

WHICH FINANCIAL INSTRUMENT TO FACILITATE STRUCTURAL REFORMS IN THE EURO AREA?

Eulalia Rubio | *Senior researcher at Notre Europe - Jacques Delors Institute*

EXECUTIVE SUMMARY

After one and a half years floating around in the European debates, the idea of creating contractual arrangements to facilitate structural reforms in the euro area starts to take shape.

Contractual arrangements are seen as the first step in the build up of a euro area fiscal capacity called to play different functions, above all, that of stabilizing euro area's economies. Despite the efforts done in recent weeks, however, there is still much confusion on the basic features of this proposal: Which countries will sign these contracts? What type of reforms will be targeted? Who will benefit from financial aid and under what grounds? Which type of financial support will be offered, and how will be financed?

This paper provides some thoughts on these questions and, more generally, on the rationale for setting up contractual arrangements. After describing the proposal which is currently under negotiation (section 1), the paper discusses some issues concerning the coverage, type of reforms targeted, national ownership and type of financial support attached to these contracts (section 2).

Section 3 then questions the rationale for these arrangements. We argue that, if used indiscriminately to support structural reforms in all euro area countries, the mechanism will end up rewarding those countries more reluctant to reform, rather than the good performers. If, on the contrary, only offered to the most distressed EMU countries, the need for an incentive tool is clearly questionable, as these countries are performing quite well under political and market pressures.

**“ THE IDEA OF
CREATING CONTRACTUAL
ARRANGEMENTS TO FACILITATE
STRUCTURAL REFORMS IN THE
EURO AREA TAKES SHAPE ”**

A closer look at these countries' reform performance reveals that the latter have been particularly active in liberalisation reforms aimed at increasing cost and price competitiveness. Yet, they are lagging behind in the adoption and implementation of costly reforms aimed at cushioning the negative social impact of the adjustment process or seeking to improve the productivity of the economy in the long run (i.e. strengthening active labour market measures, improving the performance of social protection and education systems...).

On the basis of this observation, section 4 makes a case for the establishment of a temporary euro area cohesion mechanism to support EMU countries in their internal devaluation processes, inspired on Jacques Delors' idea of setting up a “super Cohesion Fund”. The objective of this mechanism would be to ensure the sustainability of these adjustment processes (from both an economic and a social/political perspective), by helping these countries finance costly reforms aimed at smoothing the social impact of liberalisation reforms or improving the productivity basis of the economy in the long run.

TABLE OF CONTENTS

INTRODUCTION	3
1. The proposal currently on the table	4
1.1. The key features of ‘contractual arrangements’	4
1.2. Convergence on several points	4
1.3. Several points of disagreement	4
2. Issues at discussion	5
2.1. Coverage	5
2.2. Type of reforms targeted	6
2.3. National ownership	7
2.4. Type of financial support	7
3. Assessing the proposal: a flawed rationale and awful politics	8
3.1. Do we need an incentive tool?	8
3.2. Lack of political commitment, or lack of resources?	9
3.3. The political dimension: a rewarding system perceived as a punitive system	10
4. An alternative: a temporary cohesion mechanism to support euro area countries undertaking painful adjustment processes.	10
4.1. The case for a temporary EMU cohesion mechanism	10
4.2. Key features of a new euro area cohesion mechanism	11
4.3. Practical aspects and feasibility issues	12
CONCLUSIONS	13

INTRODUCTION

After one and a half years floating around in the European Union (EU) debates, the idea of creating contractual arrangements to facilitate structural reforms in the euro area starts to take shape. If everything goes as expected, the forthcoming December European Council will take some decisions on the main features of these contractual arrangements and its associated financial mechanism, with a view of reaching an overall agreement in the spring 2014.

Contractual arrangements are seen as the first step in the build up of a euro area fiscal capacity called to play different functions¹, above all, that of stabilizing euro area's economies². Despite the efforts done in recent weeks, however, there is still much confusion on the basic features of this proposal: Which countries will sign these contracts? What type of reforms will be targeted? Who will benefit from financial aid and under what grounds? Which type of financial support will be offered, and how will it be financed?

“ AN ALTERNATIVE TO CONTRACTUAL ARRANGEMENTS: A EURO AREA COHESION INSTRUMENT ”

This paper provides some thoughts on these questions and, more generally, on the rationale for setting up contractual arrangements. After a short description of the proposal, the paper discusses some issues concerning the coverage, type of reforms targeted, national ownership and type of financial support attached to these contracts. Section 3 then takes a closer look at the rationale for these arrangements. It questions the causal assumptions in which is based the proposal and makes a case for switching from a logic of incentives to a logic of solidarity. Section 4 sketches out the basic features of an alternative to contractual arrangements: a euro area temporary cohesion instrument to support countries undertaking painful adjustment process, inspired on Jacques Delors' idea of setting up a “super Cohesion Fund” for the most distressed EMU countries³.

1. Eulalia Rubio, “Eurozone Budget: three functions, three instruments”, *Tribune, Notre Europe – Jacques Delors Institute*, November 2012

2. Henrik Enderlein, Jann Spiess and Lucas Guttenberg, “Blueprint for a cyclical shock insurance in the eurozone”, *Studies & Reports No 99, Notre Europe – Jacques Delors Institute*, September 2013

3. Jacques Delors, “Rethinking the EMU and making greater Europe positive again”, *Tribune, Notre Europe – Jacques Delors Institute*, 28 June 2013 (tribune inspired on a speech delivered by J. Delors in Lisbon on 5 June 2013)

1. The proposal currently on the table

The idea of euro area member states establishing binding contracts with European Union (EU) institutions to adopt and implement structural reforms has been under discussion since the end of 2012. The proposal was both in Van Rompuy's report "Towards a Genuine EMU"⁴ and in the Commission's "Blueprint for a Deep and Genuine EMU"⁵.

1.1. The key features of 'contractual arrangements'

In both reports, these contracts were justified by the significant spillover effects associated with major economic reforms in the euro area - thus the need, from a euro area point of view, to make sure all Economic and Monetary Union (EMU) countries 'deliver' on reforms. At the same time, they were seen in both reports as a first step leading to the buildup of an euro area fiscal capacity to facilitate adjustment to economic shocks. The argument is that, by supporting re-balancing and adjustment in those countries most in need of reform, these contractual arrangements will support a convergence process within the euro area making politically feasible, in a further stage, the establishment of an EMU-wide shock absorption capacity.

The key features of these contractual arrangements were further explored in a note presented by President Van Rompuy to the June 2013 European Council⁶. In the meantime, in March 2012, the Commission published a Communication presenting a specific proposal for a "Convergence and Competitiveness Instrument"⁷. More recently, a note drafted by the cabinet of President Van Rompuy and presented to the Sherpa meeting of November 21 has provided more details on the proposal which is currently under discussion⁸.

1.2. Convergence on several points

The three documents converge in various points. There is agreement on that the contracts should be embedded in the European Semester, and serve to implement one or several of the Country-specific recommendations - particularly those issued in the context of the Macro-economic imbalances procedure (MIP). Contractual arrangements should be tailor-made to the specific needs of each country, remain focused on a limited number of key micro-economic, sectoral and institutional weaknesses and primarily concern areas where there are significant impediments to growth and jobs, and to the smooth functioning of EMU. They should be the outcome of a dialogue between the Commission and the member state, but have to be approved by the Council. As concerning the financial support attached to the contract, it should be conceived as an incentive rather than a compensation for the specific costs of implementing the reform. Therefore, money should not be earmarked to specific actions and the amount of financing should not be linked to the direct costs of reforms. Disbursement should be in tranches, conditional to the implementation of the agreed timetable of reforms.

1.3. Several points of disagreement

There are however some points of disagreement between these three documents. Differences basically concern the coverage of the contractual arrangements and the role and type of financial support attached to them. President Van Rompuy's note to the June 2013 European Council proposes making contractual arrangements mandatory for all euro area countries and voluntary for other member states, and, only in specific cases (in cases of countries "not being in a position to implement the necessary reforms in time due to their economic

4. Van Rompuy, Herman, "Towards a Genuine Economic and Monetary Union", December 2012

5. European Commission' Communication, "A blueprint for a deep and genuine economic and monetary union Launching a European Debate", COM(2012) 777 final/2 , 30 November 2012

6. "Towards a Genuine Economic and Monetary Union: State of play of the consultations with member states and institutional actors", Summary note prepared by the Cabinet of the President of the European Council, June 2013

7. European Commission's Communication "the introduction of a convergence and competitiveness instrument", COM (2013) 165 final, 20 March 2013

8. Main features of Contractual Arrangements and associated Solidarity Mechanisms, Annotated agenda of the Sherpa meeting, 21st November 2013

costs”), supporting the contracts with temporary, targeted, and flexible financial support. The latter could take form of a grant or a long-term subsidised loan. The EU Commission’s Communication conceives the financial support as an inherent part of the contract. Thus, all EMU countries signing a contractual arrangement under the ‘Convergence and competitiveness instrument’ (CII) would be automatically entitled to receive financial support. It proposes making contractual arrangements mandatory only for those countries under the corrective arm of MIP (those having ‘excessive macro-economic imbalances’) and voluntary for the rest of EU countries, except those under macro-economic adjustment programme (currently Greece, Portugal and Cyprus). Finally, unlike Van Rompuy, it only envisages the use of grants to support contractual arrangements. The document of November 21 proposes making the contracts mandatory for all EMU countries except those in the corrective arms of the MIP or under Macroeconomic adjustment programme, and voluntary for the others. According to this document, all member states signing a contract should be entitled to receive financial support. This could be available in the form of grants or long-term loans.

Table 1 ► The coverage of contractual arrangements and the role and type of financial support attached to them: comparing three EU documents

	CONTRACTUAL ARRANGEMENTS	SOLIDARITY MECHANISM
Summary note submitted by the cabinet of Van Rompuy to the June 2013 European Council	Mandatory for all EMU countries, voluntary for non EMU countries	Only for EMU countries not being in a position to implement the necessary reforms in time due to their economic costs Financial support through grants or long-term loans
European Commission’s Communication on “Convergence and Competitive Instrument” (March 2012)	Mandatory for EMU countries under the corrective arm of MIP, voluntary for the rest of countries (except those under macro-economic adjustment programme)	Open to all participating countries Financial support through grants
Note prepared by the cabinet of Van Rompuy for the Sherpa meeting of November 21, 2013	Mandatory for all EMU countries except those in the corrective arm of MIP or under Macroeconomic Adjustment Programme, voluntary for the rest of countries	Open to all participating countries Financial support through grants or long-term loans

2. Issues at discussion

2. 1. Coverage

As seen above, there is still much confusion about the countries that will be covered by the contractual arrangements. Van Rompuy’s idea to make the contracts mandatory for all euro area countries presents a number of problems. As rightly pointed out by Vanden Bosch⁹, this would imply converting all EU country-specific recommendations into binding recommendations. Although Germany has sometimes flirted with the idea of reforming the Treaty to give more powers of surveillance and control to the Commission, the fact is that a transfer of sovereignty from the national to the EU level is not currently into the EU agenda.

The common sense would hence suggest adopting the Commission’s approach; that is, making these contracts mandatory only for those EMU countries under the corrective arm of MIP (which are already obliged, under MIP rules, to submit a binding Corrective action plan) and offering them on a voluntary basis to the rest of member states.

Yet, this does not seem to be the option retained in current negotiations. The note elaborated by the cabinet of Van Rompuy for the meeting of November 21 maintains the mandatory nature of contractual arrangements. However, aware of the lack of legal basis for imposing reforms to EMU countries which are not in the

9. Vanden Bosch, Xavier, “Money for structural reforms in the Euro area: Making sense of contractual arrangements”, Egmont Paper 57, May 2013

corrective arm of MIP or under adjustment programmes, the document admits the possibility for member states to refuse signing the contract proposal discussed with the Commission. Moreover, once signed, the contractual arrangement would only have legally binding nature if accompanied with financial support. In absence of financial support, the contractual arrangement would take the form of a ‘politically binding commitment’ between the member state, the Commission and the Council.

Van Rompuy’s idea to engage all euro area countries seems to be aimed at weakening the stigmatizing effect of these contracts: however, there is no point in creating a supplementary layer of non-binding ‘political commitments’. This will only render the system of EMU governance more complex and opaque to citizens, without reporting much benefit. Even worse: it might reinforce the misperception of ‘Brussels’ imposing policy choices to national governments, which is so pervasive in certain countries¹⁰.

For all these reasons, contractual arrangements have to be voluntary. If offered on a voluntary basis, they should necessarily entail some sort of financial support (otherwise no country will chose to engage voluntarily into a binding contract with the Commission). In this case, the question then is: which countries should be eligible to sign these financially backed contracts?

“ DOES IT MAKE SENSE TO EXCLUDE ‘PROGRAMME COUNTRIES’ FROM THIS NEW FINANCIAL MECHANISM? ”

Both the Commission and the note of November 21 propose offering them to all EU countries, except those under macro-economic adjustment programme. Does it make sense to exclude ‘programme countries’ from this new financial mechanism? The underlying logic here is that these countries do not need an additional incentive to introduce reforms, as they are forced to do so by their adjustment programs. Besides, they are already benefiting from EU solidarity; they should not be entitled to more. However, this is a bit misleading as argument: while benefiting from solidarity, the EU money these countries receive is exclusively used to reimburse their debt: they do not receive any specific

EU support to help cushion the direct and indirect costs of the reforms they implement. Given the enormous adjustment process they are undertaken, and the lack of budgetary manoeuvre they have, excluding these countries under programme from this new financial assistance mechanism does not seem very reasonable. We will come back to this point in section 3.

2.2. Type of reforms targeted

The idea of contractual arrangements is to help countries adopt and implement structural reforms supporting competitiveness, growth and jobs. While in principle this can cover a broad range of areas (from regulative reforms in labour market, product and service markets to reforms in the public sector, or changes in the tax and education systems), Van Rompuy’s note of June 2013 proposes focusing contractual arrangements on “areas where significant structural rigidities in services, products and labour market prevent a member state to reap the full economic benefit of EMU membership”. The document of November 21 adopts a slightly broader scope. According to this document, contracts should be focused on a “limited number of key micro-economic, sectoral and institutional weaknesses”, and primarily concern areas “where there are significant impediments to growth and jobs, and to the smooth functioning of EMU”.

Narrowing the scope of the instrument is advisable. Given that competitiveness problems differ from country to country, the potential combination of reforms covered by each contractual arrangement could end up being very different. This would seriously complicate the tasks of monitoring and evaluation. In effect, it will be quite difficult for the Commission’s services to monitor progress in the implementation of such reforms, and to assess when a country is in a situation of “lack of timely implementation” which implies a suspension of financial support.

10. Bertoincini, Yves, “Eurozone and Democracies: a misleading debate”, Policy Paper No 94, Notre Europe – Jacques Delors Institute, July 2013

“ A FOCUS ON RIGIDITIES IN SERVICES, PRODUCTS AND LABOUR MARKET MIGHT NOT BE THE MOST APPROPRIATE ONE ”

Having said so, one might wonder whether the focus on “rigidities in services, products and labour market”, as proposed by Van Rompuy, is the most appropriate one. This choice seems to be based on the assumption that such reforms are the most important to facilitate the re-balancing of economies with external deficits, as well as those more politically difficult to pass (as they are typically resisted by vested interest who capture economic rents menaced by the reform). Thus the need to ‘bribe’ reluctant governments to pass these unpopular reforms.

Measures to liberalize labour, services and product markets are essential to facilitate adjustment in several euro area countries. Precisely because of their importance, however, these are the reforms to which markets pay more attention. In particular, as discussed in more detail in section 3, those countries more severely affected by the debt crisis are under strong market pressure to pass liberalisation reforms and, in general terms, they deliver on these areas. On the contrary, they are lagging behind in the introduction of complex and costly reforms (such as those related with the reform of the public sector), as well as in all those reforms aimed at smoothing the negative social impact of liberalisation processes or seeking to improve the productivity and non-price competitiveness of the economy in the long run (i.e. strengthening active labour market policies, increasing the efficiency of social policies, improving the performance of the education system). Taking this into account, it seems more appropriate to focus contractual arrangements on those other reforms which entail large direct economic costs, which are necessary to ensure the sustainability of the process of adjustment, and to which markets pay far less attention.

2.3. National ownership

An idea which is stressed both by Van Rompuy and the Commission is the need to ensure ‘national ownership’ of these contracts. To this purpose, the documents emphasize the need to make sure that measures included in the contract are the outcome of a dialogue with the domestic authorities, to give the possibility of re-negotiating the contract if circumstances change, and to ensure national parliaments and other relevant stakeholders’ involvement in the preparation of the contract. The latter, however, should be involved “before the endorsement of the contractual arrangements by the Council”¹¹.

It is very implausible that these measures alone resolve the problem of national ownership. On the contrary: as currently conceived, the ‘competitiveness contracts’ will probably be perceived as another attempt by “Brussels” to impose national reforms. In effect, as pointed out by Pisani Ferry¹², a bilateral approach in which the Commission and the rest of member states (i.e. the Council) strictly monitor another member state’s efforts to implement reforms and condition the disbursement of money to the adoption of these reforms resembles too much to the logic of ‘adjustment programs’. It is difficult to see how national governments will be interested in signing such contracts, even more so if, as foreseen in the note of November 21, the money received is in form of loans instead of grants.

2.4. Type of financial support

As said above, if contracts are offered on a voluntary basis, they should be all entailed with some sort of financial support. An open question is whether assistance should be provided in form of grants (as proposed by the Commission) or in form of long-term concessional loans (an option which is recently gaining ground). The note of November 21 provides various arguments in favour of loans: they are well suited to the fact that reforms provide short-term costs and long-term benefits; they are “incentive-compatible” and would

11. Commission’s communication, p 6

12. Pisani Ferry, Jean, “Distressed Europe should not be bribed to reform”, Financial Times 5 february 2013

contribute to strengthening national ownership; and above all, they would imply only limited fiscal transfers across countries.

“ THE LONG-TERM BUDGETARY IMPLICATIONS OF REFORMS DEPEND ON THE TYPE OF REFORM AND THEIR IMPACT ON EMPLOYMENT AND PRODUCTIVITY ”

are for the most part heavily indebted.

The use of loans is easier to sell to the public opinion of northern euro area countries, traditionally reluctant to make further moves in solidarity. However, it might not be very attractive for countries in need of reform. While structural reforms tend to generate long-term benefits, its impact on growth is not straightforward; it might be hampered by implementation gaps or changes in the external environment. Besides, the long-term budgetary implications of reforms are neither straightforward; they depend on the type of reform and their impact on employment and productivity¹³. For all these reasons, signing a loan, even if a cheap loan, will not be very tempting for countries which

3. Assessing the proposal: a flawed rationale and awful politics

Above all, the underlying problem with the proposal of “competitiveness contracts’ is its flawed rationale. The instrument is presented and conceived as an incentive tool to facilitate the adoption and implementation of structural reforms. However, the need for such a mechanism is questionable.

3.1. Do we need an incentive tool?

Of course, many euro area countries are lagging behind in terms of reform implementation, but this might be due to two different causes: lack of resources to finance the direct costs of reform or to compensate vested interests from the losses incurred, or lack of political commitment from domestic authorities to introduce these reforms (either for ideological reasons or for fear to become unpopular). The problem is that it is very difficult to disentangle these two causes. If used indiscriminately to support structural reforms in all euro area countries, the mechanism will set the wrong incentives. It will end up rewarding those countries more reluctant to reform, rather than the good performers.

In principle, this problem could be solved by targeting only those countries which do not have budgetary margin of manoeuvre to implement structural reforms, that is, those under macroeconomic adjustment program or having suffered important market tensions in the recent past. However, do these countries really need an ‘incentive’ to pass structural reforms? According to the latest Organisation for Economic Co-operation and Development (OECD) “Going for Growth” Report, they are performing quite well. Indeed, the report reveals that, over the period 2011-2012, “euro area countries under financial assistance programmes or direct market pressures (e.g. Greece, Ireland, Italy, Portugal and Spain) were among the OECD countries whose responsiveness was highest” to the OECD recommendations on economic policy reforms¹⁴.

This does not mean these countries are doing everything well. As said above, a closer look reveals that they have been particularly active in reforms aimed to regain cost and price competitiveness. All these countries have deeply reformed their labour markets to introduce more internal and external flexibility, and they have done notable efforts to reduce economy-wide regulatory burdens and liberalise specific sectors (network industries, professional services, etc.)¹⁵. Yet, they are lagging behind in the adoption and implementation of reforms aimed at cushioning the negative social impact of liberalisation processes or seeking to improve the

13. OECD Economic Policy Reforms- Going for Growth 2013

14. OECD (op.cit)

15. Buti, Marco ; Turrini, Alessandro (2012) “Slow but Steady? Achievements and shortcomings of competitive disinflation within the euro area”, ECFIN Economic Brief, Issue 6, November 2012; OECD (op.cit)

productivity of the economy in the long run (ie, strengthening active labour market measures, improving the performance of social protection and education systems,...). The case of Spain and its labour market reform exemplifies the dominance given to liberalisation reforms over the rest (box 1).

BOX 1 - LABOUR MARKET REFORM IN SPAIN: AN UNBALANCED REFORM

Being the EU country with the highest unemployment ratio, Spain has been under strong market and political pressure to radically reform its labour market. Two rounds of reform were undertaken in 2010 and 2011, under the Socialist government, and in February 2012, the newly elected right-wing government approved what has been defined as the most radical reform of the Spanish labour market since the establishment of the democracy in 1978. The 2012 reform has significantly increased labour market flexibility. Among other things, the reform has reduced the severance pay for dismissal of permanent workers, it has abolished administrative approval of collective contract suspensions and work-time reductions, it has created new flexible contract modalities (such as a permanent contract for firms with less than 50 employees which allows for a one-year probation period i.e., with no severance pay) and extended the coverage of existing ones (the training contract is extended to workers up to 30 years old, instead of 25), and allows firms in economic distress to opt out from the industry-level agreement and unilaterally change working conditions (including wages).

However, despite the fact that the preamble of the Law stresses the need to move towards a 'flexicurity' model, the reform introduces hardly any measures to strengthen active labour market policies. It announces future measures to promote the training of employees, but it scarcely alters training programs for the unemployed: in fact, in 2012 the Spanish government slashed the budget for retraining the unemployed by nearly 1 billion euros, with the result that at the moment the most important active policy measures are hiring subsidies in the form of social security contribution rebates. As concerning job intermediation, the only measure announced by the Law is the possibility for public employment services to establish partnerships with registered private intermediaries, an option which has not yet been put into practice.

In its Country-specific recommendations for 2013, the Commission does not require further efforts to enhance the flexibility of the Spanish labour market, but calls the Spanish government to "reinforce and modernise public employment services" and to "enact swiftly a result-oriented active labour market policies". Partly as a response to that, in July 2013 the government published the Annual Employment Plan for 2013. On the paper, the plan is very ambitious: it aims at creating a 'new model' for the planning, management, evaluation and financing of active employment measures. However, the budget for implementing the plan is 3,8 billion (far from the 7,3 billion the government devoted to finance active employment measures in 2011¹).

¹ National Reform Program of Spain 2011

3.2. Lack of political commitment, or lack of resources?

Why these countries lag behind in these other reforms? Two reasons seem to explain that. First, although essential to ensure the long-term sustainability of the process of adjustment (both from an economic and from a social/political point of view), the importance of these reforms is largely undervalued by the markets, traditionally short-term oriented in their analysis and perceptions of risks. Second, and probably more important, these type of reforms tend to be technically complex and costly to implement. Unlike liberalisation reforms - which mainly require budget-neutral legislative changes- improving active labour market or social policies requires important resources as well as coordinating different ministries - and in some countries, different levels of governments.

In conclusion: those countries more severely affected by the debt crisis have indeed difficulties to approve and fully implement certain structural reforms. However, rather than a lack of political commitment (as assumed by the proposal of contractual arrangements) in many cases what explains the implementation gap is a lack of resources and/or administrative capacity to swiftly implement the reform.

3.3. The political dimension: a rewarding system perceived as a punitive system

Let's assume, for a while, that the EMU needs an incentive tool to pass structural reforms. One could argue, for instance, that these countries have delivered under strong market and political pressure but that this will not last forever: hence the need to build up an incentive tool to guarantee EMU countries' commitment to reform in the years ahead. If we accept this argument, then the question is: will contractual arrangements, as they are designed, be the appropriate response?

We can have serious doubts on this. As explained before, the mechanism is very drastic and intrusive: it reproduces the principal-agent approach that is applied to the macro-economic adjustment programs signed between the Troika and EMU countries having received a bailout¹⁶. It is difficult to imagine many countries volunteering to be submitted to these legally binding arrangements. But in addition to that, politically, it is a bad choice. If signed by all EMU countries, contracts will give the impression that the IMF-like regime has been generalised to all eurozone countries. If signed by only some countries, they will be stigmatizing and will nurture the idea that some countries are imposing their model on others. In short, there is a serious risks that, while being originally conceived as a positive, rewarding system, will end up being perceived as a negative, punitive one.

“ THE ASSUMPTION BEHIND THE IDEA OF CONTRACTUAL ARRANGEMENTS IS THAT EMU COUNTRIES ARE FUNDAMENTALLY UNWILLING TO REFORM ”

There is a need to adopt a more positive, constructive approach to induce structural reforms in the euro area. Behind the idea of contractual arrangements there is the assumption that EMU countries (particularly the most distressed ones) are fundamentally unwilling to reform. Yet, the picture is not black and white; as everywhere, there are pro- and anti-reform forces in these countries. The challenge hence is to provide the political forces in favour of reform the EU discourse, framework and practical instruments that make it possible to forge large and durable pro-reform coalitions.

4. An alternative: a temporary cohesion mechanism to support euro area countries undertaking painful adjustment processes.

As pointed out in the previous section, there is no clear rationale for an EU instrument to incentive the adoption and implementation of reforms in the euro area. If applied to all euro area countries, an instrument of this sort would be clearly affected by problems of moral hazard. If only applied to the most distressed euro area countries, the logic of incentives is clearly questionable, as these countries are performing quite well.

4.1. The case for a temporary EMU cohesion mechanism

Rather than an incentive tool to facilitate the adoption of reforms, what the euro area needs is a temporary financial assistance instrument to support EMU countries undertaking painful adjustment processes. This could be inspired on Jacques Delors' idea of setting up a 'Super Cohesion fund'¹⁷.

Unlike competitiveness contracts, there is a clear rationale for this type of EU action. Whereas these countries' current situation is partly due their own faults, it is also partly due to the weaknesses of the EMU architecture. Had the EMU been equipped with the necessary tools to prevent the rise of competitiveness divergences, and,

16. Spiegel, Peter ; "Cheap loans for fiscal reforms: sound familiar?", Financial Times, Brussels Blog, November 25 2013

17. Delors, Jacques (op cit)

particularly, had it been equipped with and euro-area macro-economic stabilization tool before the start of the crisis, these countries would have not seen their external positions deteriorate to the point they are now, and would have not been forced to undertake a painful internal devaluation process as it is the case today. In addition to that, these countries' fate is a matter of serious concern for all euro area countries. An EU mechanism to render the process of adjustment socially and politically acceptable (therefore ensuring its sustainability) is something that benefits both rich and poor euro area countries.

This mechanism would be different than existing cohesion and structural funds. It would be temporary and specifically geared to support a convergence process within euro area countries. Besides, the Commission would have to play a greater role in deciding and controlling how the money is spent than the role she currently plays in cohesion policy. More EU control is justifiable to guarantee that money effectively serves to sustain the process of adjustment.

4.2. Key features of a new euro area cohesion mechanism

The specific design of this instrument would have to be further explored, but it would differ from contractual arrangements in various points (table 2). The mechanism would only cover those euro area countries undertaking a process of internal devaluation and having little or no margin of budgetary maneuver to implement costly reforms. Rather than a sum lump, money would be specifically earmarked to support the implementation of costly actions aimed at smoothing the negative social impact of liberalisation reforms, or seeking to improve the productivity and non-price competitiveness of these economies in the long run. Finally, while the logic of the instrument would not be to incite the approval of reforms, financial support would be conditional on the implementation of certain reforms. Yet, this conditionality will not be applied in a quasi-automatic manner (as applied in the Troika's adjustment programs) but in a flexible and constructive way, following the logic of the thematic ex-ante conditionality applied in cohesion and structural funding programs (see box 2).

BOX 2- THEMATIC 'EX ANTE' CONDITIONALITY IN COHESION AND STRUCTURAL FUNDING

Occasionally applied during the 2007-13 period, the application of thematic ex-ante conditionality in cohesion and structural funding has been generalized in the period 2014-20. Ex-ante conditionality consists into the requirement of certain ex-ante conditions which need to be in place before the disbursement of the aid and which are deemed important to guarantee the effectiveness of the EU support. Thus, for instance, in the case of the recently created "Youth Employment Initiative" whose goal is to finance the implementation of 'youth guarantees' to 15-24 years old NEET's (not in employment, education or training), member states eligible to receive this funding are asked to have approved a strategic policy framework for setting up youth guarantee schemes, as defined in the Council Recommendation on Establishing a Youth Guarantee. This 'ex-ante' condition is an important pre-requisite to ensure that MS's spending on youth guarantees is effective, and not used to finance a plethora of un-coordinated and ineffective measures.

Lack of fulfilment of ex-ante conditions can lead to a suspension of the payments. However, this condition is applied in a flexible and constructive manner. Thus, where the conditions are not met at the start of the programming period, the Commission can give two years to the country to fulfil these conditions. The country then shall set out the detailed actions relating to the fulfilment of ex ante conditionalities, including the timetable for their implementation, and the Commission shall strictly monitor the compliance with the agreed timetable of implementation in the framework of its assessment of the Partnership Contract and programs.

4.3. Practical aspects and feasibility issues

The creation of a new EMU cohesion instrument would obviously imply solving a number of political and practical issues.

From a technical point of view, it would be necessary to define the eligibility criteria. As we have said, the mechanism should be geared to help euro area countries undertaking internal devaluation processes and not having the budgetary capacity to implement costly reforms. But which precise criteria should be used to determine whether a country falls into this category? An option would be using some of the MIP scoreboard's indicators, such as the indicator of % change (3 years) in nominal Unit Labor Cost (which reflects quite well the efforts undertaken in internal devaluation) and combining it with some criterion on deficits or public debts. As the choice of indicators and thresholds could entail different results of coverage, there will surely be political battles on this aspect.

Table 2 ► Basic features of a euro area cohesion mechanism to support countries undertaking internal devaluation processes

Objective	To ensure the sustainability (from both an economic and a social/political perspective) of the internal devaluation process undertaken by certain EMU countries Ultimate purpose: supporting a process of convergence within euro area countries
Beneficiary countries	Euro area countries undertaking internal devaluation processes and having little or no margin of budgetary maneuver to implement costly reforms
Actions targeted	Costly measures aimed at smoothing the negative social impact of liberalisation reforms or seeking to improve the productivity and non-price competitiveness of these economies in the long run Ex: reforms aimed at strengthening active labour market policies, improving social protection systems or increasing the performance of education and research system
Conditionality	Subject to thematic 'ex ante' conditionality (disbursement conditional to the introduction of liberalisation reforms or other measures deemed necessary to ensure the effective use of the money provided)

There can also be different approaches concerning the type of actions targeted. One option would be leaving to the EU Commission and each member state the decision on the type of actions financed. EU money would hence serve to finance different actions in each eligible country. An alternative would be focusing EU funding on a limited number of eligible measures. This would simplify the tasks of monitoring and evaluation and enhance the impact and visibility of the EU aid provided. One could imagine, for instance, using EU money to help member states implement one or several of the recommendations put forward in the Commission's Social Investment Package¹⁸. Another option would be using EU money to finance active labor market reforms or, even more narrowly, actions facilitating intra-labor mobility in the euro area (mobility allowances, language courses..).

“ PRE-ALLOCATION
WOULD IMPLY THE
CREATION OF A NEW EU
FUND CONCENTRATED
ON THE WEAKEST EMU
COUNTRIES ”

Whether or not pre-allocating money is another question that merits reflection. Pre-allocation would imply the creation of a new EU fund concentrated on the weakest EMU countries. Creating a Fund of this type would send a strong political signal to the public opinion of the weakest countries. However, it might be difficult to sell to northern euro area's political opinions, which might be quite reluctant to increase structural fund-like spending. An alternative, inspired in Pisani Ferry's proposal, would be creating one of different thematic schemes in which money would not be pre-allocated but distributed among the eligible countries on competitive basis, according to the efforts made to attain certain common goals (i.e, reducing youth unemployment,

fostering labor mobility, increasing the employment levels of senior workers,..).

A technical issue with important political implications is the financing of the solidarity instrument. In principle, the rationale of the mechanism would make the use of grants preferable to loans. Grants can be either financed through dedicated contributions (ie on the basis of a GNI key) or on the proceeds of new financial resources specifically dedicated to it. The second option is preferable, as an instrument financed through own resources would avoid decisions on spending be misguided by the conflicts between potential recipients and potential contributors.

Finally, a particularly tricky question is whether the mechanism should be opened to non-euro area countries. In principle, the logic would recommend opening the fund only to euro area countries, as its ultimate purpose is to support a convergence process within euro area countries. However, non euro area countries- particularly poorer ones- are likely to block any attempt to create a new solidarity fund if they are excluded from it. There will probably be a need to conciliate what is desirable with what is politically feasible. What seems clear is that, if financed through national contributions, richer euro area countries will logically be against the entrance of other non- euro area countries (particularly if the latter are seen as potential recipients of this new budget). Thus, a solidarity fund funded through own resources is more likely to be extended to non EMU countries.

18. European Commission's Communication, *Towards Social Investment for Growth and Cohesion – including implementing the European Social Fund 2014-2020*, COM(2013) 83 final, 2013

CONCLUSIONS

The idea of engaging euro area countries into binding reform contracts with the Commission was first mooted by Germany when the debate on Eurobonds was at its highest. Even if not always explicit, competitive contracts were seen at that time as a necessary return for the major leap in solidarity which would entail some sort of common debt issuance. Today, a major strengthening of EU control and supervision over national economies is not justifiable on the basis of a 'solidarity contract'¹⁹. Eurobonds are out of the EU agenda, and while contractual arrangements are presented as the return for Germany's agreeing to the Single Bank Resolution Mechanism, this is not a balanced *'quid pro quo'*: the solidarity step which entails the establishment of Single resolution mechanism has already been balanced with more EU control and supervision on banks.

If we judge contractual arrangements in isolation (and not as part of a solidarity deal), then we realise that their rationale is flawed. Rather than an instrument to incentive the adoption and implementation of structural reforms, what the euro area needs is a temporary financial assistance instrument to support EMU countries undertaking painful adjustment processes.

¹⁹. Fernandes, Sofia ; Rubio, Eulalia, "Solidarity within the EMU : how much, what for, for how long ?", *Policy Paper No 51, Notre Europe - Jacques Delors Institute*, February 2012

On the same themes...

DEEPENING THE EMU: HOW TO MAINTAIN AND DEVELOP THE EUROPEAN SOCIAL MODEL?

Sofia Fernandes and Kristina Maslauskaitė, *Studies & Reports No 101, Notre Europe - Jacques Delors Institute*, November 2013

YOUTH UNEMPLOYMENT, SOCIO-ECONOMIC DIVERGENCES AND FISCAL CAPACITY IN THE EURO AREA

Maria João Rodrigues, *Policy Paper No 101, Notre Europe - Jacques Delors Institute*, November 2013

BLUEPRINT FOR A CYCLICAL SHOCK INSURANCE IN THE EURO AREA

Henrik Enderlein, Jann Spiess and Lucas Guttenberg, *Studies & Reports No 99, Notre Europe - Jacques Delors Institute*, September 2013

A SOCIAL DIMENSION FOR THE EMU: WHY AND HOW?

Sofia Fernandes and Kristina Maslauskaitė, *Policy Paper No 98, Notre Europe - Jacques Delors Institute*, September 2013

EUROZONE AND DEMOCRACY(IES) : A MISLEADING DEBATE

Yves Bertoncini, *Policy Paper No 98, Notre Europe - Jacques Delors Institute*, July 2013

RETHINKING THE EMU AND MAKING GREATER EUROPE POSITIVE AGAIN

Jacques Delors, *Tribune, Notre Europe - Jacques Delors Institute*, July 2013

EUROZONE BUDGET: 3 FUNCTIONS, 3 INSTRUMENTS

Eulalia Rubio, *Tribune, Notre Europe - Jacques Delors Institute*, November 2012

SOLIDARITY WITHIN THE EUROZONE: HOW MUCH, WHAT FOR, FOR HOW LONG?

Sofia Fernandes and Eulalia Rubio, Foreword by Jacques Delors, *Policy Paper No 51, Notre Europe - Jacques Delors Institute*, February 2012

Managing Editor: Yves Bertoncini • The document may be reproduced in part or in full on the dual condition that its meaning is not distorted and that the source is mentioned • The views expressed are those of the author(s) and do not necessarily reflect those of the publisher • *Notre Europe - Jacques Delors Institute* cannot be held responsible for the use which any third party may make of the document • Original version • © *Notre Europe - Jacques Delors Institute*

