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SERIES "NEW DECISION-MAKERS, NEW CHALLENGES"

PROMOTING STRUCTURAL REFORMS IN THE EURO AREA: WHAT FOR AND HOW?

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SUMMARY

At the moment when a new EU leadership is taking office and new policy priorities are being discussed, **talks about the need to encourage structural reforms in euro area economies are reviving with force**. There is however much confusion on why it is so important right now to promote reforms in the euro area and what would be the best mechanism to do so.

"THERE ARE THREE DIFFERENT RATIONALES TO PROMOTE REFORMS IN THE EURO AREA"

This Policy Paper distinguishes between **three different rationales to promote reforms in the euro area**:

- **improving the competitiveness of euro area as a whole,**
- **enhancing the euro area's capacity to adjust to shocks**
- **and reducing current intra-euro competitiveness gaps.**

The main argument of the Policy Paper is that each of these rationales, all relevant in today's EMU, point at different obstacles to reform and thus require a different policy response. After presenting this argument, the Policy Paper analyses in more detail **which type of policy response would be more appropriate to address each rationale**. Three main conclusions derive from this analysis.

- First, the costs of reforms are not fully recognised in the implementation of the Stability and Growth Pact, particularly for countries under the corrective arm of the Pact. To favour pro-competitive reforms in the euro area, **a more direct link should be made between efforts of reform and the extension of deadlines for deficit correction**.

- Second, non-cost competitiveness factors – and particularly, the quality of public institutions – account for an important part of the intra-euro competitiveness divide. To close this divide, there is a case to **accompany current efforts of "internal devaluation" with a EU action aimed at supporting public governance reforms in peripheral euro area countries**.

- Finally, while there is a clear case to induce euro area countries having excessive market rigidities to reform, monetary incentives do not seem the most appropriate tool to do so. A more effective incentive to reform would be **establishing minimum requirements of market flexibility and openness to competition as a pre-condition to member states' participation into a future euro area fiscal stabilisation mechanism**.

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"The ambitious implementation of structural reforms by the member states in a coordinated manner, taking the euro area dimension into account, can deliver a better result for all of them (...). High levels of adjustment capacity and competitiveness would better protect all member states against the impact of economic downturns and avoid the development of harmful macroeconomic imbalances with their associated economic and social cost".

Extract from the Commission's Communication "Towards a Deep and Genuine Economic and Monetary Union. The introduction of a Convergence and Competitiveness Instrument", COM (2013) 165 final.

INTRODUCTION

At the moment when a new EU leadership is taking office and new policy priorities are being discussed, talks about the need to encourage structural reforms in euro area economies are reviving with force. There is however a lack of consensus on how to do so. Two Italians epitomize this disagreement: Matteo Renzi, the Italian prime minister and Mario Draghi, the president of the ECB. The first, now at the head of the rotating presidency of the EU, has insisted in various occasions about the need to make full use of the flexibility of EU fiscal rules to allow countries implementing structural reforms extra time to meet deficit and debt targets[1]. The second believes there is a case to establish enforceable rules on structural reforms at the EU level similar to those applying to public deficits and debts[2].

Between these two extremes, another idea that has received much attention is providing financial support to countries undertaking reforms. This is the logic that lies behind the proposal of mutually agreed "contractual arrangements" (CA) and associated solidarity mechanisms. First mentioned in the Van Rompuy's report on "completing a genuine EMU" of December 2012, the proposal consists into the establishment of binding contracts between member states and the EU institutions by which national governments commit to adopt and implement structural reforms in exchange of financial support. The idea was discussed at the European Council of December 2013 but did not convince most national governments. Whereas some contested the rationale for providing financial support to reform laggards, others questioned the effectiveness of using financially-backed binding contracts to this end.

"THE UNDERLYING PROBLEM IS THE LACK OF CLARITY ABOUT THE RATIONALE FOR PROMOTING REFORMS"

As argued elsewhere[3], the underlying problem with "contractual arrangements" – and more generally, with discussions on how to promote reforms in the EMU – is the lack of clarity about the rationale for promoting reforms. In EU documents about "contractual arrangements", for instance, the need to promote reforms have been justified by reference to two objectives; enhancing the euro area's capacity to adjust to shocks and improving the competitiveness of euro area economies *(see quotation above)*. These two goals are interconnected

1. "We respect the rules and it is precisely because we respect them that we can say that a lot of these rules need to be changed... At the European Council meeting in October we will try to propose an initiative which goes in this direction: more incentives for those which undertake decisive reforms" (Matteo Renzi, "State of the Union Speech", European University Institute of Florence, May 2014).
2. "Structural reforms in each country are enough of a common interest to justify that they are made subject to discipline at the community level. (...) There is a strong case for us to apply the same principles to the governance of structural reforms as we do to fiscal governance" (Mario Draghi, "Memorial Lecture in Honour of Tommaso Padoa Schioppa", London, 9 July 2014).
3. Eulalia Rubio, "Which financial instrument to facilitate structural reforms in the euro area?", *Policy Paper No. 104*, Notre Europe – Jacques Delors Institute, December 2013.

(reforms leading to a more flexible economy also contribute to improve the economy's overall competitiveness) but they are not identical. In fact, they entail different implications in terms of policy responses. The first calls for an action to promote market liberalisation reforms in the most rigid euro area economies. The second can be interpreted as a general call to promote all type of competitiveness-enhancing reforms in the euro area or, more specifically, as a call to promote certain reforms with the ultimate aim of closing current intra-euro competitiveness gaps.

The point of departure of this Policy Paper is the conviction that it is very difficult to design a single EU mechanism able to address these various objectives. In other terms, each of these three rationales for promoting reforms in the euro area (enhancing the euro area's capacity to adjust to shocks, improving the competitiveness of euro area as a whole and reducing current intra-euro competitiveness gaps) all three relevant in today's EMU, require a different policy response. After presenting this argument and discussing the importance of these three different rationales in today's EMU, the Policy Paper analyses in more detail which type of policy response would be more appropriate to address each rationale. Three main conclusions derive from this analysis. First, a more explicit recognition of the trade-off between budgetary consolidation and reforms would facilitate pro-competitive reforms in euro area countries affected by both slow growth and weak public finances. In this respect, some concrete steps are proposed to honour the commitment taken by EU leaders in June 2014 to make "the best use of the flexibility that is built into the existing Stability and Growth Pact"[4]. Second, non-cost competitiveness factors – and particularly, the quality of public institutions – account for an important part of the current intra-euro competitiveness divide. To close this divide, there is a case to accompany the current process of intra-euro rebalancing with an EMU Capacity Building Mechanism aimed at inducing and supporting public governance reforms in the most crisis-hit, least-competitive euro area countries. Finally, while there is a clear case for inducing EMU countries having excessive market rigidities to reform, monetary incentives are inappropriate for this purpose. Rather than the EU giving money to national governments in exchange of reforms, a more effective and less intrusive incentive scheme would be establishing some minimum requirements of market flexibility and openness to competition as a pre-condition to member states' participation into a future euro area fiscal stabilisation mechanism.

1. Three rationales to support structural reforms in the euro area

The idea that, in a currency area, economic policies should be treated as a matter of common concern makes no doubt. The crisis has even reinforced this belief, by showing that policy choices in one country might end up having catastrophic consequences for the whole euro area. This observation has led to several reforms to improve the surveillance and co-ordination of macro-economic and structural issues. In particular, the "Six-Pack" has established a new procedure to monitor and correct macro-economic imbalances (the Macro-Economic Imbalances Procedure – MIP), which can eventually lead to sanctions for EMU member states experimenting excessive imbalances and failing to implement a corrective plan.

"CONTRACTUAL ARRANGEMENTS ARE JUSTIFIED AS A TOOL BOTH TO PROMOTE THE COMPETITIVENESS AND THE ADJUSTEMENT CAPACITY OF EMU ECONOMIES"

A question raised today is whether there is a case for complementing the current system of EU economic governance (which already includes some "last resort" sanctions to steer euro area economic policies in a certain direction, such as the sanctions under the MIP and the Stability and Growth Pact) with a positive incentive scheme to promote reforms in euro area countries. There are some general arguments for that. The current framework, only based on "sticks", reinforces the negative image some citizens have of Brussels; a positive incentive scheme might help shift this perception, by showing an EU supporting rather than admonishing national governments. Besides, structural

4. European Council Conclusions, June 2014.

reforms take long time to be implemented. Thus, it seems appropriate to induce or help countries to reform well before they face major macro-economic or budgetary imbalances.

Beyond these general arguments, however, many questions remain unanswered. Which type of reforms should be promoted and in which countries? If the idea is promoting all type of competitive-enhancing reforms in all EMU countries, what is the logic behind an EU-level action? Is it based on a purely solidarity logic (richer EMU countries helping poorer EMU countries to implement reforms) or on another logic?

Answering these questions requires a more detailed analysis of the economic rationale to promote reforms in the euro area. A look at the proposal of contractual arrangements is a good starting point in this respect. In the various EU documents developing the idea of contractual arrangements, these contracts are presented as a tool to promote both the competitiveness and the adjustment capacity of euro area economies[5]. One might argue that both goals (competitiveness and adjustment capacity) point at the same direction: the need to promote efficiency-enhancing market reforms in the EMU, which have the virtue of both improving the euro area' capacity to adjust to shocks and its overall competitiveness. However, this would equate to reducing the euro area's competitiveness problems to a matter of structural rigidities and high labour costs.

In reality, competitiveness problems in the euro area are far more complex than that. They require reforms in a broader range of fields, from fields such as competition and the regulation of labour and product markets to areas such as education, pensions and social protection systems or even sectors concerning the core activities of the state (tax collection, public administration, the judicial system). In principle the existence of these competitiveness challenges does not justify the need for an EU action in support of reforms in the euro area: after all, growth and job effects related to the implementation of structural reforms accrue everywhere, not only in euro area economies, and the problem of "short-term pain for long-term gain' affect all governments, not only those into EMU. There are however two factors that, taken together, provide a case for a EU-level action to facilitate reforms in the euro area. The first is that structural reforms have important spillover effects within the euro area, which means that lack of reform has important implications for the whole euro area. The second is that countries pertaining into the euro area have limited capacity to cushion the economic and budgetary short-term costs of reforms through expansionary fiscal or monetary policies[6]. Thus, all things equal, the adoption and implementation of reforms is more difficult within the euro area than in the rest of the EU

> "LARGE DIVERGENCES IN COMPETITIVE POSITIONS POSE A SERIOUS THREAT TO THE EURO AREA"

Finally, apart from enhancing the euro area's adjustment capacity and improve its overall competitiveness, one might think about a third rationale for promoting reforms in the euro area: reducing intra-euro area competitiveness gaps. It is widely accepted that large divergences in competitive positions pose a serious threat to the euro area: they not only increase the likelihood of asymmetric shocks but, by making some economies much more vulnerable to shocks than others, they render politically difficult the set-up of any euro area fiscal stabilisation mechanism (as the latter will end up functioning as a solidarity system, transferring resources from "strong" to "weak" economies, rather than as a pure insurance system). In case of large competitiveness gaps, hence, there is a strong EU case to support a process of structural convergence by helping the least-competitive economies improve and diversify their productive systems.

To sum up, there are at least three different economic rationales to promote structural reforms in the euro area. As will be later on discussed, each of these rationales entails different policy implications with respect to the type of reforms to be promoted, the countries targeted. More than that, as they point at different obstacles to reform they call for different types of policy action to induce reform.

5. Thus, for instance, the Conclusions of the 2013 European Council describe the scheme of "Partnerships for Growth, Jobs and Competitiveness" (encompassing contractual arrangements and its associated financial support mechanism) as a tool to "facilitate and support member states" reforms in areas which are key for growth, competitiveness and jobs and which are essential for the smooth functioning of the EMU as a whole" (p. 17). Likewise, the proposal for a "Convergence and Competitiveness Instrument" presented by the European Commission describes it as a mechanism to support reforms included in the country-specific recommendations issued under the Macro-Economic Imbalance Procedure, but in particular, "measures addressing competitiveness, promoting financial stability and improving the functioning of labor, product and services markets, and thus the adjustment capacity of the economy" (COM (2013) 165 final, p. 5).
6. Alesina, A. Ardagna. S and Galasso, V., "The Euro and Structural Reforms", *Review of Economics and Institutions*, 2(1), Article 2, 2010.

2. How relevant are these three rationales in today's EMU?

> "THE PRIORITY IN THE SHORT-TERM IS TO RECONCILE FISCAL CONSOLIDATION AND REFORMS"

How these three rationales fit in the current EMU context? One could say that the three are important, although the second is probably the most relevant one in the short-term. In effect, the current economic situation in the euro area is very fragile and there is a general agreement on that action to boost short-term aggregate demand and investment should be combined with reforms to increase the euro area's growth potential. Yet, despite much EU calls about the need for reforms, little progress is recorded at the national level. According to an analysis made by the European Parliament, less than 10% of 2013's country-specific recommendations have been fully implemented, and the ratio is lower for certain big euro area economies such as Italy or France (0 out of 6 recommendations fully implemented in both cases)[7]. There might be multiple causes explaining the difficulties to reform in euro area countries but there are hints to believe that in certain countries the combination of slow growth and budgetary consolidation seriously hampers the government's capacity to reform. If we want to push the euro area into a virtuous cycle of growth and debt reduction it will be necessary to recognize this problem and discuss ways to address it without endangering the path of debt reduction.

Another major short-term challenge is to reduce the current intra-euro competitiveness gap. It is fair to say that there has been some progress in this respect. In effect, over the last years differences in cost-competitiveness have diminished, thanks to the ambitious reforms adopted by peripheral EMU economies in their labour and product markets. These reforms have had positive results and current account improvements are the proof of that. However, one should be cautious before declaring the competitiveness gap problem resolved. As shown in section 4, at present intra-euro competitiveness gap is mostly explained by divergences in non-cost competitiveness rather than cost-competitiveness factors. Thus, efforts of internal devaluation might have limited success to reduce external imbalances on a sustainable basis unless accompanied by reforms aimed at improving the non-cost competitiveness of peripheral euro area economies. As these reforms tend to be complex and costly, and given the weak budgetary prospects for peripheral euro area economies in the coming years, a reflection on ways to help these countries implement these kinds of reforms seems very appropriate.

Finally, one of the lessons drawn from the crisis is that the euro area's capacity to adjust to demand shocks or to correct for price and wage differentials should be enhanced if we want to avoid the re-emergence of dangerous EMU imbalances in the future. The economic theory teaches us that there are basically three ways to do so, which are not necessarily incompatible: creating more favourable conditions for factor mobility (both labour and capital), setting up a currency union-wide fiscal stabilisation device and promoting national reforms leading to more flexible wages and prices. During the last five years, there have been discussions and some concrete EU initiatives to improve the two first adjustment channels. At the same time, the crisis has worked as a catalyst of market liberalisation reforms in many euro area countries (particularly those under market pressures). Yet, despite these national reforms, there remain important market rigidities in many euro area countries. It seems hence logical to envisage some EU-level action in the following years to induce or force rigid euro area economies to reform.

7. "Country-Specific Recommendations (CSRs) for 2013 and 2014: A comparison and an overview of implementation", European Parliament, DG for Internal Policies, Economic Governance Support Unit under coordination of Kajust Hagelstam.

3. Improving the competitiveness of the euro area: a more explicit recognition of the trade-off between budgetary consolidation and structural reforms

What would be the most appropriate response to the first challenge (improving the competitiveness of the whole euro area)? As pointed out above, many EMU governments have a poor record when it comes to reforming their economies. Table 1 provides some tentative evidence of that. The table ranks euro area countries according to the percentage of Country-Specific Recommendations (CSR) received in 2013 for which there has been limited or no progress one year after (according to the assessment made by the European Commission)[8]. As can be seen, only two countries have made efforts to address all the CSR received, and in six countries – Italy, Luxembourg, Slovenia, Slovakia, Belgium and Germany – the percentage of CSRs unaddressed is equal or superior to 50%.

TABLE 1 ► EMU countries' responsiveness to the 2013 Country-Specific Recommendations

	TOTAL NUMBER OF CSR	% OF CSR FOR WHICH THERE HAS BEEN LIMITED OR NO PROGRESS
Italy	6	83.3
Luxembourg	5	80.0
Slovenia	9	66.7
Slovakia	6	66.7
Belgium	7	57.1
Germany	4	50.0
Malta	5	40.0
France	6	33.3
Netherlands	4	25.0
Estonia	5	20.0
Latvia	7	14.3
Austria	7	14.3
Spain	9	0.0
Finland	5	0.0

Source: European Parliament Study, "Country-Specific Recommendations (CSRs) for 2013 and 2014: A comparison and an overview of implementation" (European Parliament, DG for Internal Policies, Economic Governance Support Unit under coordination of Kajust Hagelstam).

It should be noted that EMU countries do not score much worse than non-EMU countries. In fact, the two countries having the worst score (more than 85% non-addressed CSRs) are Romania and the Czech Republic. Yet, structural reforms have important spillover effects within the euro area, which means that lack of reform has important implications for the whole euro area.

How to induce euro area countries to reform? There might be multiple causes explaining EMU countries' lack of responsiveness to reform recommendations. In some cases (i.e. Luxembourg, Germany) there is probably a lack of sense of urgency to reform, given the strong economic and budgetary position of the country. In others (i.e. Italy, France), idiosyncrasies related with the domestic political and institutional landscape translate into strong political resistance to reform. Leaving aside these factors, however, there are hints to believe that in certain cases the combination of slow growth and budgetary consolidation hampers the government's capacity to reform. In other terms, there is a trade-off between consolidation and structural reforms that is not fully recognized in the implementation of the Stability and Growth Pact (SGP).

8. The Commission's staff documents assess the implementation of CSRs by distinguishing between five categories: "full progress", "substantial progress", "some progress", "limited progress" and "no progress". The column in the table shows the percentage of CSRs for which the Commission assessed "no progress" or "limited progress". Notice also that euro area countries under Troika adjustment programmes are excluded from the table (as they do not receive CSRs).

> "NOT ALL REFORMS HAVE SHORT-TERM COSTS, SOME CAN DELIVER SAVINGS"

Of course this trade-off does not apply to all structural reforms. Some have no significant budgetary effects (i.e. revenue-neutral tax reforms) and others can even deliver some savings (i.e. reforms aimed at increasing the efficiency of public administration). The SGP rules[9] pose no problem to implement these types of reforms, even for countries under consolidation. There are however many other reforms that might be important to boost potential growth but entail short-term budgetary costs, either direct (funding to strengthen activation measures) or indirect (compensation schemes to offset redistributive effects). Furthermore, as revealed by a recent OECD study, some reforms which in principle have positive short-term economic and budgetary effects can be temporarily detrimental if applied in "bad times", that is, in a context of very low or negative growth *(see Table 2)*.

TABLE 2 ► The short-term economic and budgetary effects of selected policy measures (based on an empirical analysis of 30 years of structural reforms in OECD countries)

	SHORT-TERM ECONOMIC EFFECTS	BUDGETARY EFFECTS
Unemployment benefits (reducing the level or duration)	Positive in good times, negative in bad times	Positive
Reform of pension system (increase in minimum retirement age and reduction implicit tax for senior workers)	Neutral /negative in bad times (short-term negative effects on senior employment)	Positive (long-term)
Reduction of labour market duality (reducing differences in contract provisions between permanent and temporary workers)	Positive in good times, negative in bad times	Neutral
Tax reforms (shift from direct to indirect taxation)	Positive	Neutral
Product market reforms	Positive	Neutral/negative (if need to compensate reform losers)
Strengthening activation policies (increase spending in training or employment incentives)	Positive	Negative

Source: Bouis R. et al., "The short-term Effects of Structural Reforms: An empirical analysis", *OECD Economics Department Working Papers*, N. 949, OECD publishing, 2012.

> "FOR COUNTRIES UNDER THE CORRECTIVE ARM, THERE IS NO EXPLICIT RECOGNITION OF THE COSTS OF REFORMS"

At present, these difficulties to reform are not fully recognized in the implementation of the Stability and Growth Pact. The upfront costs of reforms are only explicitly taken into account for countries under the preventive arm, and only for the implementation of major structural reforms having "direct long-term positive budgetary effects" *(see Box 1)*. For countries under the corrective arm, there is no explicit recognition of the costs of reforms. The EU legislation only says that "some relevant factors" (including the implementation of policies in the context of the Macro-Economic Imbalance Procedure) can be taken into account when deciding whether or not to extend the deadline for the correction of the excessive deficit. The importance given to these relevant factors, however, rests entirely at the discretion of the Commission. Furthermore, the extension of the deadline is nevertheless conditioned upon the fact of having taken "effective action" to correct the excessive deficit as well as to the existence of "unexpected adverse economic events with major unfavorable consequences for government finances".

9. For a detailed analysis of how the SGP works, see Sofia Fernandes, "National budgets and European surveillance: Shedding light on the debate", *Policy Paper No. 118*, Notre Europe – Jacques Delors Institute, October 2014.

BOX 1 ► **Flexibility clauses within the Stability and Growth Pact concerning the implementation of structural reforms**

Countries under the preventive arm:
Structural reforms can allow for a temporary deviation from the adjustment path to the medium-term budgetary objective (or a temporary deviation from this objective for countries having already reached it).
Only major structural reforms having "direct long.-term positive budgetary effects, including by raising potential growth, and therefore a verifiable positive impact on the long-term sustainability of public finances" are taken into account. Only adopted reforms are considered (art. 5.1. Council Regulation 1466/97).

Decision to place a country under excessive deficit procedure:
When deciding whether to place a country under EDP, the Commission and the Council should take into account a list of "relevant factors", which includes among other things "the implementation of policies in the context of prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union, and the overall quality of public finances".
However, for countries having more than 3% nominal deficit and a debt higher than 60% GDP, consideration of these relevant factors only applies if the deficit remains close to 3% and its excess over the reference value is temporary (art. 2.3 and 2.4 of Council Regulation 1467/97).

Countries under corrective arm:
The relevant factors cited above are also taken into account when deciding whether or not to extend the deadline for the correction of an excessive deficit to a country under the corrective arm. This however is conditioned upon the fact that the member state had taken "effective action" to reduce the deficit and that unexpected adverse economic events with major unfavourable consequences for government finances had occurred (art. 3.5. Council Regulation 1467/97).

One might argue that the lack of recognition of the costs of reform in the corrective arm is not so worrying, as far as the Council makes full use of the "exceptional circumstances" flexibility clause. In effect, if the Council allowed extra time to correct the deficit to all EMU countries on the grounds that the euro area is experiencing a period of "protracted slow growth" – as has been recommended by some experts[10] –, then EMU countries under the corrective arm would have more budgetary leeway to undertake reforms. However, even in this scenario, the extension of the deadlines might not suffice to induce reform: the most logical outcome is that governments use the extra leeway to slow down the austerity plans After all, this is what has happened so far: countries such as France have been given various extensions to the deficit correction deadline on the grounds of "exceptional circumstances" but the latter has not translated into more reforms.

"A MORE DIRECT LINK BETWEEN THE ADOPTION OF REFORMS AND THE EXTENSION OF THE DEADLINE IS REQUIRED"

To favour reform in countries under the corrective arm, a more direct link between the adoption of reforms and the extension of the deadline is required. Countries willing to adopt reforms should know that, if these reforms are well designed and economically pertinent and their costs properly quantified, the latter will be taken into account at the moment of judging their efforts of consolidation. This would not require a reform of the Stability and Growth Pact but slight changes in the way of implementing it at both the national and EU level. At the national level, it would be necessary to better quantify the costs of structural reforms in their Stability Programmes and Draft Budgetary Plans. The recently-created National Fiscal Councils can play a role here, by helping governments estimate the budgetary impact of planned reforms. At the EU level, the Commission would have to declare its commitment to take into account these costs (providing the reforms are well-designed, economically pertinent and properly quantified) when assessing whether a country has taken "effective action" to correct the deficit. Today this is not the case: progress in the reduction of the deficits is basically assessed by looking at the forecasts underpinning national budgetary plans and the fiscal measures adopted or proposed to reduce the deficit.

Admittedly, taking the costs of reform into account when defining the path of deficit reduction entails some risks. In effect, countries having been allowed more time to correct the deficit on the grounds of planned

10. Marzinotto. B., Sapir, A., "Fiscal Rules: timing is everything", Bruegel, *Policy Brief 2012/03*; Leipod, A., "Interpreting the Stability and Growth Pact. Making best use of existing flexibility within the rules", The Lisbon Council, *Special Briefing Issue* 18/2014, 2012.

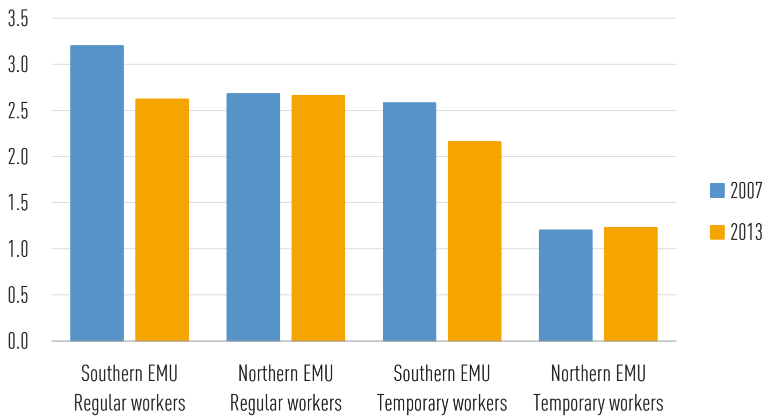
reforms might always come back to their decision, for instance in case of change of government. In this case, the Commission would find herself with no leverage to force the country to reform, after having been allowed more time for consolidate the budget. An option to avoid this to happen could be making reversible the decision of the extension of deadlines – that is, giving to the Council the possibility to remove the extension in case the government does not undertake the promised reforms. This however would require a change in the regulations of the Stability and Growth Pact.

4. Closing the intra-euro competitiveness gap: a case to support public governance reforms in the weakest euro area economies

> "REGULAR WORKERS IN SOUTHERN EMU ARE NOW LESS PROTECTED THAN THEIR COUNTERPARTS IN NORTHERN EMU"

Whereas improving the competitiveness of the whole the euro area is essential, it is also very important to reduce large intra-euro competitiveness gap as the latter might threaten the stability of the euro area in the long run. During the last years, the emphasis has been put on reducing cost-competitiveness divergences, seen as one of the roots of the euro area debt crisis. In this respect it should be noted that much has been done thanks to the ambitious reforms undertaken by peripheral EMU countries, particularly in their labour markets. As a result of these reforms, the level of employment protection has significantly decreased in Southern EMU economies, to the point that regular workers in Southern EMU are now less protected than their counterparts in Northern EMU *(see Graph 1).*

GRAPH 1 ► Strictness of employment protection, Southern and Northern EMU countries (OECD Index 0-6)



Source: OECD employment database. Northern EMU economies: Austria, Finland, Germany and The Netherlands; Southern EMU economies: Greece, Spain, Italy and Portugal. Unweighted average for each group.

Yet, a narrow focus on cost-competitiveness is unwarranted. As pointed out by various studies, wage/price rigidities in peripheral countries do not explain alone the build-up of current account imbalances within the euro area[11]; the latter were the result of multiple factors, including the asymmetric effects of major global trade shocks on euro area economies due to their different trade specialisations[12]. Furthermore, contrary to

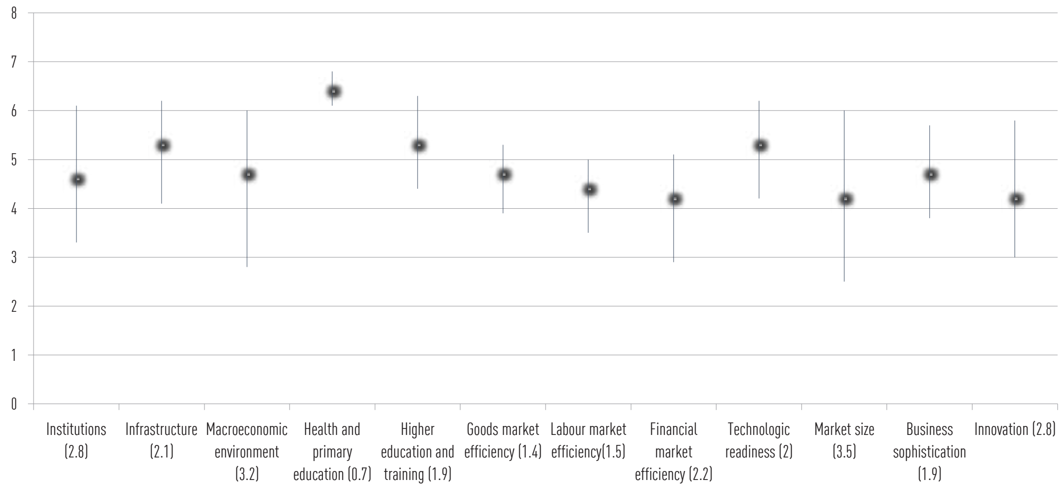
11. Estrada, A. et Galí, J., "Patterns of convergence and divergence in the Euro Area", Paper presented at the 13th Jacques Polak Annual Research Conference, November 8-9 2012; Chen, R. et al., "External Imbalances in the Euro Area", *IMF Working Paper 12/236;* Working group on Econometric Modelling of the European System of Central Banks, "Competitiveness and external imbalances within the euro area", *European Central Bank Occasional Papers*, N. 139, December 2012.
12. In particular, the rise of China during the 1990s generated strong demand for machinery and equipment tools exported by Germany while exports from Southern European countries were displaced from their foreign markets by Chinese exports. Likewise, Germany took advantage of the accession of Central and Eastern European countries by integrating these countries into its chain of production, whereas Southern European countries were negatively affected with major increases of imports from these countries (Chen et al., 2012).

common wisdom, the current intra-euro area competitive divide is mostly explained by differences in non-cost competitiveness rather than by cost-competitiveness factors.

> "THE CURRENT INTRA-EURO AREA COMPETITIVE DIVIDE IS MOSTLY EXPLAINED BY DIFFERENCES IN NON-COST COMPETITIVENESS FACTORS"

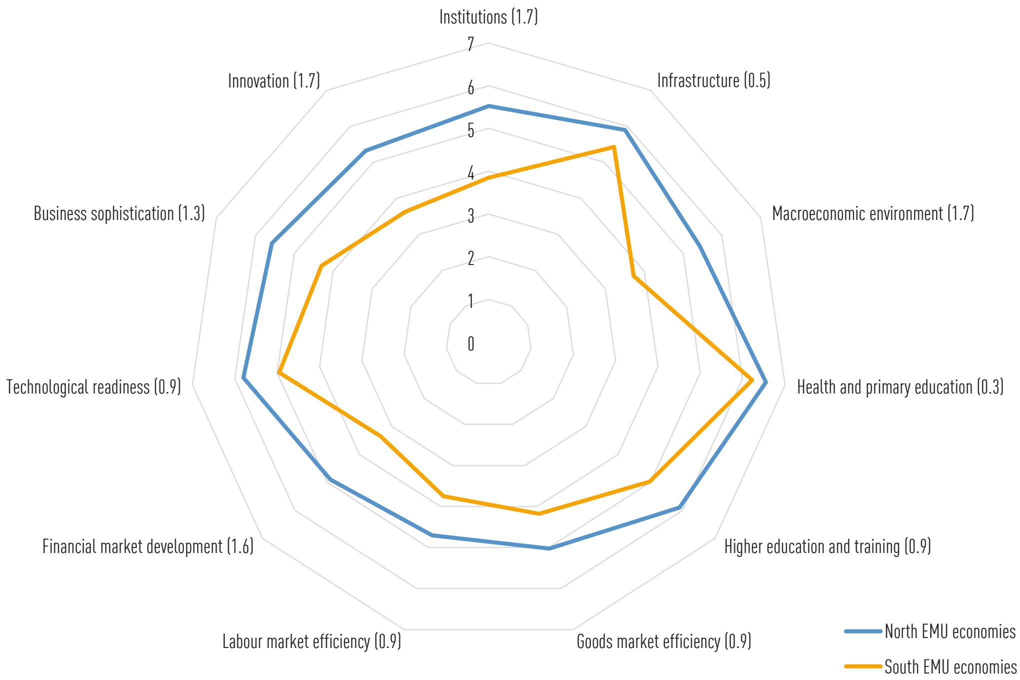
Graph 2 provides evidence of that. It shows the degree of intra-euro divergence in the 12 "pillars" that compose the Global Competitiveness Index (GCI). As can be seen, if we exclude two factors which are exogenous to national governments' actions ("market size" and "macroeconomic environment"), the two factors showing larger intra-euro divergences are "quality of public institutions" and "innovation". Curiously, after "health and primary education", the two factors showing less degree of intra-euro area divergences are "goods market efficiency" and "labour market efficiency". If one looks more precisely at the North/South competitiveness gap, the picture does not change substantially: the only relevant change is a major narrowing of the "infrastructure" gap *(see Graph 3).*

GRAPH 2 ► Intra-euro differences in competitiveness factors (12 pillars composing the Global Competitiveness Index)



Source: Global Competitiveness Index 2013-14.

GRAPH 3 ► The North/South euro area competitiveness divide.



Source: Global Competitiveness Index 2013-14. Northern EMU economies: Austria, Finland, Germany and The Netherlands; Southern EMU economies: Greece, Spain, Italy and Portugal.

How to reduce these large divergences in non-cost competitiveness factors? Some might argue that little can be done at the EU level. Improving the quality of public institutions of a country or the capacity of an economy to innovate is an enormous and complex task and there is no clear recipe on how to do so. Besides, least competitive euro area economies already receive important amounts of EU funding through the Structural Funds (SFs) to invest in areas such as education and training or research. Indeed, as shown in table 3, Southern EMU countries (Portugal, Italy, Greece and Spain) were recipients of more than half of the total amount of European Social Fund (ESF) funding allocated to education and training in the euro area during the period 2007-13. In some countries, such as Portugal, the amount allocated was quite impressive, roughly equivalent to 40% of the annual national budget on education[13]. The impact of SFs is even stronger in the field of research. According to a Study commissioned by the DG Research, during the period 2000-2006 SFs spending on research, technological development and innovation (RTDI) was equivalent to 33% of the total public expenditure on RTDI in Greece during the same period. The percentage was minor but still substantial for Portugal (19%) and Spain (11%). Given that the percentage of SFs allocated to research has increased since then, there are reasons to believe that SFs still play a major role in funding these countries' research systems.

13. According to Eurostat in 2011 public expenditure on education in Portugal amounted to 10,8 billion €.

TABLE 3 ► Total amount of ESF funding invested on education and training* in the euro area (2007-13), in million €

COUNTRY	ESF FUNDING INVESTED ON EDUCATION AND TRAINING
Portugal	4,310.9
Germany	2,046.4
Italy	1,799.3
Greece	1,336.1
Spain	850.1
France	639.7
Slovakia	471.9
Ireland	212.6
Slovenia	164.7
Latvia	128.5
Netherlands	116.2
Finland	111.8
Estonia	83.5
Belgium	64.4
Cyprus	61.0
Austria	59.5
Malta	31.5
Luxembourg	8.9
TOTAL	13,143.6
PT+IT+SP+GR	8,296.4

Source: ESF webpage
* Funding allocated to priorities "reforming education and training" and "promoting education and training throughout working life".

> "DESPITE THE IMPORTANT AMOUNTS INVOLVED, THE CAPACITY OF STRUCTURAL FUNDS TO INDUCE REFORM IS LIMITED"

Notwithstanding the important amounts involved, the capacity of SFs to induce reform is limited. Despite much rhetoric on "modernising" policies and maximising investments, the fact is that SFs are not geared to promote reforms. As the funds are pre-allocated "ex ante", the leverage power of the EU institutions vis-à-vis national authorities is very limited and this has not substantially changed with the new programming requirements and conditionalities introduced for the 2014-2020 period[14]. The result is that some countries are relatively efficient in using cohesion funding to finance innovative programmes and catalyse systemic reforms whereas others spend the EU money on "ad hoc" actions of questionable added value.

A crucial variable explaining the capacity of countries to make the best of cohesion funding is good governance and efficient public administrations. The 6th Cohesion Report[15] points at the existence of a clear correlation between the rates of absorption of cohesion policy funding and government effectiveness. In its analysis of the sources and implications of the rise of EMU imbalances leading to the crisis, G. Bertola also finds out a strong correlation between changes in the quality of public institutions and total factor productivity growth in

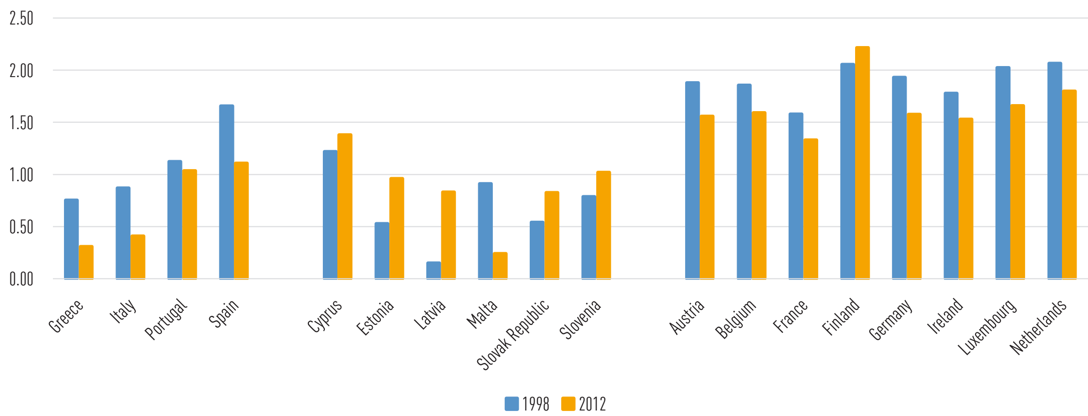
14. The new policy framework for the 2014-2020 establishes the duty for member states to prepare a "Parthership Agreement" setting out its investment priorities and how they contribute to respond to the CSrs received under the European Semester. In addition to that, two types of conditionalities have been introduced, "ex ante" conditionalities (which link the disbursement of the funds to the existence of certain institutional, regulatory and administrative conditions deemed necessary to ensure the effectiveness of EU investments) and "macro-economic conditionality" (linking the use of EU funds to action taken at national level to maintain sound fiscal policies and carry out key structural reforms). Both conditionalities however are rather weak as a non-respect can only trigger a temporary suspension of SFs payments.
15. European Commission, DG Regio, "Investment for jobs and growth: Promoting development and good governance in EU regions and cities", Sixth report on economic, social and territorial cohesion, July 2014 .

2000-07 across euro area countries[16]. Improving the quality of public institutions in the least competitive EMU economies appears hence as a key factor both to reduce current intra-euro competitiveness gaps and ensure an efficient use of EU spending in the years ahead.

"GOVERNMENT EFFECTIVENESS HAS DECREASED OVER THE LAST DECADE IN THE FOUR SOUTHERN EURO AREA COUNTRIES"

It should be noted that there is already some SFs money to strengthen institutional capacity building and promoting administrative reform in the weakest economies. However, the amounts involved are quite small: only 2.9 billion € were allocated to this purpose in 2007-13 and 4.3 billion € have been earmarked to that for 2014-2020, an amount which represents less than 1% of total SFs funding. Besides, a look at the World Bank Governance data seems to indicate that this money has been insufficient to promote major changes in public governance, particularly in Southern Europe. In fact, as shown in Graph 5, government effectiveness has decreased over the last decade in the four Southern euro area countries (Greece, Italy, Portugal and Spain), contrary to what has happened to most of their Eastern and Central European counterparts.

GRAPH 4 ► Government effectiveness in euro area countries, 1998 and 2012



Source: World Bank Governance dataset. Indicator ranking from -2.5 to 2.5.

There is hence a need to a more effective EU tool to induce and support public governance reforms in the least competitive euro area countries. An option could be to create a sort of "EMU Capacity Building Mechanism" aimed at providing support – in form of funding and technical assistance – to euro area countries willing to undertake major reforms in public governance or public administration. This could include sectoral reforms (i.e. reform of the judicial system) or horizontal measures aimed at improving the efficiency and accountability of the public sector (reforms of the tax collection or public procurement systems, measures to increase the fight against corruption or reduce fiscal fraud, measures to improve the efficiency of public administration).

One can imagine different modalities to set up this instrument. One option could be creating a something "ex novo", a sort of intergovernmental Fund outside the Multi-Annual Financial Framework financed through dedicated contributions from EMU member states (i.e. on the basis of a GNI key). This option would have some advantages; mainly the fact that it would allow resources to be allocated on competitive basis, hence giving to the EU a greater leverage on the use of funds. Yet, it is very unrealistic to imagine euro area countries accepting to make a further solidarity step to support reform in other euro area countries.

A more realistic option is building up something from the existing SFs allocations for public governance reforms. The inspiring model in this case could be the "Task Force for Greece" set up by the Commission *(see Box 2)*. This Task Force was created in 2011 with the purpose of helping Greek authorities in the design and

16. Bertola, G., "Policy Coordination, Convergence and the Rise and Crisis of EMU Imbalances", European Commission DG ECFIN, Economic Papers 490, April 2013.

implementation of reforms committed under the Troika Programme as well as to increase the absorption rates and effectiveness of EU funds in Greece. Composed of 60 EU officials, an interesting particularity of this Task Force is that it is mostly financed out of the cohesion policy funding allocated to Greece *(see Box 1)*. In effect, the European Commission pays the wages of the staff composing the Task Force but any extra costs are paid out of EU funds foreseen for Greece (in particular, using the SFs budget for "technical assistance" and unallocated resources from cohesion spending earmarked to other objectives). Another particularity is that the Task Force is supported by other member states, not through monetary transfers but with the detachment of national experts that work temporarily for the Task Force. In this respect, the Task Force involves a subtle exercise of solidarity which is much easier to be accepted and understood by the public opinion of richer countries.

BOX 2 ► The Task Force for Greece

The Task Force for Greece was created in 2011 at the demand of the then Greek Prime Minister, with the purpose of helping the Greek government design and implement the reforms committed in its adjustment program and increase the absorption rates and effectiveness of EU funds in Greece.

It consists of around 60 EU staff based jointly in Brussels (30 staff) and Athens (30 staff) and currently coordinates technical assistance across 13 broad policy domains.

The Task Force works as follows: through exchanges with the Greek authorities, it identifies the relevant needs in terms of transfer of expertise or, in a later stage, in terms of the funding of particular services or projects. Once these needs are identified, the Task Force mobilises and coordinates the experts available. Experts come from the Commission, from other International Organisations (IMF, World Bank) or from other member states. The national experts, who usually stay in Greece for as little as a few days, are paid by their home countries (the Commission covers only their mission expenses). The costs of the other experts and any other project costs are paid for out of EU funds foreseen for Greece (in particular, using the SFs budget for "technical assistance" and unallocated resources earmarked to other objectives)

The Task Force has made important contributions in supporting reforms in the areas of tax administration and public finance management and in helping Greek authorities re-allocate cohesion policy expenditure on projects having high potential economic impact. Another important success has been the increase of the absorption rate of EU funds in Greece. Indeed, Greece has now reached 5th place out of all member states in its absorption of EU Structural and Cohesion Funds, compared to 18th place at the end of 2011.The latest figures show the country has now made use of 81.3% of the funding available in 2007-2013, which is well above the EU average of 69.17%.

> "THE TASK FORCE FOR GREECE MIGHT SERVE AS INSPIRATION FOR A MECHANISM TO SUPPORT PUBLIC GOVERNANCE REFORMS IN OTHER EMU COUNTRIES"

Of course, replicating the "Task Force for Greece" to other countries seems difficult. Greece asked for that under exceptional circumstances, when the need for external help was evident, but it is difficult to imagine other national governments accepting such a degree of European interference in normal times. Besides, accepting the need for external assistance to design and implement national reforms can be perceived as stigmatising. To build up Task Forces acceptable for other euro area countries, some changes are warranted. First, the possibility to create National Task Forces to support public governance reforms should be open to any euro area country and not only to the least competitive countries. Second, Task Forces should not necessarily be as comprehensive as the Greek one; they could consist into sectorial Task Forces aimed at assisting the government for the design and implementation of specific reforms. Finally, the decision to create a national Task Force should provide more tangible "rewards" for the country accepting it. So far, the only reward is a vague promise of increasing the performance of public governance. A more tangible reward could be the provision of some extra EU funding earmarked to public governance reforms to any government accepting to create a Task Force.

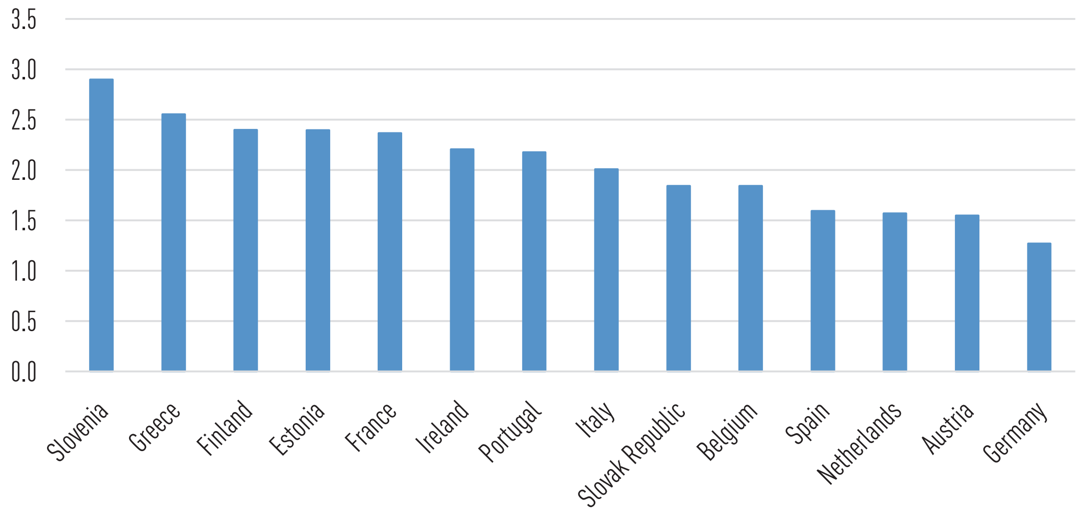
5. Removing market rigidities: the need for an appropriate incentive to reform

Finally, there is also a strong rationale for promoting market-liberalisation reforms in order to enhance the euro area's capacity to adjust to shocks. It should be noted that the EU interest in this case is to induce or force those countries having excessive market rigidities to reform, not to promote market-liberalisation reforms in all euro area economies.[17]

"MARKET RIGIDITIES ARE PRESENT IN COUNTRIES AS DIFFERENT AS GREECE AND GERMANY"

This might in practice concern a large number of euro area countries, as different euro area countries are affected by different types of market rigidities. Graphs 6 and 7, which rank OECD euro area countries according to the restrictiveness of their regulations on network industries and on professional services, illustrate this point. Whereas Greece, for instance, maintain a highly restrictive regulation on network industries, it is one of the countries having more flexible and open markets of professional services. The opposite is true for Germany: flexible and open markets on network industries coexist with one of the strictest regulations of professional services in the euro area.

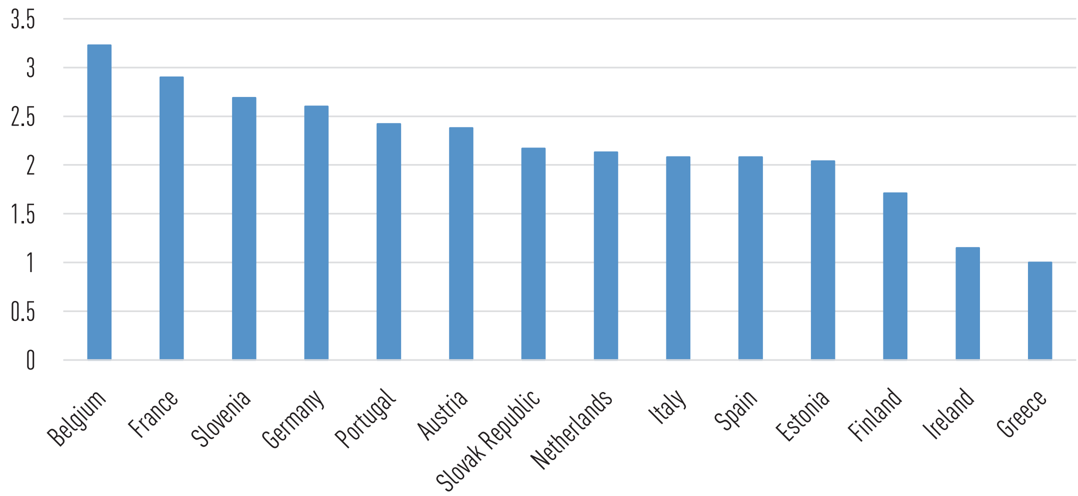
Graph 5 ► Regulation in Energy, Transport and Communications (ETCR), OECD index (0-6), 2013



Source: OECD.

17. Some economists would argue that more flexible markets are always positive for the functioning of the euro area but this should be qualified. On the one hand, the benefits of more market flexibility depend on the existence and effectiveness of other channels of adjustment in the EMU (i.e. labour and capital mobility, fiscal transfers). If these other channels function properly, more flexible markets might not be necessary to secure a well-functioning EMU. On the other hand, market flexibility is not politically-neutral; different levels of regulation reflect differences in citizens' preferences. In the logic of the subsidiarity principle, hence, the EU should limit its action to promote the degree of flexibility needed to endow EMU countries with an appropriate capacity to adjust to shocks (no less, but not more).

GRAPH 6 ► **Regulation of professional services, OECD index (0-6), 2013**



Source: OECD.

How to induce this heterogeneous group of euro area countries to liberalise their markets? An option would be imposing sanctions to non-reforming countries[18], but there are clear legal limits to do so at the EU level as well as serious doubts about its efficacy. If sanctions are not available, the alternative is incentives. One can assume that countries do not reform because they are confronted to the typical problem of "short-term pain for long-term gain"; that is, the fact that reforms entail important short-term costs (both economic and political) and only bear benefits in the long term. If this is the case, a way to induce reforms is by providing to governments an extra incentive, so that the benefits of reforming overpass the short-term political and economic costs of the reform.

5.1. The problems with monetary incentives

Would monetary incentives be the answer? This is in fact the logic behind "contractual arrangements"; that is, providing some financial support to countries in exchange of their commitment to reform. At first sight the idea seems appealing, but in fact the use of monetary incentives is confronted to various problems.

> "THE MAIN PROBLEM WITH MONETERY INCENTIVES IS THE DIFFICULTY TO DETERMINE THE EXACT AMOUNT REQUIRED"

The main problem is the difficulty to determine the exact amount required. To be effective the monetary incentive provided should be related to the costs of reform. However, it is very difficult for the EU authorities – if not impossible – to calculate the short-term economic costs of a reform, and even more to judge the amount needed to compensate the reform losers. In addition to that, the political costs of reforms are not entirely exogenous to the government's decisions and attitudes. Governments might be more or less skillful in persuading the public opinion and vested interests about the need for reform, and in designing appropriate strategies to compensate the losers. To sum up, there is a problem of imperfect information which creates serious risks of moral hazard. The "principal" (EU) should rely on the "agent" (national government) to fix the amount required to compensate for the costs of reform. In these conditions, the agent has a clear incentive to magnify the economic costs the reform and no incentive to minimise its political costs.

18. Sanctions that would work on a more preventive basis than those foreseen in the context of the Macro Economic Imbalance Procedure (which only apply to countries affected by excessive imbalances and placed under the corrective arm of the MIP).

Apart from the difficulties of fixing the amount required, another problem with monetary incentives is the negative effects they might have in terms of political legitimacy and ownership at the national level. A system in which money is provided in exchange of reforms requires the establishment of strict conditionality and close monitoring. As the experience with the Troika programmes shows, there is a clear risk that too much conditionality backfire, by creating more domestic political resistance to a reform perceived as an imposition from "Brussels".

Finally, as we have seen before, the countries in need of liberalising markets are very heterogeneous and some of them, such as Germany, have a strong budgetary position. One might seriously doubt that a system of monetary incentives would be effective to convince countries in good fiscal shape to reform.

5.2. An alternative: reforms as a pre-condition to participate into a future euro-area common shock absorber facility

There is hence a need to find a more effective, less intrusive, non-monetary incentive to push for reform. An idea that merits reflection would be linking such reforms to member states' participation into a future euro area cyclical shock mechanism (be in form of a common unemployment scheme or intergovernmental transfer mechanism). In effect, participation in this mechanism (allowing the country to receive financial support in case of future shocks) could work as a powerful incentive to reform. At the same time, there is a clear logic in requiring the adoption of these reforms as a pre-requisite to join the mechanism, as countries with rigid wages and prices would require more time to adjust to a shock, hence being in a position to "free-ride" from a common shock absorber capacity.

More precisely, one could imagine the establishment of some minimum requirements of market flexibility and openness to competition as a pre-condition to participate into the common shock absorber facility[19]. Such requirements or minimum standards should be defined in broad terms and measure policy outputs rather than specific policy reforms (i.e. by using OECD regulatory indicators or similar tools). A system of this sort would have three advantages vis-à-vis the use of monetary incentives.

- First, the incentive to reform would be fixed and the same for all.
- Second, by being based on broad outputs rather than monitoring of specific reforms, it would reduce the problem of political legitimacy.
- And finally, the need for reform would be easier to communicate for citizens, given the existence of a clear logic between the efforts required (more market flexibility to increase the country's capacity to adjust to shocks) and the reward obtained (a promise of being helped to smooth the impact of the adjustment).

19. In a way, that would be similar to the "common rulebook for stabilisation" proposed by Enderlein et al. in their proposal of a Cyclical Shock Insurance (Enderlein et al., "Blueprint for a Cyclical Shock Insurance in the euro area", *Studies & Reports No. 100*, Notre Europe – Jacques Delors Institute, September 2013).

CONCLUSION

Euro area countries need to undertake structural reforms to boost their long-term growth prospect and improve their capacity to adjust to shocks, but not all EMU countries are in equal need of reform neither they are confronted to the same difficulties to reform. As argued in this Policy Paper, there are different policy problems concerning the adoption of reforms in EMU, and each one calls for a different policy response.

The most pressing problem today is the existence of a trade-off between reforms and budgetary consolidation that is not fully recognized in the application of the Stability and Growth Pact. This is particularly the case for countries under the corrective arm, for which the upfront costs of reforms are not taken into account when assessing “effective action” towards the reduction of deficits. If we want to push the euro area into a virtuous cycle of growth and debt reduction we need to recognize this problem and adopt the necessary measures to allow EMU countries under budgetary consolidation to reform without weakening their commitment to deficit reduction. This Policy Paper makes some proposals in this respect, which can be seen as a contribution to current discussions on how to apply the flexibility clauses inserted into the Stability and Growth Pact

Another problem having important medium-term implications is related to the large competitiveness divide that exists today in the euro area. Contrary to common wisdom, this gap is mostly explained by differences in non-cost competitiveness rather than cost-competitiveness factors, which means that current efforts of “internal devaluation” in peripheral countries will not suffice to close the gap unless accompanied by reforms aimed at improving the non-cost competitiveness of peripheral euro area economies. In this context, setting up an EU action to support public governance reforms in peripheral countries seems very pertinent, and this Policy Paper makes some proposals on what type of EU action could be envisaged for this purpose.

Finally, one of the lessons drawn from the crisis is that the euro area’s capacity to adjust to shocks should be enhanced if we want to avoid the re-emergence of dangerous EMU imbalances in the future. There is hence a clear case for promoting market-liberalisation reforms in rigid EMU economies. As argued in this Policy Paper, the most effective way to do so would be establishing minimum requirements of market flexibility and openness to competition as a pre-condition to member states’ participation into a future euro area fiscal stabilisation mechanism.

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