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Dolls, Mathias; Fuest, Clemens; Krolage, Carla; Neumeier, Florian; Stöhlker, Daniel

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Incentivising structural reforms in Europe? A blueprint for the European Commission's Reform Support Programme

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Poschingerstr. 5, 81679 Munich, Germany
Telephone +49 89 9224-0, Telefax +49 89 9224-1462, Email Dolls@ifo.de
Editors: Mathias Dolls, Clemens Fuest
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Incentivising Structural Reforms in Europe?

A Blueprint for the European Commission's Reform Support Programme

Mathias Dolls, Clemens Fuest, Carla Krolage,

Florian Neumeier, Daniel Stöhlker[1]

February 2019

Abstract

This paper contributes to the current debate how a faster implementation of structural reforms fostering the process of economic convergence in Europe can be achieved. We discuss the rationale and potential adverse effects of providing financial incentives for structural reforms. After a discussion of the European Commission's proposal of the 'reform support programme', we present our proposal of 'national convergence roadmaps' which deviates from the Commission proposal in some key dimensions. Our proposal of national convergence roadmaps reflects the fact that ensuring progress towards convergence targets is primarily a responsibility of the individual member states, not of the EU or European institutions and bodies like the European Commission and the Eurogroup.

1. Introduction

In December 2017, the European Commission proposed a reform support programme in its roadmap for further institutional reforms in the Economic and Monetary Union (European

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Commission 2017a,b). Anchored in the upcoming multiannual financial framework for the period 2021-2027, the reform support programme would provide financial and technical support for member states pursuing growth-enhancing structural reforms. The European Commission followed up with a more detailed proposal on the establishment of the reform support programme in June 2018 (European Commission, 2018).

This article discusses the rationale and potential adverse effects of the idea to incentivise governments to conduct structural reforms by means of fiscal transfers. We discuss strengths and weaknesses of the reform delivery tool, the key component of the proposed reform support programme, and subsequently present our proposal of 'national convergence roadmaps' which may serve as a blueprint for the reform delivery tool.[2] Our proposal is driven by the overarching principle that the responsibility for making satisfying progress with respect to structural reforms and economic convergence needs to be rebalanced between the member states and the European Union. Giving the European Commission additional competences in areas where national economic policies generate considerable spill-overs can be helpful, but may blur responsibilities and allow national politicians to blame 'Europe' for unsatisfying results, even if these results are primarily caused by shortcomings of national policies and the failure to implement necessary reforms.

We therefore propose to strengthen the role of national responsibility for the convergence process by giving member states the possibility to propose a convergence roadmap in the context of the European Semester. National convergence roadmaps would be assessed by the European Commission, while the Council could approve financial support of structural reforms. In our view, the key rationale for incentivising structural reforms is that some beneficial reforms with positive spill-over effects to other member states and the EU as a whole may not be implemented without incentives. A key difference of our proposed framework to the European Commission's reform delivery tool is that we propose to reallocate existing resources from the European Structural and Investment Funds (ESI) for reform support rather than establishing a separate budget line. This is motivated by empirical evidence pointing to limited effectiveness of existing cohesion funds[3] and by the existence of a significant amount of unused funds in the various EU support programmes. As outlined below, we think that it is essential to provide financial incentives in a targeted and efficient way, focusing on those structural reforms that generate spillovers across borders and have the highest potential to foster economic convergence in Europe. Granting financial support in one single tranche upon full implementation of the reform package and without linking support to the costs of reforms as foreseen in the current European Commission proposal of the reform delivery tool may lead to an inefficient use of resources.

The rest of the paper is structured as follows. Section 2 discusses the rationale and potential adverse effects of incentivising structural reforms. Section 3 discusses the European Commission proposal of the reform support programme. Section 4 presents our proposal of national convergence roadmaps. Section 5 concludes.

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[2] This paper refines and extends ideas the authors have developed in a briefing paper requested by the European Parliament's Committee on Economic and Monetary Affairs (Dolls et al. 2018).

[3] See e.g. EEAG (2018) for an overview.

2. Rationale and potential adverse effects of incentivising structural reforms

Why could it be that EU member states do not pursue reforms that are in their own interest? One main factor which may obstruct the implementation of reforms is the timing and the distribution of costs and benefits over time. While economic costs may arise immediately, benefits may take longer to materialize as the economy gradually adjusts to the reform (Banerji et al., 2015; Marrazzo and Terzi, 2017). Moreover, gains might be widely distributed across the population, whereas a smaller group may incur significant losses, garnering higher visibility than the reform beneficiaries. Another reason why some structural reforms are not pursued is that positive spill-over effects to other member states are not fully internalized by national governments (Grüner, 2013). These short-term economic and political costs and the neglect of the common European interest are an important explanation for reform fatigue, even though in principle efficiency-enhancing structural reforms allow for Pareto improvements by compensating the losers of the reform. Financial incentives could help to overcome these politico-economic impediments.[4]

However, incentive mechanisms may come with unintended side-effects that need to be carefully addressed in their design. First, if fiscal transfers are paid as a reward for reforms that would have been implemented anyway, such an instrument would lead to windfall gains, put an unnecessary burden on taxpayers and hence be inefficient. Second, there is a concern that financial support for structural reforms could cause moral hazard. This would be the case, for instance, if reform efforts are delayed until governments become eligible for financial support. Third, at the national level reforms may be more difficult to implement if they are perceived as being imposed from the outside or as giving in to pressure exerted by the EU.

3. The European Commission's Proposal of a Reform Support Programme

The reform support programme comprises three separate but complementary instruments: (i) the reform delivery tool, a financial support instrument for incentivising reforms, (ii) a technical support instrument as a follow up to the Commission's Structural Reform Support Programme, and (iii) a convergence facility to support structural reforms in non-euro area member states and to prepare them for future membership in the euro area. These instruments shall be established as part of the multi-annual financial framework 2021-2027 and encompass a total volume of EUR 25 billion. With an intended volume of EUR 22 billion, the reform delivery tool constitutes the largest instrument of the reform support programme.

[4] Regarding short-termism one may of course ask why this problem should be less severe at the European level, where financial incentives are set. A possible answer is that the member states may effectively use EU programs as a commitment device.

The reform delivery tool is intended to support reforms that aim at strengthening member states' economic resilience and that are expected to exert positive spill-over effects on other member states. Member states can apply for funding by committing to the implementation of structural reforms that address the economic challenges brought forward in the context of the European Semester's policy dialogue. For that purpose, they can propose a multiannual reform commitment package with a detailed set of reform targets and milestones for implementation, together with a timetable for completion within a maximum period of three years. A rating system determines whether the reform package fully meets the Commission's assessment criteria, and the full amount of funds is made available, or whether the Commission's targets are only satisfactorily met, in which case a country can draw on half of the amount. If one of the criteria is not met at all, the proposed reform is not eligible for funding. The progress in implementing the reform is regularly monitored by the European Commission within the framework of the European Semester.

The amount a member state can receive is proportional to population size and is not linked to the costs of the reform. More precisely, each member state is entitled to a share of the total funds equivalent to the share of its population in the total population of the EU-27 member states. The funds are made available at several stages of the programme period. In the first 20 months of the programme, 11 billion are made available for which member states can submit proposals. At a second stage, a further 11 billion are up for allocation. If funds remain after these two calls, further calls will be launched. The funds are paid in a single instalment once the reform has been implemented. This has to take place within three years of the adoption decision. If the reform is reversed or if its results are significantly obstructed by other measures within the five years after payment, the Commission might reclaim the funds.

Assessment of the Reform Delivery Tool

In many aspects, the reform delivery tool resembles the Convergence and Competitiveness Instrument proposed by the European Commission in 2013 which eventually lacked political support by the member states (European Commission, 2013; Steinbach, 2016). In our view, it includes several provisions pointing into the right direction. First, the reform delivery tool strives to foster national ownership of reforms by making participation voluntary and by inviting member states to submit their own reform proposals. This is preferable to an approach where the Commission proposes reform agendas to the member states. Second, member states are required to outline implementation milestones as well as a timetable for the completion of their reform commitment packages. These provisions should lead member states to pursue reform efforts with a significant degree of commitment. Third, reform consultations include a peer review process, enabling member states to learn from successful reforms implemented in other member states.

Yet, some provisions in the Commission's proposal give rise to scepticism. First, it is questionable whether the reform delivery tool should be equipped with additional budgetary resources in addition to the existing European Structural and Investment Funds. Evaluation studies on the effectiveness of the European Union's cohesion policy indicate only a limited contribution to economic convergence and overall growth (EEAG, 2018). Moreover, a substantial fraction

of EU support programme funds has not been retrieved in recent years due to missing co-financing or a lack of suitable projects (ECA, 2018). Against this background, it would be conceivable to instead reallocate a share of the EUR 270 billion that have not been retrieved from ESI funds to the reform delivery tool.

Second, if the proposed reform complies with the Commission's key criteria, the current proposal allocates funding based on population size, irrespective of the scope and the cost of the reform. In such a setting, populous member states may receive large financial support for reforms with a comparatively small scope. As structural reforms could be more effective in countries with lower initial productivity levels (Banerji et al., 2017), this allocation key may channel the bulk of funds into the member states in which their effectiveness is rather low.

Third, it would be advantageous to condition the disbursement of funds not only on the implementation of the agreed reforms, but also on the achievement of convergence targets in the medium run. Such a setup would incentivise governments to not only consider the reform in isolation, but to enact general economic, fiscal and social policies that complement the convergence strategies funded with EU support. In addition, the current financial governance framework already provides for some inherent flexibility regarding fiscal reforms, enabling governments to bear possible short-term costs of structural reforms. As experience shows, successful but unpopular reform efforts might be prone to a later reversal, or trigger the implementation of counteracting reforms. In this context, ex-post conditionality would foster a more long-term commitment to growth enhancing economic policies and structural reforms.

4. National Convergence Roadmaps: A Blueprint for the Reform Support Programme

Economic and social prosperity as well as fiscal sustainability depend on each member states' policies and can hardly be achieved with the limited set of instruments that is available to the EU. However, national policy makers occasionally blame the EU for unsatisfactory economic developments at the national level. In an attempt to divert attention away from their own policy shortcomings, the EU is frequently accused of 'prescribing' wrong policies or breaking its convergence promises. We think that this dilemma for the EU can only be overcome by rebalancing the responsibility for achieving progress with respect to key convergence targets between the member states and the EU. We propose a framework where member states agree on convergence targets laid out in what we call 'convergence roadmaps' which also specify how and over what time horizon these jointly agreed targets should be achieved. A key goal of our proposal is to strengthen national ownership of structural reforms that help governments to achieve economic convergence targets.

Convergence targets

The EU is currently proposing a multitude of indicators for measuring convergence in its various stability and convergence-related programmes. For more effective policy-targeting, we propose to restrict the list of targets. First, focussing on a small set of indicators ensures that

their relative importance as compared to other targets is not blurred by the multitude of indicators and allows for more effective policy targeting. Second, by restricting the list to output instead of input-related goals, member states gain more flexibility with respect to achieving these goals which need to be ultimately in line with national policy preferences as well as country-specific economic circumstances.

We propose to focus on two real convergence indicators which are of ultimate importance for the economy as a whole: per capita income and unemployment rates. Both indicators reflect the widely accepted concept of β-convergence where initially less prosperous countries are growing more quickly than more developed countries.[5] In its convergence roadmap, each member state applying for EU support would be required to provide a sound economic ex-ante assessment of each reform's potential for raising potential output, per capita income and reducing unemployment.[6] We suggest to focus on structural components of per capita output and unemployment in order to sort out short-run business cycle dynamics and transitory expansions, e.g. through temporary fiscal policy interventions.[7]

Assessment and approval of national convergence roadmaps

National convergence roadmaps would be presented by the member states in the context of the European Semester, thereby making sure to take the benefit from the existing platform. Once convergence targets are agreed upon, the countries are asked to propose concrete reform initiatives that they consider to be suitable for reaching those targets and intermediate objectives while meeting country-specific preferences and aligning with economic circumstances at the same time. Continuous dialogue with the European Commission and exchange with other member states would help identifying reforms with positive externalities.

The proposed roadmap would then be reviewed and assessed by the European Commission before being approved by the European Council for unlocking financial support.[8] Giving the Council the ultimate decision-making power is coherent as the financial support for structural reforms would be conditional on positive spill-overs.

Countries could fail to reach targeted convergence outcomes. In case this is due to events which are beyond the control of the member state, the Council could grant an extension of the agreed time horizon after an explanation of the member state for why those targets were

[5] Some contributions have found that income gaps between high- and low-income countries shrink by 2% per year on average (e.g., Sala-i-Martin, 1996). However, the academic literature has not reached a consensus on structural parameters such as the rate of convergence (Islam, 2013).

[6] See e.g. Barrios et al. (2018) who develop a dynamic scoring framework for ex-ante evaluations of tax reforms in the EU.

[7] The estimation of structural income per capita and unemployment could be based on the ECOFIN's 'approved production function methodology' as well as the corresponding estimates and forecasts of the non-accelerating wage rate of unemployment (NAWRU).

[8] See the Commission proposal on the Convergence and Competitiveness Instrument which also includes an obligatory approval of the Council (European Commission, 2013).

not reached.[9] If failure to comply with targets is due to partial or no implementation of reform roadmaps or implementation of counterproductive reforms, the EU could deny access to financial support.

Financial resources, conditions for financial support and program eligibility

In our view, sufficient resources for financing the proposed incentive scheme are already available, most prominently in the European Structural and Investment Funds. A substantial share of ESI resources remains unused every year, partly because member states cannot or do not want to deliver the required own-financing ratios (see above). We think that these resources could be more efficiently used for reform support.

Financial support should be conditional on the potential for positive spill-overs across country borders, continuous implementation of the reform package and the achievement of the convergence targets. This implies that only those structural reforms which are expected to have a direct and measurable impact on the two convergence indicators specified above would qualify for financial support.[10] More specifically, we propose that funds should be paid in several tranches after important milestones have been achieved in order to incentivise member states to fully implement their convergence roadmaps.

Substantial reform interventions which have the potential to improve economic prosperity and resilience in the long-run may come along with more pronounced negative effects for production and employment during the transition phase. Therefore, we propose to make the amount of financial support proportional to the short-term costs of the reform. Furthermore, by restricting programme eligibility to member states with below average per-capita income and non-participation in other programs such as the ESM, resources are effectively channelled towards those countries with the highest need to catch up.

Yet, it remains a challenging exercise to put a price tag on the short-run costs, which would determine the initial support tranches. It is a well-documented observation in the economic literature that losses in production and employment following both product and labour market reforms can be substantial in size before paying off in the medium and longer run. For instance, benefits of the reform through new firm entry and increased hiring often follow a gradual process while reform-driven layoffs may be immediate (see for example Cacciatore et al., 2016). One option for governments could be to respond with expansionary fiscal policy to counteract the transitory dip in output and employment. Estimates of the extent of extra fiscal spending that would be necessary for maintaining the pre-reform output level can be found, for example, in Sajedi (2018) who simulates reductions in mark-ups in product and labour markets under active fiscal policy regimes. When calibrated to the Eurozone as a whole, the drop in production following a reduction in mark-ups of 1% can be offset by additional

[9] The Brexit and its expected adverse impact on the Irish economy might serve as an example for such an event which is beyond the control of a member state.

[10] Arguably, in an economically-integrated currency area such as the euro area any growth-stimulating structural reforms should have positive spillovers to other member states. Conversely, reforms without quantifiable spillover effects, for example judiciary reforms, would not qualify for financial support.

government spending during the transition period not higher than 0.85% of GDP over the whole period and is quickly repaid after only four years following the reform.

5. Conclusion

Convergence is one of the key objectives of the European Union and has taken centre stage in many recent debates. In an attempt to overcome existing reform fatigue among EU member states and to revamp the convergence process, the European Commission has proposed a 're-form support programme' as part of the multi-annual financial framework 2021-2027 and equipped with a separate budget of EUR 25 billion. Its key pillar, the 'Reform Delivery Tool', intends to support reforms that aim at strengthening member states' economic resilience and that are expected to exert positive spill-overs on other member states. Member states can apply for funding by committing to the implementation of structural reforms which have been identified in the context of the European Semester's cycle and laying out a detailed set of reform targets and intermediate milestones. Available funds are proportional to each member state's population size and are paid out as a single instalment upon full implementation of the agreed reform package.

Despite being an improvement to the current top-down approach of the European Semester, some key features of the proposed programme are likely to constrain the success of the programme considerably. We therefore propose an alternative framework where member states agree on convergence targets laid out in what we call 'convergence roadmaps' which also specify how and over what time horizon these jointly agreed targets should be achieved. A key goal of our proposal is to strengthen national ownership of structural reforms that help governments to achieve economic convergence targets. We propose to restrict the target indicators to a small set of structural outcome variables such as per capita income and the unemployment rate. This does not only allow for better policy targeting but also for more flexibility how to reach these targets. The countries themselves are asked to propose concrete reform initiatives that they think are best suited to reach those targets and align with national political preferences and economic circumstances at the same time. Integrating the process in the context of the European Semester facilitates effective interaction between the member states and the European Commission. Furthermore, financial support should not be a one-time pay-out but should be split in different tranches taking into account the potential for positive spill-overs, continuous reform implementation and achievement of convergence targets. Programme eligibility needs to be restricted to countries with below average per capita income levels – independent of population size – in order to channel available resources to those countries with the highest need to catch up. Last, resources for financing the incentive scheme are already available, for example in the European Structural and Investment Fund where a large share of funds is not used every year and effectiveness has been shown to be only limited.

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