GOVERNANCE OF ECONOMIC POLICY REFORMS

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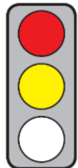
KEY ISSUES

Objective of the Communications: The Commission intends to govern economic policy reforms of Member States more strongly.

Parties affected: All citizens and politicians from Member States.



Pro: (1) Today Euro area Member States are liable for other Euro area Member States, on whose policies they have no influence. The proposed measures allow them to exert – limited – influence.

Contra: (1) The proposals reduce the liability of states in need for their policies.

(2) Concerning the Convergence and Competitiveness "Instrument", deadweight losses and moral hazard cannot be avoided by sorting out reforms motivated by such reasons.

(3) Reform arrangements of the Instrument should be legally binding. A binding agreement could only be based on the flexibility clause (Art. 352 TFEU), which requires unanimity of the Council.

CONTENT

Title

Communication COM(2013) 165 of 20 March 2013: Towards a Deep and Genuine Economic and Monetary Union – **The introduction of a Convergence and Competitiveness Instrument**

Communication COM(2013) 166 of 20 March 2013: Towards a Deep and Genuine Economic and Monetary Union – **Ex ante coordination of plans for major economic policy reforms**

Brief Summary

► **Background and objective**
- The Commission wants to
  - introduce a "Convergence and Competitiveness Instrument" [COM(2013) 165] and
  - establish "ex ante coordination of plans for major economic policy reforms" in EU law [COM(2013) 166]; this is already set out in Art. 11 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union ("Fiscal Compact"; see cepPolicyBrief).
- Both are intended to ensure that Member States consider "spill-over effects" of economic policy reforms on other Member States when making decisions [COM(2013) 165, p. 3 and 166, p. 3]. Spill-over effects appear especially in the Euro area.
- The Commission proposes different options for the design of these measures. It asks Member States and stakeholders to give an opinion. Legislative proposals are too follow by 2013.

► **Convergence and Competitiveness "Instrument": general outline**
- The "Instrument", besides considering spill-over effects, is aimed at
  - a higher "adjustment capacity and competitiveness" of Member States (p. 3) and
  - ensuring that "the structural reforms which are needed to remove key weaknesses" of Member States are implemented in a timely manner (p. 3).
- The "Instrument" is based on two pillars (p. 2):
  - an "arrangement" - given no legal specification in the Communication – between a Member State and the EU, that commits the Member State to implement reforms within a specific timeline, and
  - financial support for the implementation of the reforms.
- The "Instrument" is
  - mandatory to all Euro states – except those that are in a macroeconomic adjustment programme [Regulation (EU) No. 472/2013, see cepPolicyBrief], e.g. due to a financial request at the European Stability Mechanism (ESM, see cepPolicyBrief – in German only) and
  - voluntary to all other Member States, as far as "ways" can be found (p. 4).

► **Convergence and Competitiveness "Instrument": arrangement on the reform plan**
- The Member State presents a plan with concrete reforms and deadlines. This should be done
  - voluntary on anytime or
  - only on request of the Commission, but is then mandatory, or
  - only if preventive measures are taken due to a macroeconomic imbalance [Regulation (EU) No. 1176/2011, see cepAnalysis – in German only], then either voluntary or mandatory.

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– If a State under the excessive macroeconomic imbalance procedure [Regulation (EU) No. 1176/2011 and 1174/2011] has to present a corrective action plan, this plan replaces the reform plan. In this case, too, the country receives financial support.
– The reform plan should be based on the country-specific recommendations, that the Council addresses to the Member States as part of the European Semester [Art. 2 (a) Regulation (EC) No. 1466/97, see **cep-PolicyBrief**].
– The Commission assesses the reform plan and negotiates details with the Member State. Only such reforms should be included in the arrangement that
  - eliminate the weaknesses of the State that are taken up in the country-specific recommendations,
  - have spill-over effects on other Member States,
  - are compatible with the long-term sustainability of public finances of the State,
  - are sustainable in their social impact and
  - the State, if it doesn't receive financial support (p. 4),
    - cannot implement in a timely manner (avoidance of "deadweight losses") or
    - doesn't delay in order to receive the financial support (avoidance of "moral hazard").
– The reform plan is transmitted to the Council that can recommend modifications or approve the plan.
– In order to guarantee democratic legitimacy and accountability, the national parliament should best approve the reform plan before the Member State presents the plan to the Commission, but latest before its approval by the Council.

► **Convergence and Competitiveness "Instrument": financial support**
– The financial support should be used for "flanking measures" to overcome "social and political difficulties" that arise from the implementation of reforms (p. 3).
  - For each reform contained in the reform plan a lump-sum could be payed.
  - The disbursement of the financial support should
    - come in regular instalments,
    - depend on the implementation of individual steps of the reform or,
    - depend on the full implementation of the entire reform.
– For financing, a "financial support mechanism" should be defined in a legal act (p. 7).
  - The volume of the mechanism will be limited, but could be increased „over time".
  - The financial means for the mechanism could come from
    - „new specific financial resources" (p.7) or
    - payments of all participating states where the amounts are determined by the Gross National Income (GNI).

► **Convergence and Competitiveness "Instrument": implementation**
– The Commission monitors the implementation of the arrangement. In the case of non-compliance with the arrangement the Commission
  - requests the Member State to correct the deviations,
  - withholds the payments, if it doesn't correct the deviations, or suspends the payments in serious cases of non-compliance, and
  - reports on it in an annual assessment of the implementation of the arrangement.
– "Similar arrangements" should be applied if reforms or their implications are reversed (p. 8).

► **Ex ante coordination of economic policy reforms**
– "Major" reforms should be coordinated ex ante to consider spill-over effects and guarantee the efficiency-enhancing nature of reforms (p. 6).
– In the ex ante coordination should take part:
  - Euro area Member States
    - basically mandatory,
    - voluntary if they are in a macroeconomic adjustment programme and
  - voluntary to all other Member States.
– The Member State submits information to the Commission on its „major" economic reform plans (p. 5). These should include:
  - reforms that affect competiveness such as product or labour markets reforms,
  - reforms that affect the financial stability and fiscal sustainability of public finance and
  - reforms where the ex ante coordination should help to prevent domestic opposition by exchanging views and communicating advantages of reforms by Member States.
– Submission is done on the Member State`s own initiative or upon request of the Commission or the Council
  - once a year in the National Reform Programme that is presented in the European Semester or
  - without delay, "where the urgency of the economic situation requires" such (p. 5).
– The Commission adopts an opinion to the reform plans. It can propose changes. Council and Eurogroup discuss the opinion.

- The Council can suggest changes to the reforms where they are "justified" by expected effects on other Member States (p. 6)
- The opinion of the Commission and the outcome of the discussion of Council and Eurogroup are included in the "policy advices" issued to a Member State in the context of the European Semester (p. 6).

Policy Context

The blueprint of the Commission [COM(2012) 777] and the report of the 5th December 2013 from the four Presidents of the European Council, the Commission, the Eurogroup and the European Central Bank (ECB) for a genuine economic and monetary union (see cep**PolicyBrief**) already contains considerations for reform arrangements that include financial support and for the ex ante coordination of economic policy reforms. At the European Council on 13th and 14th December 2013 the heads of state and government have called on the Council and the Commission to concretize these considerations.

Options for Influencing the Political Process

Leading Directorate General:	DG Economic and Financial Affairs (in charge)
Committee of the European Parliament:	Economic and Monetary Affairs (in charge), rapporteur: N.N; Legal Affairs; Employment and Social Affairs; Budget
Leading German Federal Ministry:	Finance (in charge)
Committee of the German Bundestag:	Affairs of the European Unions (in charge); Finance, Economics and Technology, Budget

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

A Member State's decision to pass or not to pass economic policy reforms may have an impact on the economic development of other Member States. However such spill-over effects exist just as well between Member States and third countries, if they enjoy strong trade links with each other. For this reason do spill-over effects neither justify the Convergence and Competitiveness "Instrument" nor the ex ante coordination of reforms. Instead, both projects must be assessed in the light of the actually existing union of joint liability of the Euro area Member States: **Today, Euro area Member States are liable for other Euro area Member States, on whose policies they have no influence**. Countries only act responsible, if they are liable for their own acts. **On the one hand do the proposed measures indeed allow potential donor states to exert – limited – influence on potential states in need,** given that the Council must approve the reform plan as part of the "Instrument" and that the Council and the Eurogroup discuss the reforms as part of the ex ante coordination. **On the other hand the measures reduce the liability of potential states in need for their policies**. For the Euro area Member States will be more willing to grant financial aid to another Euro state, if they are jointly responsible for its situation, particularly if it is in need of financial aid although it has adhered to the recommendations of the other countries.

False incentives of the "Instrument" cannot be eliminated. It cannot be proven to a country that it would not implement a concrete reform without financial support (deadweight losses) or that it intentionally delays the reform in order to receive the support (moral hazard). Accordingly, **deadweight losses and moral hazard cannot be avoided by prohibiting to include reforms in the reform arrangements, which are motivated by such reasons**. They could only be avoided if the EU would decide autonomously on all reforms in the Member States. This would not yield the desired results, because reforms can only be successfully implemented if they enjoy public support and are not imposed from the outside. The "Instrument" also entails the danger that countries, which are on the verge of claiming financial aid, threaten to reform only on receipt of the financial support. The current discussion on the introduction of the "Instrument" may as well already lead to a delay of reforms.

The intended ex ante coordination of reforms may at best help inefficient countries to deter their competitiveness from further erosion by preventing reforms with negative effects on competitiveness, like a raise of minimum wages. At worst, it will prevent a country with a high competitiveness to boost its competitiveness further.

Impact on Efficiency and Individual Freedom of Choice

The reform arrangements made under the umbrella of the "Instrument" should be legally binding and not mere political arrangements. Since countries commit to the latter only under pressure from the public or peer pressure of other countries. Both have regularly not worked out in the past. Only Euro area Member States should participate, because the actual union of joint liability exists only between them. The intended use of the "Instrument" – that is to say: the payment of financial support – in the excessive macroeconomic imbalance procedure causes deadweight losses, because the countries have to implement the reforms anyway due to the corrective action plan. The disbursement of financial support has to depend on the full implementation of the entire reform. Otherwise states could pocket money although the reform has failed during the last implemen-

tation step. If reforms are reversed, countries should be obligated to repayment. (In a telephone call with the CEP, the Commission advocates such an obligation, but it isn't mentioned it in the Communication).
The ex ante coordination with the right of the Commission to request Member States to forward reform plans prevents countries from submitting unproblematic reforms only. However, the "policy advice" addressed to the Member States should only include the opinion of the Commission, and not the considerations of the Council and the Eurogroup. Since at this point there is a danger of recommendation of reforms not for their positive impact but for political bartering.

Legal Assessment

Legal Competence

The Commission has left the legal nature of the reform arrangement between the Member State and itself open. In question are (1) an agreement under international law, (2) a non-binding agreement within EU law and (3) a legally binding agreement within EU law.
The EU as an entity in international law may enter agreements of international law (Art. 47 TEU). The EU may expressly enter such agreement with third countries or international organisations (Art. 216 TFEU). Even if one is to assume that this treaty-making power also extends to treaties with its own Member States, as intended for the withdrawal from the EU of a Member State (Art. 50 TEU), may the EU not act beyond the competences conferred upon it (cf. Declaration No. 24 to the Lisbon Treaty), that provide basically only for non-binding agreements.
The EU has the competence of coordination of economic policies of all Member States (Art. 121 (6) TFEU). To this, the EU may monitor and assess economic policy and address recommendations to the Member States. Such a coordination, only specific to Euro area Member States, may be based on the setting out of economic policy guidelines (Art. 136 (1) (b) TFEU). **Therefore, a political agreement with no legal effect, based on recommendations of the EU is possible**, comparable to the macroeconomic adjustment programme or the corrective action plan within the excessive imbalances procedure.
A legally binding agreement could only be based on the flexibility clause (Art. 352 TFEU), all this, of course within the limits of the treaties, such as social security systems (Art. 153 (4) TFEU). The flexibility clause states that the EU can act if it is necessary in order to realise the aims of the EU treaties – which includes the establishment of an economic and monetary union (Art. 3 (4) TEU). **For this,** however, **unanimity of the Council is required.**
The intended "financial support mechanism" goes beyond the coordination of economic policy and does therefore not rely on this legal basis (Art. 121 (6) and Art. 136 (1) (b) TFEU). However, the EU may establish the mechanism in design of a fund, if this fund should serve to boost economic, social and territorial cohesion in the EU as a whole (Art. 175 (3) TFEU in conjunction with Protocol No. 28). This condition is legally met, should Member States not implement necessary reforms elsewise. Apart from that may participating states agree on a "financial support mechanism" outside EU law.
Ex ante coordination of economic policy reforms can rely on the coordination of economic policy (Art. 121 (6) and Art. 136 (1) (b) TFEU). As intended by the Commission, must the final decisions on reforms be with the Member States, since the EU has only a coordination competence.

Subsidiarity

Unproblematic.

Impact on German law

Should the "financial support mechanism" use additional national funds, must the volume of the German contribution be limited and foreseeable. This applies in particular if the volume should increase at later time because the budgetary responsibility of the German Bundestag cannot be "assigned to other players by way of vague budgetary authorisations" [Federal Constitutional Court – Bundesverfassungsgericht (BVerfG) "Euro-Rettung", Case 2 BvR 987/10 inter alia, par. 125]. Permanent "mechanisms", which result in the assumptiom of liability for the decisions of other countries, are unlawful, especially where they involve consequences which are difficult to calculate (cf. BVerfG "Euro-Rettung", Case 2 BvR 987/10 inter alia, par. 128).

Conclusion

Today, Euro area Member States are liable for other Euro area Member States, on whose policies they have no influence. On the one hand, does the Convergence and Competitiveness "Instrument" as well as the ex ante coordination of economic policy reforms allow potential donor states to exert – limited – influence on potential states in need. On the other hand do the measures reduce the liability of potential states in need for their policies. False incentives of the "Instrument" cannot be eliminated. Deadweight losses and moral hazard cannot be avoided by prohibiting to include reforms in the reform arrangements, which are motivated by such reasons. The reform arrangements should be legally binding. A legally binding agreement could only be based on the flexibility clause (Art. 352 TFEU) which requires unanimity of the Council. The competence of the EU to coordinate economic policy (Art. 121 (6) and Art. 136 (1) (b) TFEU) is limited to non-binding agreements.

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