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## DISCUSSION PAPER

# Policy recommendations for the new European Commission: priorities for stabilising EMU

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### Executive Summary

The euro area crisis exposed substantial structural flaws in the currency area's architecture. Improvements in the euro zone's economic governance, the introduction of a (limited) banking union, the European Central Bank's (ECB) unconventional support, and, consequently, the substantially reduced fear of a country exiting the common currency have all contributed to overcoming the immediate risk of the euro area's collapse. But a number of fundamental issues still need to be addressed.

In the short term, an appropriate balance within the new governance system between sustainable public finance consolidation and Member States' public/social investment needs has to be found, but such flexibility should not lead to a repatriation of fiscal powers to the national level. The new European Commission should develop a new framework to assess the real returns to growth of public and social investment, which could open the path for more flexibility on deficits in future.

In close coordination with the European Parliament (EP), the Commission should also review the way the Country Specific Recommendations (CSRs) are drawn up. The CSRs specifically need a stronger focus on a smaller number of key priorities for each country, clearly focused on growth and going beyond mere expenditure cuts. There is also a need to foster political commitment by all of the Eurogroup to adhere to the new governance and to politically support it in public.

The absence of mechanisms to provide effective *ex ante* fiscal risk sharing in the euro zone needs to be addressed. This could be done through the establishment of a fiscal capacity. Euro area governments and EU institutions (including the EP) should intensify their efforts to set out the conditions, roadmap and outline features of such a fiscal capacity in the very near future. The Commission should make the construction of a fiscal capacity a priority in the new political cycle.

In addition to institutional/governance issues, the attention now needs to be directed even more strongly towards encouraging growth and thus, ultimately, jobs. To boost growth, there is a need to encourage private, public and

social investment, at EU and at Member State level. The crucial step needed now is an ambitious European Investment Programme (EIP). The Commission should expedite the creation of such a Programme and ensure that the implementation of a EIP is compatible with the long term goals of a fiscal capacity, and that the possibility for a consolidation of the two measures in the future is given.

In the medium term, these actions are necessary but not sufficient. There continues to be a need to systemically address the flaws and gaps in the current governance framework, including the questionable effectiveness of EU policy in influencing national policies, the need to further deepen the banking union, a need to strengthen the social dimension of Economic and Monetary Union (EMU) and the creation of a fully-fledged fiscal union, including addressing the incomplete political legitimacy and accountability framework, and creating a better framework for the limited mutualisation of some public debt.

## Introduction and context

The EU, and in particular the euro zone, has been in the grip of crisis for more than five years. While other industrial countries outside Europe also suffered from the outbreak of the global financial crisis in 2007, the consequences, such as the evolution into a sovereign debt crisis, were nowhere felt as severely as in the euro area. To make matters worse, the EU was/is facing not just one but a number of highly complex, multi-rooted and highly interlinked crises: a banking crisis, a public and private debt crisis, a competitiveness crisis, an institutional crisis, a growth and investment crisis, a social/unemployment crisis, and, last but not least, a political crisis characterised by high levels of political instability and the rise of populist anti-establishment/elitist, anti-EU/euro and anti-immigration parties and movements.

Together all these crises have produced a crisis of confidence, undermining the trust of markets, citizens, elites, and global partners in the future of the euro and of the EU itself. The individual and collective experience of recent years has thus revealed and exacerbated significant deficiencies in the EU's, and especially EMU's, economic and political construction, as well as highlighting consequences of past decisions, such as a lack of fundamental structural reforms in Southern Europe or the breach of the Stability and Growth Pact (SGP) by Germany and France in 2003.

## Origins of the crisis

At the inception of the EMU it was acknowledged that structural differences between Member States existed, but it was widely assumed that a currency union would lead to business cycle symmetry, which would also create synchronicity when economic shocks hit, which could then be dealt mainly through centralised monetary policy (IMF 2013). While some predicted the exact opposite, i.e. the divergence of economic cycles<sup>1</sup>, others such as Frankel & Rose (1998) argued in an influential paper that the participation in the monetary union itself would drive convergence.

In reality, large country-specific shocks persisted within the euro zone. Consequently, two years after the collapse of Lehman Brothers in 2007, Europe became the epicentre of the biggest financial and economic crisis since the Great Depression in the 1930s. What began as a government debt crisis in some of the smallest economies on its periphery soon exposed the fundamental deficits of a fully-fledged monetary union without an equally strong economic and political dimension, making it clear that the euro area was in need of, at the very least, more effective fiscal policy coordination. When the Greek crisis escalated in early 2010, many European leaders insisted the country's problems were unique, but the markets disagreed. The crisis quickly spread to other EU countries and it became obvious that the Union – and especially the euro area – was insufficiently equipped to weather the storm; EMU lacked the necessary institutional structures, procedures, rules and instruments to prevent such a crisis from beginning, spreading and deepening.

## New governance

In response, the EU has introduced a wide range of new governance instruments, entailing a much greater degree of intervention, especially in relation to fiscal policy and the financial sector (banking union). With the absence of an effective *ex ante* economic governance, the current crisis had to deal with a newly created *ex post* rescue mechanisms: the temporary and permanent euro zone firewalls EFSF (European Financial Stability Facility) and ESM (European Stability Mechanism), which have provided the currency area with a powerful tool to combat immediate crisis and to also deal with future substantive economic shocks, which could put sovereigns under fiscal stress. In addition, the ECB's readiness to do 'whatever it takes' has stopped the spiral of uncertainty and speculation, which led to unsustainable public debt financing costs, particularly in Southern Europe (Emmanouilidis 2013).

Since this mechanism of *ex post* rescue is costly in terms of output and employment, the so-called 'Six-Pack', 'Two-Pack' and 'Fiscal Compact' have also been introduced to substantially improve *ex ante* fiscal governance. The 'Six-Pack', which is applicable to all Member States, introduced the Macroeconomic Imbalance Procedure (MIP) and reinforced the preventive and corrective arm of the SGP. The 'Two-Pack' is directed towards strengthening the euro area's surveillance mechanisms. It improved the monitoring and assessment of the euro area and introduced special provisions for those countries in difficulties regarding their financial stability and those in receipt of financial assistance.<sup>2</sup> Furthermore, the Fiscal Compact, which refers to the fiscal part of the intergovernmental Treaty on Stability, Coordination and Governance (TSCG), complements the Six-Pack in a more stringent way with regards to the SGP. The new 'Reverse Qualified Majority Voting' (RQMV) for the corrective arm of the SGP and the MIP, which was introduced with the Six-Pack, reflects a new form of automaticity (Thillaye *et al.* 2014).

The construction of a banking union, despite the non-inclusion of sufficient financial backstops, was the most prominent reform to EMU governance. Prioritising the banking union over other euro-area-level reforms was important: through cross-border portfolio diversification and borrowing and saving, capital and credit markets can play an even more important role than national fiscal policy for the stabilisation of the business cycle (IMF 2013). Furthermore, overcoming uncertainties in the financial sector is important for the euro's stability and particularly for the recovery of crisis-hit countries, and thus to halt and reverse economic fragmentation within the EU and euro area. Without this, peripheral countries could find themselves trapped in a permanent cycle of low investments, high capital costs, savings flight, wage deflation, low growth and persistently high unemployment, with a negative impact not only on these countries but also for the growth perspectives of the EU and euro area as a whole.

## Further progress needed

While the situation remains volatile, at the time of writing (September 2014), fears of the worst-case scenario of a euro meltdown have receded. A number of fundamental issues still need to be addressed to prevent a reoccurrence of acute crisis in future. In the short term, there is a need to find an appropriate balance within the new governance system between sustainable public finance consolidation and public/social investments (flexibility), as well as ensuring that the new governance mechanisms work as effectively as possible in encouraging sustainable economic and fiscal policies at Member State level.

There now is a need to shift focus from enforcing fiscal discipline, which was necessary in order to tackle the immediate risks stemming from the sovereign debt crisis, to creating mechanisms to provide effective *ex ante* fiscal risk sharing in the euro zone through the creation of a fiscal capacity. In addition to institutional/governance issues, the attention needs to be directed even more strongly towards encouraging growth and thus, ultimately, jobs through an EIP. Although most levers to drive long term growth and employment lie at Member State level, EU policies can create a facilitating environment, as, for example, set out in the Europe 2020 strategy, where the mid-term review might provide a chance to closer align the strategy to current economic challenges.

In the medium term, it will become necessary to correct the existing flaws and gaps in the current governance framework, including enhancing EU implementation/enforcement powers. Further automaticity is essential in order to credibly prevent the build-up of future crises: if political decisions at Member State level are needed to precede any support action, it forecloses necessary *ex ante* prevention. The available instruments, both old and new ones, are also too complex and therefore difficult to understand for policy-makers that need to quickly apply and comply with the rules. This complexity is thus a further factor that leads to low automaticity, potentially obstructing the necessary degree of *ex ante* support for the prevention of new crises.

In the longer term, there is also need to further deepen the banking union (including especially the establishment of bigger common fiscal backstops), a need to strengthen the social dimension of EMU (see, for example, Andor 2013) and the creation of a fully-fledged fiscal union, including addressing the incomplete political legitimacy and accountability framework and integrating the governance instruments outside the EU system into the existing EU mechanisms, as well as creating a better framework for the mutualisation of (at least some) public debt. In addition, Europe will need to address the debt overhang (public as well as private) that persists in a number of countries. Expansionary monetary policy will also be needed to counteract the threat of (continuous) deflation in a number of countries.

The new economic governance at EU level, especially at euro zone level – and its likely further development in the coming years – also raises a number of broader political issues. Can an effective way be found which combines common responsibility for some debt while avoiding additional moral hazard? How best to improve the incomplete legitimacy/accountability mechanisms? How much sovereignty are euro zone countries willing to pool in return for a more stable system, which includes assistance for those under pressure? How will this affect the overall EU integration process, with deeper differences in integration between euro zone and non-euro zone?

## **Coordination within and between the EU Institutions**

At this point in time, there is clearly a need to make the existing economic governance instruments, including the European Semester work as effectively as possible (within its limitations which will be discussed later in this paper). This will also require effective coordination within the Commission. The new structure of the Commission aims to enforce Commissioners breaking out of their policy silos through the new coordination role of the Vice-Presidents (VPs). There is also a closer link to the challenges the EU faces by giving each Vice-President (VP) broad policy objectives as their area of responsibility.

But this new structure carries risk. The new structure is a flexible matrix, with groups of Commissioners working together on a case-by-case basis which can raise questions over clear lines of reporting, not only for Commissioners but also for the Commission services. A structure with designated clusters under each VP would have been clearer.<sup>3</sup> There are overlaps between the different portfolios and it is not clear how coordination will look in practice. This matters especially for the governance of EMU. There are at least three Commissioner-designates closely linked to this, namely VP Valdis Dombrovskis (Euro and Social Dialogue), VP Jyrki Katainen (Jobs, Growth, Investment and Competitiveness) and Pierre Moscovici (Economic and Financial Affairs, Taxation and Customs).

Their mission letters<sup>4</sup> trigger a number of questions: What exactly is the difference between steering and driving the European semester process? How (and led by whom?) will structural reforms be delivered and incentivised? What happens if there is a potential trade-off between growth and fiscal discipline? Who (and with what supporting bureaucracy) will develop the proposals for action on areas such as the fiscal capacity if a VP and a Commissioner both have this task? What happens if there is a dispute over whether certain areas fall within the remit of a VP, for example, what elements of regulating the financial sector should be considered part of EMU governance? At the very least, there will have to be more clarity at the outset of how exactly this new structure is envisioned to work in practice.

It also needs to be recognised that, in particular for the development of new proposals and initiatives, a link to the Member States is essential. With the Commissioner for Economic and Financial Affairs, Taxation and Customs representing the Commission at the Eurogroup meetings, it is difficult to see how the VPs can exert direct influence. This could become an even greater issue if the Eurogroup tasks the Commissioner for Economic and Financial Affairs, Taxation and Customs with particular actions. In practice, would the VPs overrule such direction from the Member States?

Regarding deficit targets, in cooperation with the (European) Council, the Commission also needs to find an agreed way forward regarding flexibility/adherence, including how public/social investment should be treated and who, has the decision making power on this matter. The question of who should be the lead Commissioner to develop and implement a proposal on this follows the questions raised above, concerning the effectiveness of the new structure.

As far as the medium and long term is concerned, a crucial but missing euro zone *ex ante* crisis prevention instrument is a fiscal capacity. The European Commission should make the creation of such an instrument a priority in the new political cycle, while coordinating its efforts closely with the EP and the next President of the European Council. Independent of its concrete design, EU institutions and participating Member States need to underline the democratic legitimacy of the novel instrument by making sure that the EP will be responsible for scrutinising the operation of any kind of a new fiscal capacity.

Furthermore, as a fiscal capacity would first and foremost affect the euro zone, the Eurogroup would need to be granted a more significant role. This could for instance be accounted for if a full-time Eurogroup President was to be established. Taking into account the multiple challenges ahead and the heavy workload of finance ministers it makes sense to create such permanency, providing the capacity to devote the Eurogroup president's full attention to the tasks associated with the post and to take a more pro-active role on the governance development of the euro zone.

In addition, there is a need to encourage private, public and social investment to boost growth. This is a considerable challenge in the current environment but there are a number of possible ways of boosting investment and thus, in the longer term, sustainable growth. The crucial step needed now is a EIP, which in particular provides support to SMEs in crisis countries to overcome the limited access to finance. The European Commission should draw up such a programme and ensure its support by the Member States, as well as monitoring the necessary Member State actions. The priorities of the EIP should then be reflected in the Annual Growth Survey, to be translated into CSRs.

Finally, to promote institutional coherence and reduce the complexity of the enhanced system of economic governance, the European Commission should (continue to) actively support the gradual integration of EMU structures created outside the Union's framework into the EU Treaties. The many intergovernmental agreements and arrangements of recent years should, at some not too distant future, be integrated into the Union's treaty framework. To prepare the grounds for an amendment of the Union's primary law, a group of 'wise (wo)men' could in the first half of the new political cycle prepare a report on the areas where the EU Treaties will need to be reformed in the course of the next decade in light of the manifold economic, financial, political and global challenges. The EP should be closely involved in the process of preparing the EU for treaty change.

## **The new governance in practice**

### **The European semester and the implementation of Country-Specific Recommendations**

While the euro zone has introduced many new governance instruments aimed particularly at fiscal discipline, which seemed impossible some years ago, the success or failure of the reformed EMU will depend on whether



it can reduce critical imbalances within the euro zone. This includes a clear need for those countries which have fallen behind in terms of competitiveness to catch up by continuing to carry out structural reforms. However, the EU still lacks effective ways to promote and support reforms in individual euro zone countries.

The main instrument, the European Semester process with the associated CSRs, is not functioning as originally envisaged. The main potential of the European Semester exercise is that it reveals structural macroeconomic weaknesses in Member States and so can help to trigger or foster debate about what needs to be done at national level. However, despite all the time and energy invested at both the national and European level, in most cases, the recommendations attract little attention.

Even when the more controversial recommendations are discussed at Member State level, they are rarely implemented outside programme countries: recent experience has shown that the implementation of national reform programmes in line with the CSRs is at best partial across the EU.<sup>5</sup> Member States are all too often reluctant to risk a domestic political backlash by translating recommendations, which they have agreed to at European level, into practice, especially if these concern painful reforms which affect key parts of the electorate, for example, pensions or public services. Consequently, a number of governments have publicly criticised 'Brussels' for telling them what to do rather than implementing the agreed reforms. In the end, the system lacks effective implementation mechanisms: Member States ultimately cannot be politically forced to implement reforms against their will unless they are subject to strict adjustment programmes supervised by the Troika.

There is also criticism that often the recommendations are primarily driven by the need for expenditure cuts to achieve fiscal consolidation, rather than being future growth oriented. Specifically, there is a concern that public and social investments are not considered sufficiently and that the idea of 'invest-to-save' to improve the long-term efficiency and effectiveness of public services does not feature. This is often coupled with the, partially justified, criticism that the recommendations reflect a 'Christmas tree' approach, i.e. that every part of the Commission adds their particular areas of concern, with no real prioritisation and that there is no real assessment of the ability/capacity of countries to deliver these reforms.

Together with the EP and in close coordination with the Eurogroup/Council, the Commission should review the way the recommendations are drawn up, specifically focusing the process on a smaller number of key priorities for each country, with strong attention on future growth. There is then a need to systematically monitor the implementation of the CSRs and to initiate discussion within the Eurogroup if key recommendations are not implemented, regardless of the country involved, also pointing out the implications of non-compliance for the governance of the euro zone as a whole. In addition, more innovative ways must be found to encourage the implementation of recommendations agreed at EU level. In other words, there is a need to provide incentives for reform to ensure decisive implementation of adjustment measures at the Member State level (IMF 2013, p. 18). One way to incentivise structural reforms is through contractual arrangements linked to a fiscal capacity, discussed later in this paper.

In the end, these actions can counteract some of the shortcomings of the current governance system but it will not be the full answer. The governance at EU level still lacks an effective way of ensuring the implementation of CSRs at Member State level but this will require a more systemic governance reform.

## **Budgetary flexibility**

A particular area of focus for the new governance has been fiscal policy, especially within the euro zone, including budgetary surveillance, with governments having to regularly submit their budgets for Commission scrutiny and the Commission being able to demand revised plans if there is non-compliance with the SGP. This complements the Excessive Deficit Procedure (EDP), which applies to countries exceeding the thresholds of 3% of deficit to GDP and 60% of debt to GDP not diminishing at a satisfactory pace. This increased power over Member States' fiscal policies has been controversial, as reflected in the debate in recent years about the potential trade-off between austerity and growth, and what implication this should have for deficit/debt targets.

While in many ways this is a false dichotomy, there nevertheless has been a growing recognition that too strong fiscal austerity does not deliver the desired results in countries in acute distress; this was reinforced by the recognition of the IMF in end-2012 that the fiscal multipliers (i.e. the negative impact of public expenditure cuts on growth) were higher than previously thought. This has led to many, especially from Southern Europe, suggesting that national reforms could be incentivised through a higher degree of flexibility regarding the implementation of the Stability and Growth Pact and the rules enshrined in the 'Six-Pack' and 'Two-Pack', while still respecting the spirit of the Pact and the need to maintain a course towards fiscal consolidation. They further contend that the rules should be relaxed to ensure that excessive public spending cuts do not end up triggering a downward spiral by negatively affecting growth which in turn reduces revenue and worsens deficits, requiring further austerity. This argument is made especially strongly with regard to public investments.

However, for countries in public finance distress outside the direct support mechanism of the euro zone, market mechanisms will, at least in part, impose a certain level of fiscal discipline through higher borrowing costs. Flexibility thus needs to be accompanied by a credible, medium-term strategy: "Flexibility in the fiscal rules will only be credible if fiscal policy is anchored in medium-term fiscal plans that clearly state the path back to lower debt levels. In particular, any accommodation for the cycle during downturns needs to be accompanied with plans to offset this over the medium term, possibly in an automatic way. While such corrective mechanisms have in principle been agreed in the Fiscal Compact, they still have to be designed at the national level, and made consistent across countries." (IMF 2013, p. 17)

It is also not clear what exactly is meant by flexibility. In effect, the current provisions already incorporate a considerable degree of flexibility – countries can be given a longer time frame to return to the deficit ceiling under the EDP if there are good reasons for this longer convergence path. The debate around flexibility might thus not (only) be about a specific application of the rules but rather about who makes the assessment and decisions, i.e. that this is done at EU level, rather than being an autonomous decision left to the Member State itself as in the pre-crisis period. Thus, for some countries, it seems that the main objection is to the imposition of rules by the European level, rather than the content of the rules itself or how flexibly they are applied. This is in essence an argument about the repatriation of fiscal governance, away from the European level and back to the Member State level. Moving in this direction would undermine effective fiscal coordination at the euro zone level, in part restoring one of the flaws which were at the origin of the 'euro crisis'. It would also undermine the underlying political bargain of solidarity within the euro zone: support only with conditionality to achieve greater fiscal consolidation and structural reform.

There are also good arguments for a more flexible interpretation of the rules if money is invested rather than consumed. While total public deficit matters, the quality of public spending is probably more significant. If spending enhances long-term growth, for example, through public infrastructure or social investment in areas such as innovation, skills and education, it is important that this kind of investment is maintained, even in times of fiscal constraints. It is also vital to recognise that public funding is crucial to carry out long-term sustainable structural reforms which go beyond simple expenditure cuts (e.g. invest-to-save in digitalisation, preventative spending on health, labour market activation policies) where again fiscal constraints should not stop public spending.

To classify spending as public or social investment, the crucial issue is one of return – this kind of spending needs to produce the desired outcomes effectively. To be able to take this investment into account consistently, the EU would have to develop a framework on how spending can be assessed for its long-term growth effects, i.e. how far it constitutes public or social investment rather than public consumption and whether it effectively enhances growth potential; a process which needs to be initiated by the Commission and supported by the EP.

Even if such assessment framework can be developed, it does not address the underlying issue of fiscal space: public finances remain constrained in many countries, with a continuing need for fiscal consolidation. There is thus a need for a limited degree of debt mutualisation, as well as direct support. The fiscal capacity, which has been discussed for the euro zone, might be a mechanism that can provide cross-border support for this kind of spending.

## Limitations of rules-based governance

The debate around flexibility also shows some of the limitations of a 'rules-based' approach. It is difficult to pick appropriate rules/targets in the first place, especially if the environment is changing rapidly (e.g. is the 3% deficit limit appropriate for all countries in all economic circumstances, pre- and post-crisis?). It is also difficult to determine whether a country's failure to meet a target is down to willingness or incapacity to deliver. In addition, in times of crisis, rules sometimes need to be treated more flexibly. This raises the questions of under what circumstances there needs to be a more flexible interpretation of the rules and who decides, i.e. whether this is decided at European level.

A perennial challenge in a rules-based system is how to ensure compliance and what enforcement mechanisms are available. As demonstrated by the impact of France and Germany breaching the SGP in 2003, it is especially important that all countries are seen to comply with the rules, including the larger, more powerful ones, to safeguard the long-term credibility of such a governance system. Here, the reactions in Germany regarding the investigations of its export surplus under the MIP (fully in line with the governance instruments that have just been created) are concerning. The Commission's start of an in-depth review of Germany's account surplus (which the Commission was required to carry out as the surplus was above the 6% threshold) raised objections from across the political spectrum, alleging that the EU was trying to reduce the competitiveness of German industry. This controversy leaves, at the very least, some doubts whether bigger and more powerful countries feel that the rules apply to them equally.

## Fiscal capacity

While the improvements in economic governance will be helpful to support fiscal-policy coordination and prevent the accumulation of macroeconomic imbalances, in the absence of individual exchange rates, internal adjustment mechanisms need to offset negative economic shocks in a currency union. In the literature on Optimal Currency Areas (OCAs), which builds on Mundell's (1961) Nobel Prize winning work, two main necessary criteria for OCAs' functioning are identified: factor mobility, in particular labour, and prices and wages flexibility. Labour mobility has been traditionally low in the euro area, which, in comparison to other currency areas such as the U.S., can be partially explained by language and cultural barriers. Other factors, that prevent higher unemployment to be absorbed through intra-EU mobility, are persistent institutional barriers between euro area members, i.e. for instance the missing cross-border portability of pensions and unemployment benefits (IMF 2013, p. 9). In addition, prices and wages in the euro area exhibit large downward rigidities making timely real exchange rate adjustments difficult (Jaumotte & Morsy 2012); and real wage adjustments are socially and politically costly. Due to the weak fulfilment of these basic pre-conditions in the euro zone, other factors are needed to compensate and should therefore be strengthened to make the currency union functional, such as trade integration and fiscal integration.<sup>6</sup>

In addition, the current architecture of the euro area only allows for an insufficient response to large country-specific shocks, because some euro area members are currently not in the position to give sufficient fiscal responses and centralised monetary policy cannot, by definition, counteract the occurrence of localised shocks. The crisis has shown that, when country-specific shocks are large and national fiscal buffers are low, Member States cannot deliver stabilisation policy alone. There is thus a need for some form of centralised fiscal policy in order to future-proof the euro area. The introduction of a 'fiscal capacity', especially for countries in the euro area, could be a means to enhance intra-area risk sharing, which could provide *ex ante* support to euro countries before crises can fully materialise (Wolff 2012). While smaller shocks should continue to be dealt with at national level, a fiscal capacity could provide relief against insufficient national fiscal policy when larger shocks occur. Furthermore, the fiscal capacity could also provide stabilisation policy in case of area-wide shocks. A centralised fiscal capacity could guarantee, if equipped with adequate resources, a better provision of countercyclical responses to such shocks to prevent the under-provision of fiscal stimulus caused by 'free riding' behaviour which leads to a suboptimal fiscal policy mix.



A requirement for generating the necessary political support for the fiscal capacity in the foreseeable future would be a strong commitment to longer term distributional neutrality, i.e. the avoidance of permanent transfers. Without such a norm, political backing from surplus countries will be unlikely. In practice, the long term distributional neutrality can, however, be impossible to achieve because even if the capacity would only aim at covering temporary shocks, permanent shocks may be difficult to distinguish when they occur. Furthermore, smaller countries would probably draw on the capacity more often, as they may be more exposed to idiosyncratic shocks and would therefore receive more than they would contribute over the long term. However, the euro area's centralised monetary policy is more influenced by larger countries' inflation developments and therefore centralised fiscal policy could be a good counterbalance to this large country bias. (IMF 2013, p. 26)

## Fiscal capacity instruments

In theory, the best way to distribute spending as well as revenue shares of such a fiscal capacity would be to tie payments to a measure of the business cycle. This could be achieved through the use of real time output gaps. Large negative (positive) output gaps would thus imply large received (paid) contributions from the capacity. In practice, however, the forecasting methods necessary for estimating output gaps in real time are controversial and the differences between estimates and historically revised output gaps are large.<sup>7</sup> Other forms of automatic stabilising could be achieved through the linking of support to sovereign bond spread deviations from a pre-defined threshold. While this would be an effective method to support sovereigns that are threatened to be priced out of the market when large shocks occur, such a mechanism would most likely lead to permanent transfers (Wolff 2012, p. 10).

The fiscal capacity could also be tied to labour market performance and be organised as an automatic stabiliser, for example, the provision of an area-wide insurance scheme against short-term (cyclical) unemployment.<sup>8</sup> However, this type of support might not achieve the required level of crisis prevention, as unemployment insurances are considered to have a negligible macroeconomic effect on regional shocks and are therefore weak shock absorbers (Asdrubali *et al.* 1996, cited in Wolff 2012, p. 8). This is related to the fact that unemployment lags GDP contraction, which raises the question of how timely such insurance can provide relief against economic shocks. Moreover, such an insurance could only be made possible if a completed Single Labour Market would allow for labour taxation and potentially pension rights to exhibit a certain degree of harmonisation (IMF 2013, p. 20). In addition, there are real questions about the necessary scale which would need to be achieved to effectively carry out this function.

Even without setting up automatic stabilisers, unemployment could also be used as a targeting criterion for discretionary spending, but this could even increase the timing issue, which is already apparent if such spending was designed as an automatic stabiliser. It would also be necessary to exclude any targeting on structural unemployment since this could lead to permanent transfers due to large area-wide differences. Politically, this could raise the spectre of a 'transfer union', which is not acceptable in the countries which would now need to provide the bulk of the funding.

When deciding on the actual policies supported, many have advocated that a fiscal capacity should focus its spending on labour market policies and on public/social investments that are beneficial for creating long-term growth, such as infrastructure or education. A centralised capacity could also span some form of social security net that would ensure the minimum provision of government services and social security in case of major crises. Spending could either be carried out directly at euro zone level, for instance for infrastructure projects, or be delegated to the national level, which would however require some form of central oversight and enforcement power.

The latter could be addressed through the conclusion of 'contractual arrangements' between the respective country, as set out *i.a.* in the Commission's (2013) proposal for a Convergence and Competitiveness Instrument (CCI). However, such contractual arrangements could be unpopular with recipients if seen as a way of exerting central/EU control, especially in case the incentives provided through a new fiscal capacity are not significant enough. Contractual arrangements between individual Member States and the EU/Commission also need to be designed carefully to make the projects implementable in practice, otherwise the process could become slow,

cumbersome and bureaucratic, with too many small projects, and there might be difficulties of finding sufficient eligible projects, providing real structural reforms rather than mere cutting of expenditure, as well as monitoring their delivery. Many of these problems are mirrored in the EU's structural and investment funds; it is necessary to prevent the fiscal capacity from essentially becoming a copy of the regional funds for the national level.

While there are many problems and uncertainties which need to be addressed, the creation of some form of centrally coordinated fiscal policy is necessary and should be introduced in the immediate future. Over time, the fiscal capacity could be further extended and refined, learning from the initial implementation period, i.e. the introduction of a fiscal capacity should be a 'dynamic process'.

## **Financing the fiscal capacity**

On the revenue side funding could either be generated through GNI or VAT contributions, similar to the EU budget, or the fiscal capacity could generate its own revenue through taxes that are best enforced at European level such as a harmonised European Corporate Tax, the Financial Transaction Tax (FTT) or some form of environmental taxation. The FTT seems a particularly suitable source, as it can simultaneously contribute to the containment of short-term financial speculation and raise substantial revenues.<sup>9</sup> The revenue contributions could be also made cyclical, such as through the use of output gaps, and would therefore become part of the fiscal capacity's stabilisation mechanism. With dedicated resources backing the fiscal capacity, borrowing from the centre should also be permitted, which would enhance the counter-cyclical support capabilities of such an area-wide risk sharing mechanism. The borrowing capacity would need to be backed by a budget of significant size in order to create an impact.

## **The fiscal capacity – an essential element of euro zone stability**

With a fiscal capacity the number and impact of future crises could be reduced, as higher fiscal risk sharing will not only decrease the occurrence of crises, but could also prevent cross-border spillovers (IMF 2013, p. 23). This new structure could indeed be a strong element to correct some of the flaws of the currency union. However, the creation of such a new institutional framework might require lengthy political negotiations and an overhaul of the current legal framework, including potential treaty changes in the future. In addition, the fiscal capacity, if poorly constructed, could favour moral hazard and will therefore require a strong form of central oversight (IMF 2013, p. 23). Furthermore, conflict could arise about the demarcation of the euro area from the EU in its entirety: How would the fiscal capacity be managed in the current institutional framework? How could the fiscal capacity exist next to the Multiannual Financial Framework (MFF)? Could the fiscal capacity also apply to non-euro area members and if yes, under which conditions?

A fiscal capacity would be an essential element of future euro zone stability but it "should follow some basic principles: it should not act as a brake on further integration; it should be substantial and effectively demonstrate solidarity with the crisis countries and their citizens without excessive conditionalities; it should be focused with a clear purpose; and it needs to be inclusive in order not to cement a separation of the euro zone from the rest." (Zuleeg & Emmanouilidis 2012, p. 2). Nevertheless, signalling commitment and setting off along this path, by introducing a mechanism which can be developed further in future in a dynamic, ongoing process, would create further confidence for the future of the euro area. Euro area governments and EU institutions (including the EP) should thus intensify their efforts to set out the conditions, roadmap and outline features of a fiscal capacity in the very near future. As mentioned previously, the construction of a fiscal capacity should constitute a key priority in the new political cycle. In addition to a fiscal capacity, the euro area is also in need of growth and job inducing measures in the short term. Thus, a fiscal stimulus should be provided now through a temporary one-off provision. In a similar vein as the transition of the EFSF into the ESM, this temporary fiscal support could be institutionalised into the fiscal capacity at a later stage.

# A growth and investment programme

## Growth and structural reform

Although it seems that the recession has bottomed-out and that GDP growth in the euro area is slowly picking up, a positive longer-term outlook is far from certain due to low labour productivity growth in the region (OECD 2014a) and continuing difficulties in some countries to achieve a sustainable growth path.

So far structural reform and internal devaluation have been the predominant parts of the policy mix aimed at creating higher growth for the entire euro area. Due to the fact that economic crises significantly accelerate reform efforts and resistance to fundamental reforms are weaker, a lot has been achieved, especially in the Programme Countries, in the fields of product and labour market policies, education, pensions, fiscal consolidation, tax reform and less so in infrastructure since the onset of the crisis (OECD 2014b).

In recent years, since the crisis hit, the formerly large negative current account in deficit countries, especially in Southern Europe, has been reduced and in some countries even turned into a surplus. While these current account improvements can largely be ascribed to the collapse of internal demand, a significant part of this adjustment also seems to be permanent and irreversible due to structural adjustments carried out in deficit countries. Price competitiveness in these countries was improved through the large reductions of unit labour costs. However, reform progress was more limited in product markets which prevented, among other things, prices to adjust in the same manner as wages. (OECD 2014a, p. 15)

Whereas the focus of structural reforms in the entirety of the euro area should be placed on further product market reform, some countries, such as Greece and Spain, are still in need of continuing labour market improvements. Once the recovery will gain momentum, without labour market reform, high unemployment may not decrease to pre-crisis levels and would therefore become structurally embedded in these countries' labour markets given the severity and long duration of the recession. The key priority in this field should therefore be to counteract such a potential transmission of high cyclical into structural unemployment (OECD 2014a, p. 24). As the largest part of the necessary fiscal consolidation in the euro area has already been carried out, remaining reforms are likely to have a smaller negative impact on growth in the short term (OECD 2014a).

Despite these positive signs, competitiveness, growth and employment has not picked up as initially expected in some of the countries that undertook the largest efforts, such as Greece.<sup>10</sup> This is also reflected in the unemployment situation: although seasonally adjusted unemployment in the euro area in July 2014 was at 11.5%, a reduction of 0.4 percentage points compared to the previous year, the most recent figures for Greece (May 2014) and Spain are still at around 25%, with youth unemployment still recording above 50% in these two countries. While, in addition to encouraging national structural reforms, the EU has introduced a Youth Guarantee – to invest in young people's transition into the labour market – and a Compact for Growth and Jobs – to especially ease the availability of investment finance, these initiatives have, however, not had the hoped impact on the ground, with question marks over the level of commitment, including financing, behind them.

Going forward, the burden of continuous adjustment can thus not only fall on deficit countries, also because these countries would benefit from higher external demand. Better product market regulation in surplus countries could improve business environments and therefore give a boost to domestic private and public investment which would in turn be beneficial for overall euro area growth (OECD 2014b). In fact the service sectors in France and Germany have, according to the same study (p. 3), the highest barriers to competition in the euro area, even higher than in Italy and Spain. Hence, a large potential for reforms in core countries, deficit as well as surplus, is also a given. According to OECD (2013a) calculations, productivity and GDP in the euro area could be raised by about 17% through comprehensive product market reform by 2060.

More also needs to be done to have a tangible and effective impact on growth prospects and to lead the whole region on a sustainable, i.e. long-term, growth path. The EU has identified this problem and the designated Commission President Jean-Claude Juncker has signalled his willingness to tackle it in the new political cycle, with his announcement to free funds in the range of euro 300 billion for a European Jobs, Growth and Investment Package.<sup>11</sup>

## **An investment programme<sup>12</sup>**

Most of the structural factors underlying long-term growth can be shaped by governmental action, including human capital, R&D investment, infrastructure, quality of regulation, taxation or the well-functioning of financial markets (Barro & Sala-i-Martin 2004). While structural reform and improvements in economic governance are necessary conditions for a long-term recovery, strengthening other important components for long-term growth has so far been widely omitted from the policy mix. Investments in education, health and infrastructure have been largely neglected. It is now imperative to tackle Europe's public and social investment crisis. While the bulk of the investments' return will only be collected in the long run, the additional demand for capital goods will also create higher growth and additional employment in the short term, for example in necessary construction related to infrastructure investment. Surplus and deficit countries will both benefit from these programmes.

There is a need to re-allocate more money from the EU budget to growth-enhancement measures. The mid-term review of the MFF in 2016 could be used to redirect spending to areas such as energy security and efficiency, the completion of the single digital market, additional and targeted support for structural reforms in individual EU countries, or investments aimed at improving the links between regional and European infrastructure projects. At Member State level, EU countries with relatively low public debt and deficit levels should use the fiscal space available to lead the investment drive required for Europe's economy to recover. Germany and others should increase domestic demand by, for example, increasing public investment in areas such as education or the modernisation of their infrastructures. Finally, private investments and growth could also be stimulated by intensified efforts to complete the single market, filling the gaps in areas such as services, the digital economy, research and energy. Open and interconnected product and services markets could have positive spill-over effects across sectors and drive economic growth.

Higher investment in education, health and infrastructure would have positive long-term growth effects in most Member States in the current low investment environment. However, in times of scarce public resources and tough decisions on allocation of public funds, supporting one economic sector equals another sector's disadvantage. The same applies for distributing the funds among Member States. Even taking into account the promise of designated Commission President Juncker, of an additional euro 300 billion in investment, a strategic approach to targeting and prioritising the available funds to those sectors with the best prospect for success is essential.

However, identifying and targeting the best-suited areas for intervention, in particular for public investment, is not a straightforward exercise. According to Zachmann (2012), the success of economic sectors in receipt of public investments is dependent on investing in all structural factors that were identified as being necessary for sectoral growth. The author argues that, for example, in the case of high-tech industry, only investing in broadband infrastructure but not in complementary education would not lead to success. This type of investment strategy therefore requires investment in factors that have been largely neglected in the policy mix up to now, such as basic education. It would also imply the reduction of public investment for sectors which have lower growth prospects. The existing smart specialisation approach in the EU regional development field could be a starting point to make strategic assessments to decide on priorities for public investments aimed at boosting growth. As far as the identification of the appropriate sectors for investment is concerned, Hidalgo *et al.* (2007 cited in Zachmann 2012, pp. 8-9) note that new specialisation efforts often occur in under-developed sectors that are similar to those that already exist in a country. Hence, one way to target public investment and reform could be to identify these types of connections between under-developed and already successful sectors.



Furthermore, finding the right mix between public and private investment and ensuring complementarity is also important, because large-scale public intervention can crowd out private capital. There should thus be a focus in surplus countries on structural reforms, which are beneficial for creating private investment, as well as on increasing public investment: "Measures to create more favourable conditions for investment in these [surplus] countries would not only support medium-term growth but also help ensure that the ongoing rebalancing persists once cyclical conditions improve." (OECD 2014b, p. 27)

Despite historically low ECB interest rates, the high cost of credit for countries like Greece and Portugal, shows how low confidence and high uncertainty is preventing private investors from investing in the periphery and that the available capital is not reaching those economies which are in need of it the most. Such systemic uncertainty, including country-specific risks, will continue to prevent private investments unless action is taken at EU level. For this reason, the European Policy Centre (EPC) has in the past called for the introduction of a European Investment Guarantee Scheme (EIGS), which could provide an investment insurance for European and non-European investors against political and excessive economic risk in these countries. The EIGS could thus be a means to overcome the harmful impact of uncertainty on private investment through better risk sharing between Member States. (Zuleeg 2013a). While the EIGS could drive a wedge between high uncertainty and low investment and thus contribute to higher growth, reducing uncertainties alone will not be sufficient to restore capital formation. Schneider and Giorno (2014) show that in countries such as Greece, Portugal and Ireland, the climate of high uncertainty was only partly responsible for the overall investment plunge recorded since the onset of the crisis. Reducing uncertainties would therefore be a supportive measure to the pivotal direct provision of funding, in particular for the European periphery.

There is a particular need to provide access to funding for SMEs in the periphery. In this regard, the banking union is a necessary but not sufficient condition for restoring lending, especially in crisis countries, where households and non-financial corporations, especially SMEs, continue to suffer high barriers to accessing finance; for example, average cost of credit for 2013 in France and Germany was around 2.3 and 2.1% respectively, while in Greece around 5.9% and in Portugal 5.5% had to be paid (OECD 2014a, fig. 14). Here, targeted but ambitious ECB policy and a significant extension in scale and scope of European Investment Bank (EIB) activities are required. At EU level, investments could be stimulated by increasing the EIB's capital base and expanding the Project Bond initiative implemented by the Commission and the EIB. The EIB should also be equipped with essential funds so that a provision of low-interest public capital for the correction of clear market failures is always available (Zuleeg 2013b).

Investment in infrastructure, innovation and human capital, continuing structural reforms, improving access to finance and the reduction of uncertainty through faster implementation of reforms and innovative measures such as the EIGS are all essential components in a policy mix to overcome the current crisis. But long-term growth is difficult to obtain through structural reforms if at the same time funding is cut for structural growth-supporting factors such as education or infrastructure, so the economic governance framework needs to take account of public and social investment as detailed above. Thus, based on comprehensive *ex ante* assessments, streamlining investment to only those structural factors that are indispensable inputs for the creation of growth could also justify more flexibility with regards to the 3% deficit limit in the SGP. The European Commission could make these types of assessments mandatory in the decision-making on country's fiscal policy.

The fiscal capacity and the actions for stimulating investment in the euro area are complementary measures with the former directed towards the medium and long term and the latter towards the immediate short term. The Commission should therefore ensure that the implementation of an EIP is compatible with the long term goals of a fiscal capacity and that the possibility for a consolidation of the two measures in the future is given.

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## Endnotes

- 1 See for instance Krugman (1993).
- 2 See European Commission (2011).
- 3 See, for example, Zuleeg (2014).
- 4 All mission letters can be found in European Commission (2014).
- 5 For an overview of the implementation process of the 2013 CSRs see for instance European Parliament (2014a, 2014b). The analysis shows that implementation is patchy at best. Even in the areas where there has been progress, actions are hard to attribute to the CSRs, i.e. was Member State action taken because of the recommendations or were the recommendations in line with actions the Member State was taking anyway.
- 6 For an overview of these factors see for instance Box 1 in Caudal *et al.* (2013).
- 7 See, for instance, the comparison between real time and historically revised output gaps in Box 2 of Caudal *et al.* (2013).
- 8 See, for example, Dullien (2013) for such potential schemes.
- 9 For an overview on the proposition for a European FTT see for instance Schneider (2014).
- 10 See, for instance, Table 2 in OECD (2013b) in which the official IMF projections for GDP growth in Greece are compared with the actual outcomes. The differences were particularly large in 2011 and 2012, which were periods of major fiscal consolidation in Greece.
- 11 See Juncker (2014).
- 12 Some of the policy recommendations regarding growth and investment were already made in Zuleeg & Emmanouilidis (2011).

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