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Don't complicate it even further: Macroeconomic Conditionality as a Substitute for new Structural Reform Contracts

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"Simplicity is the ultimate sophistication"
Attributed to Leonardo da Vinci

The idea of introducing contracts between Member States and the EU on structural reforms has its merits, it also has several disadvantages. Most notably, the contracts risk rendering European economic governance even more complex and cumbersome. It is therefore sensible to first try to integrate the structural reform contracts into one of the foreseen economic governance instruments.

This Policy Brief argues that macroeconomic conditionality can serve this purpose. With some minor reforms, it could even become a full-fledged substitute for structural reform contracts – without suffering some of latter's disadvantages.

INTRODUCTION

The European Union tends to have little leverage to bring about reforms of Member States' economies. Numerous ideas have been put forward to address this issue. One of the most prominent suggestions is to let Member States sign a contract with the EU on their upcoming structural reforms. Such structural reform contracts were first proposed by European Council President Herman Van Rompuy, after which the idea gained traction in various EU institutions. The European Commission proposed its own kind of structural reform contracts, while the European Council asked its President to examine the feasibility and modalities of the contracts by June 2013 (European Commission, 2012a; European Council, 2012).

The idea of structural reform contracts has a sound basis. But when considering such contracts, the EU has failed so far to take

into account one of its own basic rules for better regulation: the need to take stock of what is already in place. A key problem of structural reform contracts is precisely that they would add yet another layer to the already complex and burdensome European economic governance framework.

The EU should hence examine whether elements of the foreseen economic governance framework could not provide a worthy substitute for new structural reform contracts. This Policy Brief argues that macroeconomic conditionality, one of the foreseen economic governance instruments, can indeed play this role.

STRUCTURAL REFORM CONTRACTS

The European Council President proposed a range of measures to achieve a "*genuine*" Economic and Monetary Union. Many of them are seen as measures that would be implemented in a few years' time at the earliest. His proposal for structural reform contracts, however, constitutes one of the few measures that could be put into practice rather swiftly.

The concept

The concept of structural reform contracts has been given a variety of names: the Commission refers to it as a "*convergence and competiveness instrument*", the European Council President calls it "*arrangements of a contractual nature*", while the European Council itself describes it as "*contracts for competiveness and growth*". Whichever term is used, the goal of the instruments is self-evident, namely to give the EU a more powerful instrument to push forward structural reforms in the Member States.

According to the proposals, some (or perhaps all) eurozone countries would be invited to sign a contract with the EU. For eurozone countries facing particular difficulties, signing such a contract could even be made mandatory.[1] Each contract would detail the structural reforms that a specific Member State commits to undertake in the coming years, including the timeline for these reforms. The structural reforms would, *inter alia*, aim to liberalise the labour market and remove restrictions to the provision of goods and services in the country. The contracts would be drawn up by the EU and the Member State, perhaps in collaboration with the national and European parliaments.

The structural reform contracts are to be based on the country-specific recommendations that are made by the EU at the end of the European Semester. It thus seems natural that these contracts would be drafted in the second half of the calendar year, i.e. after the country-specific recommendations have been issued.

In order to become a balanced instrument, the structural reform contracts would include a financial incentive for certain countries that meet their contractual commitments. This financial incentive, or "*carrot*", is to offer a compensation for the short-term costs attached to the reforms. To ensure that it is well-targeted, the financial incentive would only be available for those structural reforms that are deemed the most needed. The incentive would be financed by a specific budget that is still to be created (Vanden Bosch, 2013).

In a nutshell, the structural reform contracts aim to combine more European control over national reforms with more European solidarity. The structural reform contracts

could indeed offer an instrument to push forward key reforms in the Member States.

The problems attached

Despite the appealing elements of the structural reform contracts, they also have serious disadvantages. Three problems seem to be of particular importance.

First and foremost, the structural reform contracts would yet again add a layer to the European economic governance framework. European and national administrations already have a multitude of planning and reporting requirements during the European Semester and the remainder of the year. The complexity does not stop there. Economic governance becomes even more demanding when certain problems are detected in a Member State, by means of the Excessive Deficit and Excessive Imbalance Procedures, as well as macroeconomic conditionality.

Practitioners rightly perceive the economic governance process as complex and cumbersome. The EU seems pretty far away from applying the design motto "*keep it simple*". Despite its good intentions, the proposal to add an additional governance layer in the form of structural reform contracts therefore risks actually having an adverse effect on the effectiveness of European economic governance.

The need for an additional budget to make the contracts work constitutes a second disadvantage. The new budget should have a certain size for it to play a role of importance. It would, as a consequence, worsen the national budget deficits of countries that are net contributors to the new budget. Even if the budget would be limited to € 10bn per annum, it would still add about 0.1% of GDP to the budget deficit of countries that contribute to the fund without receiving substantial funding in return.[2] While 0.1% of GDP might seem insignificant to some, it is highly questionable whether Member States are willing to accept any such deterioration of their already dire public finances.

A final disadvantage of the envisaged contracts is the fact that they would require considerable legislative and political energy before becoming operational. The efforts that would be needed would come in addition to the already massive workload of the European institutions and the Member States before the end of the European legislative period mid-2014. It seems that the structural reform contracts would thus have to gain priority over other urgent legislative initiatives (notably the Banking Union) or, alternatively, that an agreement on these contracts would only be reached once they have lost their short-term purpose.

MACROECONOMIC CONDITIONALITY AND STRUCTURAL REFORMS

Given the problems attached to introducing entirely new structural reform contracts, it seems much more sensible to examine whether the idea could be integrated into the foreseen economic governance framework. For this purpose, macroeconomic conditionality would provide a most suitable instrument.

From 2014 onwards, macroeconomic conditionality is set to become a powerful instrument in economic governance. It is a rather innovative –and controversial[3]– instrument, as it links European cohesion policy funding to respect for the rules of economic governance. Macroeconomic conditionality can be called upon whenever a Member State is not in line with the rules or recommendations of the European economic

governance framework. This includes a Member State insufficiently considering country-specific recommendations on structural reforms.[4] In such instances, the Commission can ask the Member State to revise its "*Partnership Contract*" with the EU (in which it sets out its commitments to ensure the proper and effective use of cohesion policy funding).[5]

A detailed procedure has been foreseen to apply macroeconomic conditionality. When the procedure is opened, a Member State is to propose amendments to its Partnership Contract, which can include setting out the structural reforms that it seeks to undertake. Subsequently, the Commission assesses the proposed reforms. If the amendments proposed by the Member State are thought to be insufficient after a first warning, the country risks having its cohesion policy funding suspended as a sanction.

For countries that are under a European bailout, macroeconomic conditionality does not only entail a possible sanction: in such cases, macroeconomic conditionality can also provide a positive financial incentive to the Member State. This "*carrot*" takes the form of increasing the European co-financing of cohesion policy projects in the Member State. As a consequence, the required additional national funding for these projects is reduced. Such higher European co-financing would, crucially, allow the fiscally troubled Member State to continue to invest in its economy (Verhelst, 2012).

While this was not necessarily the intention at its inception, macroeconomic conditionality could be applied in both a binding and a non-binding manner. It would be binding when the Commission states at the start of the procedure that a sanction can be applied in case of inadequate reform proposals by the Member State. Alternatively, macroeconomic conditionality could remain non-binding when the Commission invites the Member State to propose amendments to its Partnership Contract, while indicating that it does not foresee applying a sanction at that stage.[6]

MACROECONOMIC CONDITIONALITY AS A FULL-FLEDGED SUBSTITUTE FOR STRUCTURAL REFORM CONTRACTS

A popular English expression states that "*if it looks like a duck, swims like a duck and quacks like a duck ... then it probably is a duck*". To a large extent, the expression can be applied to macroeconomic conditionality and structural reform contracts. As they both involve a document of a contractual nature detailing structural reforms, drawn up by the EU and the Member States, it would be difficult to keep the two apart. However, for macroeconomic conditionality to be a full-fledged substitute for structural reform contracts, it would need to undergo two small, but beneficial, changes.

Firstly, the use of its financial incentive should be expanded. The financial incentive currently foreseen in macroeconomic conditionality is only available to countries that receive a European bailout (see supra). It would be a rather easy step to widen the use of this financial incentive so that it also covers structural reforms (or even all types of macroeconomic conditionality).[7] While such an incentive is less far-reaching than an entirely new budget, it would be a useful and – crucially – less expensive alternative. If a new budget nonetheless proves to be feasible, it could easily be integrated into the framework of macroeconomic conditionality.

As a second beneficial change, the rules on macroeconomic conditionality should allow

for sufficient involvement of national and European parliaments. This seems essential to ensure the ownership of the instrument, and would take into account the ongoing concerns about legitimacy and accountability of the European Economic Union.

CONCLUSION

In theory, contractual arrangements for structural reform are a good idea. In practice, however, they risk rendering European economic governance even more complex and cumbersome. This would have counterproductive consequences for the overall effectiveness of the European economic governance framework.

Given the disadvantages of creating a completely new instrument, the EU should look at how it can make better use of the instruments already at its disposal. Macroeconomic conditionality, serving as a bridge between cohesion policy and economic governance, offers such an alternative. It provides the EU with the option of requiring a Member State to detail its structural reform plans in a document of a contractual nature.

To ensure that macroeconomic conditionality becomes a full substitute for structural reform contracts, it would need to undergo two minor adjustments. Firstly, the use of its financial incentive should be expanded to provide a less expensive alternative to creating an entirely new budget. Secondly, macroeconomic conditionality should allow for parliamentary involvement, so as to meet concerns about the EU's legitimacy.

In sum, using macroeconomic conditionality as an alternative for structural reform contracts avoids needlessly duplicating procedures. This prevents a further increase in complexity. In addition, it would allow the EU to overcome key problems linked to the creation of structural reform contracts, while at the same time benefiting from their potential advantages.

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ENDNOTES

[1] The mandatory nature of such a contract would most likely be linked to a specific stage in the Macroeconomic Imbalance Procedure (see Regulation No 1176/2011).

[2] Given its limited size, the fund should be well-targeted. Using the fund for many reforms (and thus in many countries), would reduce its effectiveness.

[3] The European Council has approved it by unanimity in its multi-annual budget agreement, while the European Parliament is not in favour of macroeconomic conditionality, (European Parliament, 2012; European Council, 2013). Given the support from the Member States, it seems likely that macroeconomic conditionality will be introduced.

[4] Which boils down to insufficient consideration for the broad economic policy guidelines and the employment guidelines on which the country-specific recommendations are based (Article 21(1)a of Commission Proposal COM(2011) 615 final/2).

[5] The Partnership Contract should notably include the national arrangements "*to ensure alignment with [...] the targets set in the country-specific recommendations*" (Article 14 of COM(2011)615 final/2).

[6] Such an application of macroeconomic conditionality would correspond to the non-binding invitation by the Commission to sign structural reform contracts.

[7] This would be achieved by expanding the conditions mentioned in Article 22(1) of Commission Proposal COM(2011) 615 final/2.

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