission publication (D’Auria et al, 2010), authors acknowledge that ‘estimating the output gap is difficult since potential growth is not directly observable whilst actual GDP is subject to significant historical /

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<sup>31</sup> An Output Gaps Working Group is in place in the Council of the EU ‘to ensure technically robust and transparent potential output and output gap indicators’ and ‘develop progressively the commonly agreed method for calculating output gaps’, [http://europa.eu/epc/working\\_groups/output\\_gaps\\_en.htm](http://europa.eu/epc/working_groups/output_gaps_en.htm)

forecast revisions'. Kempkes (2012) finds for instance a substantial downward bias of EU's autumn forecasts of the output gaps over the period 2002-2011 in the EU-15.

Enderlein et al (2013) nevertheless think that the risk of error can be tamed in two ways:

- By paying in several instalments: 50% of due in- and out-payments would be transferred in January on the basis of autumn forecasts of output gaps. The remaining 50% would be paid in two instalments in summer and autumn on the basis of adjusted forecasts.
- By basing payments calculations on the difference between national output gaps and the average output gap. As adjustments are highly correlated between countries, plausible nominal errors in national output gaps would likely be distributed evenly and, thus, have little impact.

Option 2 would circumvent statistical problems, but would be faced with institutional challenges. An EU-level treasury to collect taxes and manage spending would be necessary. Perhaps more difficult would be the significant convergence in national labour law and, in particular, the conditionality of unemployment benefits.

#### **4. F. Recommendations**

Given the significant barriers faced by the proposed cyclical stabilisation tool, it is highly advisable to:

- Make better use of the existing cyclical provisions of the Stability and Growth Pact.
- Design a small-sized, 'experimental' cyclical insurance fund based on a strong statistical consensus;
- Link any discussion about a common unemployment scheme to the pre-required convergence of labour market laws.

## Conclusion

The future of EU economic governance has been subject to passionate debates since the beginning of the sovereign debt crisis. Strong opinions are being expressed, quite often suggesting that there is little choice but, either ‘getting back to basics’ (which might mean dismantling the Eurozone) or embracing a much more integrated trajectory. These conflicting statements often reflect the clash of political and economic rationales, which gives the impression of an intractable solution - that economic interdependence and spill-overs need to be managed by central institutions, which are at odds with political preferences in most member states.

This paper has sought to highlight the fact that European policy-makers have to navigate their way through an even more complex landscape. Like at national level, the limits of technocratic governance have to be taken into account when devising new institutions for the EU. Risks and failures such as moral hazard and low implementation capacity should take centre stage in the debates about the Eurozone’s future governance. Therefore, the analytical framework put forward in the paper attempts to cover the whole spectrum of implications of any reform initiative, from its intellectual justification to its ‘implementability’ and over its political acceptability.

The three case-studies give an indication of the hurdles faced by the champions of more socially-oriented and reciprocity-based governance in the EU. Wage coordination might not be the simplest and most legitimate way to tackle current account divergences; contractual arrangements risk being seen, at best as a cumbersome process fraught with political motivations, and at worst as unjustifiable external interference, in the absence of a shared diagnosis over the reforms needed; a cyclical stabilisation tool at EU level touches the hypersensitive nerve of cross-EU trust and solidarity despite the apparent simplicity of possible designs.

As the EU’s history shows, small and experimental steps might be necessary to build up consensus. It is all the more important to start from existing frameworks of governance, and

to garner the public's support around them, a dimension too often found wanting in past EU ventures. This goes through the densification of policy coordination before considering any further integration steps, and through the ability of EU leaders to craft practical solutions to overcome very diverse views of the world and implementation failures.

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## **Project Information**

### **Welfare, Wealth and Work for Europe**

#### **A European research consortium is working on the analytical foundations for a socio-ecological transition**

##### **Abstract**

Europe needs change. The financial crisis has exposed long-neglected deficiencies in the present growth path, most visibly in the areas of unemployment and public debt. At the same time, Europe has to cope with new challenges, ranging from globalisation and demographic shifts to new technologies and ecological challenges. Under the title of Welfare, Wealth and Work for Europe – WWWforEurope – a European research consortium is laying the analytical foundation for a new development strategy that will enable a socio-ecological transition to high levels of employment, social inclusion, gender equity and environmental sustainability. The four-year research project within the 7<sup>th</sup> Framework Programme funded by the European Commission was launched in April 2012. The consortium brings together researchers from 33 scientific institutions in 12 European countries and is coordinated by the Austrian Institute of Economic Research (WIFO). The project coordinator is Karl Aiginger, director of WIFO.

For details on WWWforEurope see: [www.foreurope.eu](http://www.foreurope.eu)

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