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Unfinished business: the governance of the Economic and Monetary Union

Fabian Zuleeg

Compendium of EPC publications on the future of the Euro

"Hesitating and waiting creates a cost in terms of growth and jobs. We should avoid this. The proposed implementation calendar of the 5-presidents report – as a follow-up to my 4-presidents report – shows no urgency and is, I fear, not being taken seriously enough. We have to take urgent steps towards a Capital Markets Union, a commitment to structural reforms by all member states and later on, a real fiscal capacity. On top of more responsibility and more solidarity, we will also need more shared sovereignty."

Herman Van Rompuy,
President European Policy Centre,
Inauguration Address, 10 September 2015

EUROPEAN POLICY CENTRE

EMU - crisis as a stepping stone to further integration or as a trigger for further fragmentation?

Europe is once again engulfed in crisis. The sheer scale of refugees coming daily is not only a major challenge for the transit and destination countries, it is also exposing distrust between member states (and *vis-à-vis* the EU institutions). It has also shown that there is an unwillingness to cooperate and compromise within the EU system, in part a collateral damage of the eurocrisis. With a continuing sluggish economy and high unemployment, external challenges such as the conflict in Ukraine and internal ones like the referendum on EU membership in the UK, the EMU crisis looks less urgent at this point, with an agreement with Greece preventing the disastrous consequences of a Grexit, at least for now.

The crisis is not over

Time and time again, this has been the pattern of this crisis. Driven by domestic political considerations, actions would only be taken when 'there is no alternative', i.e. in the midst of acute crisis. In times of a relative lull, the drive towards improved governance always lost urgency. This lack of urgency could clearly be seen in the publication of the Five Presidents Report: despite suggesting an unambitious implementation timetable, the reception by Eurozone members has been lukewarm at best.

Without further governance reform, the crisis will re-enter a hot phase in the near future, most likely in an even more unmanageable form, potentially mixed up with the other crises Europe is facing. This summer's Greek crisis highlighted sharply the tricky political economy of the Eurozone: economic interdependence and imbalances requiring simultaneously a need for reform and support, driven at EU level, while the political consequences of actions are still domestic. Questions around sovereignty and democratic legitimacy were posed but ultimately not answered, in part because in the current governance framework they are unanswerable. After all, both the Greek Government and the creditors could refer to the democratic legitimisation of their actions coming from the domestic level.

Unless one believes that EMU can be unravelled without significant damage to the economic and political substance of the EU, the ultimate answer would be a genuine Economic and Monetary Union, underpinned by EU-level democratic legitimacy. But this is far-off for now. The mood is for less Europe, not more Europe and a European *demos* is not apparent. Realistically, while not the ideal answer, 'ambitious muddling through' is the way forward for now. Making small steps now can rebuild trust and become the seed for further governance reform in future, as well as putting the mechanisms in place that will be needed when the next crisis hits.

The case of Greece

Clearly, further attention will need to be given to Greece. It is a special case, with the crisis deeper and more intractable than in other Eurozone countries, intermixed with a challenging domestic political environment that makes implementation of any reform plans doubtful. But this time, Greece will have to deliver. Whatever party comes out in front, the new government must implement reforms. The 3rd package of support will be the last – domestic politics in the creditor countries will not allow for further such deals. Greece must take this opportunity, otherwise the Eurozone will accept Grexit as the lesser evil.

But the rest of the Eurozone can, and should, help Greece to deliver. Structural reforms, especially those that are growth-enhancing, can often have negative fiscal consequences in the short term. Change is costly and the EU should provide more funding – flexibly and unbureaucratically - to facilitate such reforms.

Whatever reforms are implemented, without growth, debt and deficits will become more and more unmanageable. While some elements have been implemented, there needs to be further action[1]; the need for a comprehensive 'New Deal' remains as strong as it was 4½ years ago. See EPC Commentary A New Deal to help save the euro

Beyond Greece: a new governance?

The need for EMU governance reform is broader than the case of Greece. The (quicker) implementation of the Four Presidents Report and the Five Presidents Report needs to be at the top of the agenda. EMU must improve both its mechanisms to prevent future crises and the capacity to deal with a crisis when it emerges. See EPC Policy Brief Pathways to achieve a genuine Fiscal Union

The construction of a fiscal capacity should be made a priority to resolve the absence of a mechanism to provide effective *ex ante* fiscal risk sharing in the Eurozone. The EU should also develop a new framework to assess the real returns of growth of public and social investment, which could open the path for more flexibility on deficits in future. There is also a need to critically assess how the new governance mechanisms are working, including reviewing the Country-specific Recommendations with a stronger focus on a smaller number of key priorities for each country. See EPC Discussion Paper Policy recommendations for the new European Commission: priorities for stabilising EMU

The political economy of EMU

At the heart of the impasse on the further development of EMU lies a political economy problem: while creditors might be willing to provide further support, they fear that reforms are not implemented, resulting in a need for ongoing transfers. As a consequence, these countries insist on mechanisms to monitor and enforce reforms. For those needing support, the price of giving up sovereignty is often only considered *in extremis* and the temptation to backslide on reforms is ever present, mixed up with the often limited institutional capacity to deliver. It is time to look again at possible solutions to this impasse. A fiscal capacity, combined with contractual arrangements, could be a way of rewarding progress. This could even be tied to debt relief, with a write-off of debt linked to delivery of investment and reform.

There is also a need to depoliticise the more technical aspects of economic governance. Increasingly, the Commission is seen as a political actor, which clashes with its role to provide independent assessment and enforcement of policies, including in the fiscal policy field. There is a need to re-think what role the Commission will take in future governance and whether some new institutional arrangements are needed to ensure that member states find it easier to accept EU-level recommendations and decisions. See EPC Discussion Paper Can the Eurozone's economic governance combine political accountability, legitimacy and effectiveness?

What ultimate destination?

Making these changes to EMU governance will not solve all the underlying flaws but it will provide for a more robust architecture, which will be better able to weather the next storm when it comes. Rather than blaming each other for the lack of progress, at EU level there is a need to work out possible deals that are acceptable for all member states. Pragmatic but ambitious muddling through is not the ultimate answer but, for now, it is better than the alternatives.

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1 Such as the Juncker Investment Plan: see EPC Discussion Paper Growth for Europe – Is the Juncker Plan the answer?

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Commentary

A New Deal to help save the euro

Fabian Zuleeg and Janis A. Emmanouilidis

The rescue package for Portugal and the recent electoral success of the populist True Finns party shows that the euro crisis is not over. Even if the current support mechanisms stabilise the markets, they will not be sufficient in the long term: growing economic divergence between the eurozone's strongest and weakest members will increase the strains on political, economic and monetary management of the single currency.

Countries such as Greece and Portugal have low growth forecasts and, lacking sectors with high economic potential, their current structural reforms and wage moderation will not close the competitiveness gap. In the long run, these countries will be unable to cope with a rapidly rising debt burden, especially with limited access to financial markets, high spreads and a rising interest rate. Without light at the end of a long and dark tunnel, maintaining the reform momentum will become increasingly difficult politically.

Ultimately, growth is prerequisite for a sustainable reduction of debt on Europe's periphery. Conversely, the absence of growth would most likely necessitate support for weaker member states unable to service their debt. Even a reduction in the cost of financing (for example, through eurobonds) or an orderly restructuring of debt will not suffice if the issue of long-term divergence is not addressed effectively. Without growth in the periphery, chances are high that it will be possible to maintain the Economic and Monetary Union only with ongoing support, getting us close to the 'transfer union' feared by many.

What can be done to overcome this Catch-22?

What is needed is a 'New Deal' for the euro, based on investment rather than transfers. Among its principal measures would be:

First, continuous reforms in the weaker countries to enable productive investment, such as a simplification of administrative procedures and labour-market reform.

Second, a separate treatment of productive investment (such as education) in the excessive debt procedure, austerity programmes and fiscal consolidation plans.

Third, a re-allocation of the EU budget (especially cohesion funding), including a change in eligibility criteria, with less focus on gross domestic product and more on combating the crisis and reducing imbalances, as well as a new focus on governance and on spending on core drivers of growth, such as education.

Fourth, the establishment of a dedicated investment fund - a new Stability and Growth Fund (SGF) aiming specifically to deliver the goals of Europe's growth strategy, Europe 2020, in countries unable to make the necessary investments themselves. Funds from the SGF would not be a bail-out but a loan-based investment - not a transfer union but an 'investment union'.

Finally, increased use of new loan/private-public partnership instruments, including project bonds, to increase leverage. This would require some funding from the SGF, the European Investment Bank or the European Bank for Reconstruction and Development.

A New Deal concentrating on investment would increase the political feasibility of reforms, demonstrate solidarity, boost growth and employment in the weaker economies, reduce divergence in the eurozone and, in the end, calm markets: even speculators take long-term growth potential and the political feasibility of reform into account.

Such an approach should also be more acceptable politically in the stronger economies: investing money would give them a real stake in achieving economic growth in the weaker economies. Further economic integration, a reinvigorated single market, reduced divergence and growth in the periphery using surplus savings from the centre would increase Europe's economic dynamism. It might even prove strategically important: if political and economic transformation takes hold in north Africa, southern Europe could become a hub for investment projects along the EU's southern periphery.

Are Europe's leaders ready for this? Not yet - but it will become increasingly clear that half-way houses will not work, politically or economically.

Many might argue that a New Deal for the euro is highly unlikely, but economic necessities are powerful drivers: who would have thought two years ago that member states would agree on the establishment of a permanent rescue mechanism with an effective lending capacity of €500,000,000,000?

Fabian Zuleeg is Chief Economist and Janis A. Emmanouilidis is a Senior Policy Analyst at the European Policy Centre.

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EUROPEAN POLICY CENTRE

POLICY BRIEF

3 June 2013

Pathways to achieve a Genuine Fiscal Union

Francesco Nicoli

BACKGROUND

Since July 2012, financial-market pressure on the euro has eased, thanks to the European Central Bank's (ECB) commitment to do, in the words of President Mario Draghi, "whatever it takes" to save the single currency. But the euro area is still in a precarious condition which cannot be resolved, *in ultima ratio*, by the ECB's action: the aftermath of the Cypriot bailout shows that Europe is still facing a structural crisis.

While the financial crisis originated in the US through an excess of deregulation in financial markets, it acquired a truly European nature in 2010, when the survival of the single currency began to be questioned. Today, the euro area continues to face an *endogenous* crisis (generated by shortcomings in the design of the euro area) and fuelled by the macroeconomic imbalances that have emerged since the establishment of the single currency. These can only be addressed by structural reform of EU instruments and institutions.

Many now contend that some degree of fiscal integration is necessary to overcome the euro area's structural problems. To fulfill this role, any form of fiscal union must accomplish, regardless of its institutional shape, two basic *functions*: preventing the emergence of endogenous asymmetric crises[1], and correcting acute economic and fiscal crises.

To fulfill its 'preventative' function, a genuine fiscal union must have two kinds of mechanism: a credible system to coordinate economic policies (particularly in the field of employment) and fiscal rules to prevent governments from spending beyond sustainable limits.

To accomplish its 'corrective' function, there must be (i) a mechanism to support member states in the implementation of structural reforms by providing financial support, (ii) some form of fiscal rules to lend credibility to government claims of paying back debts, and (iii) instruments to promote economic growth where and whenever necessary.

STATE OF PLAY

So far, five building blocks have been created to reinforce the governance framework: the 'Six Pack', including five regulations and one directive (designed to strengthen the Stability and Growth Pact); the Fiscal Compact, a new treaty aiming to reinforce euro-area budgetary discipline; the 'Two Pack', two regulations designed to underpin the Six Pack; the European Stability Mechanism, providing a permanent financial rescue mechanism; and initial pieces of legislation regarding the creation of a banking union. There is widespread commitment among euro-area leaders to progress further, creating – in the medium term – a so-called 'Genuine Economic and Monetary Union' (GEMU).

But do these innovations deliver the two essential functions required for a fiscal union? And if not, what more needs to be done in the short and medium run?

Assessment of the preventative function: fiscal rules, policy coordination and imbalances

European fiscal rules are currently based on the **Stability and Growth Pact (SGP)** and the Fiscal Compact. With the Six Pack, the SGP has become stricter and more enforceable – and a new set of sanctions and new rules to deliver them have been introduced.

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However, such fiscal rules might not be credible if they deepen economic recession in crisis countries. Where they work effectively, for example in the US, pro-cyclical fiscal rules are complemented by counter-cyclical expenditure flows, aiming to offset some of the negative effects on individual states' economies. With the SGP, a similar function could be achieved with a counter-cyclical 'fiscal capacity' at European level. Even if the introduction of a fiscal capacity is now included in some official proposals aiming to further enhance EMU governance[2], its proposed functions, as well as its likely size, seem to be inadequate to deliver this counterbalancing function.

The second innovative instrument introduced with the Six Pack is the so-called **'European Semester'** (ES): a system of enhanced national economic policy coordination. The ES is built on the Annual Growth Survey (AGS), a strategic document on economic policy published by the European Commission at the beginning of each budgetary year, and on a process of coordination of national policies based on country-specific recommendations. The ES is complemented by a second package of legislation, the so-called **'Two Pack'**. The Two Pack gives the Commission the power to deliver recommendations on national budgetary laws, which must be submitted to the EU executive according to a common time schedule.

However, the implementation of reforms at national level still depends on the willingness of national governments and their parliaments to carry them out. This implies that member states, in most cases, pursue necessary (and often unpopular) reforms only in cases of extreme financial distress, when no other choice is possible. It would be more beneficial to have a mechanism to induce reforms in member states when imbalances are detected, before the critical phase of the crisis.

Ongoing discussions about the so-called 'fiscal capacity' (or 'solidarity mechanism') are mostly related to this shortcoming: following the political agreement of 29 June 2012, some kind of financial support might be provided to member states implementing recommendations agreed in the framework of the European Semester. The Commission announced on 20 March 2013 that it will propose such a financial instrument to support agreed reforms in member states. This development might be positive if the available resources are sufficient and if the conditionality attached to the agreed reforms is economically justified. In this regard, a better democratic legitimacy mechanism will be needed for the ES, provided that additional financial resources are made available.

The third innovation introduced by the Six Pack is the **Macroeconomic Imbalances Procedure**, which aims to prevent the emergence of serious imbalances within the euro area and individual member states. Even if the mechanism provides limited incentives to avoid excessive imbalances, some of them – for example excessive intra-euro area current account surpluses or deficits – are typically a matter of coordination, and often arise following unilateral reforms enhancing asymmetrically the competitiveness of one member state relative to others. Effective *ex-ante* coordination, more than *ex-post* sanctioning, is what matters when dealing with potential macroeconomic imbalances; the excessive imbalance procedure may therefore complement *effective* policy coordination across the EU, but by itself it is insufficient.

Assessment of the corrective function: the European Stability Mechanism and the new role of the ECB

While there has been some progress in terms of preventing future crises, the euro area still lacks a proper tool to pursue macroeconomic stabilisation in the event of asymmetric shocks. The only instrument introduced so far is the European Stability Mechanism (ESM), which provides finance to member states having difficulty funding their spending through the financial markets: provided that they accept the conditionality attached to ESM support and are ready to give up substantial sovereignty on fiscal issues and policy design.

This mechanism has three major shortcomings: first, the intergovernmental nature of the contributions to its funding implies that national parliaments could acquire veto rights on aid disbursements to partner countries, undermining the credibility of the mechanism, as a level of uncertainty remains. Second, the limitations imposed on a country's sovereignty have proven to be so severe that member states do not ask for help until in desperate need, wasting the opportunity to deal with problems when they first emerge. Thus there is a risk that the ESM, which can intervene only when there is no other alternative and via adjustment programmes painful for populations, will be perceived as lacking in democratic legitimacy in the affected countries. Third, the size of the fund is limited, raising concerns over its capability to bail out large countries like Spain or Italy.

Finally, there is the new role for the ECB. Under Mario Draghi's leadership, the ECB has already played an essential role, buying time by calming financial markets. Now the Bank is becoming the institutional cornerstone of a European Banking Union. But the contribution of the Banking Union to euro-area stability is limited by its current design. The goal of a banking union is to break the vicious circle between distressed banking systems and sovereign finances. To achieve this, banking unions usually have three elements: supervision powers, resolution powers and a deposit guarantee. In the European case, however, only the first two are being discussed. The final element, the joint deposit guarantee, which would have prevented a substantial proportion of capital outflows from peripheral countries (stabilising banks and reducing the need for support) is not on the table at the moment, depriving the European Banking Union of an essential facility. The weakness of the Banking Union measures being discussed at the moment was evident during the Cyprus crisis, when a full-fledged banking union could have prevented capital flight from the country: thus avoiding the re-introduction of capital controls, which have distanced the isle from the rest of the Monetary Union.

PROSPECTS

Addressing the euro area's structural shortcomings: the way forward

These reforms represent a concrete step towards creating a sustainable monetary union. In terms of *prevention*, significant steps have been taken, but the euro area still lacks a genuine and enforceable mechanism of policy coordination, as well as a fiscal capacity that provides positive incentives for reform before a crisis spreads and that is able to make counter-cyclical investments that lend credibility to national fiscal rules. In terms of *correction*, the main instrument, the ESM, is lacking in several respects: there is a lack of democratic legitimacy in programme countries, an excessive dependency on national parliaments' decisions, and a lack of credibility for troubled countries, as well as a lack of sufficient firepower to deal with bigger countries.

Some steps could be taken immediately to address these problems and boost stability and growth in the euro area:

Firstly, an agreement must be reached over the **role of the European Parliament** in legitimising the Commission's recommendations and shaping the AGS.

Secondly, euro countries should fully implement the third point of the euro-area agreement of 29 June 2012, creating a **mechanism to deliver positive financial incentives** from the ESM to countries respecting the Country-Specific Recommendations agreed under the ES process.

Thirdly, the **ESM should be reinforced with its own system of 'own resources'** (for example, building on the Financial Transaction Tax) to ensure that its size can be adapted over time to emerging challenges. In this framework, the European Parliament should acquire a role in providing a democratic backstop to EU decisions.

In the medium term, further action is needed to create a **Genuine Fiscal Union**, to address such fundamental problems as democratic legitimacy, coherence and accessibility for EU citizens, as well as adding further elements of strength to prevent a similar crisis from destabilising Europe again.

A genuine fiscal union should build on the foundations of fiscal and policy coordination facilities created during the crisis, reinforcing their democratic legitimacy and complementing them with additional instruments, rather than creating a completely different model.

In the medium term, such a Genuine Fiscal Union could have three main pillars to deliver the preventative and corrective functions:

A reformed EU budget[3] with a degree of fiscal sovereignty for the EU institutions. This implies three elements: an own-resource system based on (limited) tax-raising powers; flexible spending power in areas of EU competence; and the power to make localised investments to offset, when required, negative pro-cyclical consequences of fiscal rules. Such a system of own resources would provide a backstop to issue Union Bonds[4], which could leverage the EU's investment capacity.

The functions of the EU budget would be threefold: firstly, it would continue to deal with existing supranational policies. Secondly, it would deal with emergency cases, providing financing to member states in financial difficulty under strict conditionality (with the funding and functions inherited from the ESM, now merged into the EU budget). Thirdly, it would provide an investment vehicle to sustain the real economy of countries adjusting their fiscal balance. Euro-area budgetary support should be subject to democratic scrutiny at EU level through the European Parliament, with the Commission accountable to Parliament for discretionary expenditure.

In terms of resources, these operations could be financed with Union bonds backed by the EU's new fiscal powers: this would substantially boost the link with own resources (and therefore legitimacy) while postponing the financing needs of the adjustment to the future, *after* the rebalancing process, reducing the actual financial burden on today's lending countries. This solution would be attractive both for lending countries, which would pay less for euro-area adjustment, and for crisis countries, which would enjoy financial support for reforms that they had already committed to implementing.

A Joint Budgetary Procedure: The second pillar would include the functions of budgetary and policy coordination managed today under the ES and the Two Pack. The Joint Budgetary Procedure would be negotiated through a reiterative process between national governments and parliaments and the EU institutions. Parliaments would retain power over their part of the spending and would be incentivised to follow the EU framework by having a guarantee underpinning at EU level the part of their spending agreed with their partners.

This procedure gives all member states a clear incentive to comply: firstly, effective coordination would free up resources for use in national budgets. Secondly, it would be politically difficult for non-cooperating countries to obtain resources from the EU budget. Finally, lack of cooperation would imply participating in guaranteeing other countries' debt without enjoying the same protection – which could meet with political opposition from national constituencies.

A 'super-commissioner' elected by the European Parliament would have the power to veto implementing budgets if they differ from the Joint Budget Agreement. A joint guarantee from member states might be available for debt emitted in order to achieve the agreed level of expenditure, while no guarantee would be available for debt emitted to finance budgets vetoed by the Commission but still pursued at member-state level.

National budgets: In this proposed model of fiscal union, member states would autonomously pursue their own aims and would finance their sovereign budgets independently for any kind of expenditure that is not a source of systemic risk. No joint guarantee on debt emission would apply for this national expenditure. The only constraint would be the SGP, applied to the national budget in its totality. Surpluses or balanced budgets under the second pillar would free up resources for non-systemic expenditure, creating a sustainable dynamic; deficits under the second pillar would not create systemic risks but would impose restrictions on national budgets.

In the event of heavy financial distress at national level, the EU budget and the ESM might provide, under strict conditionality, temporary financial support for sovereign budgets.

The threefold model of fiscal union has its advantages: it addresses the shortcomings of the euro area's design, prevents long-term mutualisation of historical debt stocks (a politically and economically tricky issue), and creates strong policy coordination in many sectors where EU added value could be the foundation of a European renaissance.

There are, of course, other models of how to complete fiscal union; most of them, however, fail to take into account both the needs and interests of surplus and deficit countries. They lack the element of 'great bargaining' that would ensure the compliance of all member states. Whatever route is chosen, the creation of a genuine fiscal union must be a political priority for euro-area countries. Any delay or eventual failure to proceed with fiscal integration would leave the shortcomings of EMU unaddressed, leading to the reemergence of the crisis once the effect of the ECB's monetary interventions inevitably wanes.

Francesco Nicoli is a Programme Assistant at the European Policy Centre.

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1. An *asymmetric* crisis occurs when two countries are hit by the same phenomenon in opposite ways: for example, falling GDP in the first country and increasing GDP in the second country at the same time. Such crises are particularly dangerous for monetary unions, because neither monetary policy nor exchange rates can act as tools for adjustment.
2. The 'four presidents' report and the European Commission's 'Blueprint'.
3. In the long run, all member states except the UK and Denmark are committed to participating in the Monetary Union. However, it is unclear whether all of these countries will indeed join the euro area. If they do not, the creation of a single Union Budget might be problematic, and specific solutions for the euro area would be needed.
4. Union bonds, in contrast to Eurobonds, are not a form of mutualisation of historical national debt: they represent an instrument to pursue new forward-looking joint expenditure.

European Policy Centre ■ Résidence Palace, 155 rue de la Loi, 1040 Brussels, Belgium
Tel: +32 (0)2 231 03 40 ■ Fax: +32 (0)2 231 07 04 ■ Email: info@epc.eu ■ Twitter: @epc_eu ■ Website: www.epc.eu

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EUROPEAN POLICY CENTRE

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DISCUSSION PAPER

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

Jan David Schneider, Fabian Zuleeg and Janis A. Emmanouilidis

Executive Summary

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

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

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

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

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

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

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

Introduction and context

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

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

Origins of the crisis

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

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

New governance

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

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

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

Further progress needed

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

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

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

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

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

Coordination within and between the EU Institutions

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

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

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

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

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

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

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

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

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

The new governance in practice

The European semester and the implementation of Country-Specific Recommendations

While the euro zone has introduced many new governance instruments aimed particularly at fiscal discipline, which seemed impossible some years ago, the success or failure of the reformed EMU will depend on whether it can reduce critical imbalances within the euro zone. This includes a clear need for those countries which have fallen behind in terms of competitiveness to catch up by continuing to carry out structural reforms. However, the EU still lacks effective ways to promote and support reforms in individual euro zone countries.

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

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

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

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

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

Budgetary flexibility

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

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

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

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

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

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

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

Limitations of rules-based governance

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

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

Fiscal capacity

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

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

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

Fiscal capacity instruments

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

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

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

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

The latter could be addressed through the conclusion of 'contractual arrangements' between the respective country, as set out *i.a.* in the Commission's (2013) proposal for a Convergence and Competitiveness Instrument (CCI). However, such contractual arrangements could be unpopular with recipients if seen as a way of exerting central/EU control, especially in case the incentives provided through a new fiscal capacity are not significant enough. Contractual arrangements between individual Member States and the EU/Commission also need to be designed carefully to make the projects implementable in practice, otherwise the process could become slow, cumbersome and bureaucratic, with too many small projects, and there might be difficulties of finding sufficient eligible projects, providing real structural reforms rather than mere cutting of expenditure, as well as monitoring their delivery. Many of these problems are mirrored in the EU's structural and investment funds; it is necessary to prevent the fiscal capacity from essentially becoming a copy of the regional funds for the national level.

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

Financing the fiscal capacity

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

The fiscal capacity – an essential element of euro zone stability

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

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

A growth and investment programme

Growth and structural reform

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

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

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

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

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

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

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

An investment programme[12]

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

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

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

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

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

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

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

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

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

Jan David Schneider is an Economic Research Assistant, Fabian Zuleeg is Chief Executive, and Janis A. Emmanouilidis is Director of Studies at the European Policy Centre (EPC).

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Endnotes

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

European Policy Centre
Résidence Palace, 155 rue de la Loi, 1040 Brussels, Belgium
Tel: +32 (0)2 231 03 40 - Fax: +32 (0)2 231 07 04
email: info@epc.eu - twitter: @epc_eu
www.epc.eu

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DISCUSSION PAPER

Can the eurozone's economic governance combine political accountability, legitimacy and effectiveness?[1]

Fabian Zuleeg

After years of economic crisis, resulting in significant changes to economic governance at EU level, especially for the eurozone, the time has come to consider the longer term political and economic implications of this new situation for the economic integration process. Not only to determine how well the system is likely to function but also what more needs to be done to ensure long-term stability and to provide the EU institutions with sufficient political legitimacy to carry out this new role.

This article does not consider abolishing the euro, based on the conviction that introducing the euro created a path dependency that makes trying to unpick the seams of the process extremely costly. While, economically, the exit of one eurozone member state might conceivably be manageable (but costly, especially for that country), the long term political costs might end up unravelling the whole European integration process, with the potential for a bankrupt and politically unstable state outside the euro but still within the EU. However, the *status quo* situation is still unstable, politically and economically, and needs further policy reforms.

Governing reluctant member states

The crisis has shown that the EMU has created an even higher degree of interdependence, with imbalances and lack of convergence – partially inflicted by countries themselves – threatening the stability of the EMU as a whole and thus driving the need for (politically controversial) support for economically weaker member states. The key policy levers to influence these imbalances are at member state level rather than being controlled by the EU institutions. It follows that one of the key features of the post-crisis eurozone governance framework is the need to directly influence the behaviour of member states, in particular in terms of fiscal policy choices and structural reforms.

To address this need, the new governance framework mostly relies on a legalistic, rules-based approach, i.e. an EU legal framework with sanctions for non-compliance. In many ways, this represents a halfway house between market forces and 'federalisation', i.e. pooling sovereignty at EU level in an executive that can enforce common policy decisions. Not only is a rules-based system the EU's traditional response (its backbone is legislative, after all), but both market-based and federalised solutions were seen as undesirable: market-based solutions might lead to sovereign defaults and banking system troubles, while federalisation was seen as an undesirable transfer of sovereignty that would be constitutionally tricky, as fiscal policy touches on some of the most fundamental functions of the nation state, and would be politically impossible to sell to northern European electorates, as it would have to include the mutualisation of public debt.

However, the new EMU governance framework is not purely rules-based: it also contains new provisions that are more akin to the open method of coordination. In the new European Semester process, the main driver behind member state compliance is 'peer group' pressure, i.e. being monitored by fellow heads of state and government. However, in the past these methods have not worked successfully and this seems to be the case once again for the implementation of the Country-specific Recommendations (CSRs). Studies suggest that implementation of the CSRs is patchy at best. In essence, those member states that want to implement the CSRs do so, while the rest can safely ignore them without the fear of sanctions.[2] While the European Semester process could be improved, for example, by putting a stronger focus on a smaller number of key recommendations, this structural deficit of a lack of enforcement mechanisms will continue to limit the effectiveness of CSR implementation.

In one area of the new governance, enforcement mechanisms had been ever present: the programmes introduced by countries requiring public finance support, with implementation monitored by the troika of European Commission, ECB and IMF. However, the troika mechanism has been highly controversial, because of the loss of sovereignty it implies. Consequently, many have criticised the troika and the recent developments in Greece can, in part, be interpreted as a backlash against the perceived lack of legitimacy of the troika's actions, which is reinforced by the exclusion of the support and implementation systems in programme countries from the community method.

The limitations of rules-based systems

For the foreseeable future, it therefore appears likely that the EU will rely on the tried-and-tested method of rules-based governance. But the effectiveness of the system is still questionable, as rules-based systems suffer from a number of limitations, including:

- questions about how to pick appropriate rules/targets, adapted to both the economic environment and country-specific conditions;
- the way that rules suffer from low anticipatory powers: they often address past crises rather than coming ones. To deal with emerging risks, it is necessary to have significant instruments that can be employed quickly (or even automatically) rather than having a set of inflexible rules;
- the perennial question of enforcement mechanisms, especially since, at EU level, enforcement is often reliant on the willingness of the heads of member states to censor or even fine their peers;
- whether a country's failure to meet a target is down to willingness or capacity to deliver and under what circumstances there needs to be flexibility, and who decides on it;
- and that the available instruments, both old and new, are too complex and therefore difficult to understand for policy-makers that need to quickly apply and comply with the rules. This complexity is an additional factor that leads to low automaticity that obstructs the necessary degree of *ex ante* support for the prevention of new economic and financial crises.

The rules-based system is further complicated by the need to interpret rules which always opens up potential disagreement. While the system offers the opportunity of taking the legal enforcement route, this requires the political will to take countries to court, as well as patience, as rulings take time to be delivered. In addition, there are questions over whether a court with legal rather than economic competence is well-placed to rule on matters of economic governance. Furthermore, the reliability of monitoring information is critical to ensure consistent implementation of the rules. If there is a degree of interpretation – in conditional rules, for example, which are based on some form of relative concept rather than a simple, absolute target – it can be difficult to reach agreement on how the data should be interpreted.

Given the difficulties in changing the EU's strategic direction, it is also very challenging to change any of the rules that have been written into the EU treaties. Furthermore, it is nearly impossible to take into account country-specific conditions and circumstances, or changes in the broader macro-environment. This raises a number of crucial questions: Is the same inflation target still appropriate in a situation where deflation is threatening? Is it right to focus strongly on public debt? Is a deficit target of 3% the right one for all countries, given divergent growth performances and debt financing costs? Again, if, for any of these rules, there is a need to consider more flexibility, who is empowered to make such a decision?

For some countries, it seems that the main objection to any economic governance arrangement is more the fact of attempting to impose rules at European level than disagreement with the content of the rules themselves or how flexibly they are applied. In essence, under the guise of flexibility or reductions in austerity, countries may aim for a repatriation of fiscal powers, which would undermine effective fiscal coordination at eurozone level, as well as undermining the underlying political bargain: debt financing support only with attached conditionality.

Another key challenge is to ensure compliance with the rules by both small and big countries to safeguard the long-term credibility of the new governance system. Previous experience with the Stability and Growth Pact shows that if large, powerful countries do not comply with the rules, the remaining countries will soon follow suit. Recent debates already seem to show that some member states think the rules apply less to them than to others, as illustrated by the debates about the flexibility of sticking to the 3% deficit limit (prompted by large countries with public finance problems) and recent discussions on export surpluses, which provoked highly negative reactions in Germany, despite being fully in line with the recently-created governance instruments. Any exceptions to the rules, for example regarding flexibility, should only be decided at the eurozone level and be equally applied to all member states.

But the lack of a *priori* flexibility in rules-based systems is a particular challenge in times of crisis and uncertainty. It raises the question of who makes the decision on whether rules can be suspended or eased in such instances. In the case of fiscal governance, any such decision (or the decision to enforce the rules) by the Commission is likely to be challenged, especially by the bigger countries. However, if it is down to the Council, it is difficult to see heads of state and government holding their peers strictly to account.

In the current situation, the rules need to be adapted to encourage more private and public/social investment. But this needs to be done while still maintaining the integrity of the governance framework as a whole. The only way to do this consistently in a rules-based system is to amend the rules. In this case some form of Golden Rule, excluding productive investment from the deficit criterion, would be a feasible, if politically contentious, option. This would need to be accompanied by a framework to define what falls under social/public investment for the purpose of such a Golden Rule. But, yet again, significant hurdles need to be overcome, such as how to define what falls under the rule, determining who makes the final decision on it, and ensuring its implementation relies on objective, independent evidence.

But the difficulties with a rules-based, legalistic system go further than this. In the policy areas which the EU now needs to cover which are close to the heart of national decision-making systems, the reliance on a rules-based approach is unlikely to function well. While, at times, adhering to European rules in politically sensitive areas can be politically useful in order to shift responsibility for unpopular measures, at other times the political cost of compliance outweighs the consequences of breaking the rules, especially for the more powerful countries.

A game-theory view of economic governance

The challenge of implementing rules in a dynamic and uncertain environment should not, thus, be seen as a legal problem. It is, in reality, a political economy problem and here it can be useful to borrow some concepts from game theory, political economy theory and transition economics to highlight some of the fundamental political conflicts that limit the further development of eurozone governance.

Political feasibility: The crisis management strategy chosen by the EU to deal with the euro-crisis has not taken political feasibility sufficiently into account, as is clearly demonstrated by the election victory of Syriza in Greece. This should not have been unexpected. After all, in a situation with rapidly falling living standards and few positive economic prospects, the messages of populists will gain traction. A crisis management strategy must thus build in the need to create constituencies for reform, as well as providing populations with realistic prospects of future improvement.

Time inconsistency and moral hazard: Agreements based on the commitments of member states suffer from moral hazard problems, i.e. the tendency of countries, once they have received the support they need, to backtrack on the more difficult reforms and commitments they have previously made. This can be especially difficult when governments change. As a result, any support becomes time inconsistent and the result is sub-optimal, with no support and no reform.

Bounded rationality and asymmetric information: There are a number of information limitations which arise in such complex governance frameworks. This is aggravated by information asymmetry, where national governments hold more information than the institutions or the other member states, for example, on whether reforms are implemented or whether there is only on-paper compliance.

These issues, in combination with the distrust between member states which arose from the euro-crisis, imply that there is a prisoner's dilemma at the heart of EU policy: without support, there is no reform, but without reform there will be no support. In the EU, traditionally, Germany has been able to overcome the prisoner's dilemma by making the first move, with a focus on the longer-term national interest, but Germany no longer takes this role, having become more 'normalised', i.e. looking out for more narrowly-perceived national interests.

The final result is inertia. Member states try to muddle through without having a long-term agreed-upon vision, necessitating ongoing ECB action to prop the system up. Given the continuing structural challenges within the EMU, these periods of muddling through will be accentuated by an acute crisis for which short term responses are found without addressing fundamental governance reform. In the long run, this may well threaten the European integration process if a particularly acute crisis runs out of control or when the long-term imbalances lead to a build-up of political frustration in the countries providing and the countries receiving support.

The role of the Commission

To overcome these issues, the literature suggests that a 3rd party could take the role of arbitrator, acting as an honest broker. The member states (the principles) could delegate some common functions to an independent body (the agent), which acts in the common interest. This could be (and arguably was in the past), a function fulfilled by the Commission. But the member states no longer trust the Commission to act in the common interest, in part because the Commission has become more politicised. There is a fundamental conflict between the political function of the Commission, taking a role in the overall political direction of the EU, and its role as an independent monitoring/assessment agency, regulator and arbitrator in the application of EU law, for example in areas such as competition policy or in the assessment of member states' budgetary policies. With an increasingly 'political Commission', potentially further reinforced by the link to the EP elections made through the Lisbon treaty and the *Spitzenkandidaten* process, maintaining credibility as an independent and objective arbitrator might be severely challenged in the future.

One way to address this would be to outsource some of the functions that call for impartial arbitration or objective advice and recommendations. Independent bodies could be set-up such as, for example, a separate competition authority, as well as bodies to monitor fiscal policies, a statistics agency and a council of wise men and women to provide advice on the economic strategy and position of the EU. Undoubtedly, this would be a longer term process, but thinking about a fundamental reform of the Commission along these lines should start now, including clear provisions to reinforce the political accountability of such bodies.

But the fundamental issue is that, at member state level, many have had enough of 'more Europe' due to the crisis and think that it is now time for 'less Europe'. In many countries, there are also signs of the 'British disease', namely that any further integration is seen as undesirable and that further integration steps are blocked, with the argument that this might raise strong objections in the electorate. This will be a significant challenge for the EU. There are already a number of areas where a process of 'inverse subsidiarity' can be observed. These are areas where member states want to retain control but EU solutions are now needed as it is no longer possible to deal effectively with the issue at national level, such as energy security or migration. In addition, further integration is also becoming necessary for the eurozone due to a process of 'spill-in', i.e. further integration within a policy area with the aim of avoiding negative consequences, here driven by the necessity to correct the flaws of the EMU (these contrast with positive reasons for integration, such as a wish to move towards a federal Europe or the pull of positive spill-over effects). Increasingly, we will see that what is politically possible diverges further and further from what is required to effectively deal with the challenges the EU faces. Clearly, to have effective decision-making, there first needs to be agreement on what the EU should be doing. At the moment we are nowhere near such agreement.

More government than governance

Ultimately, there is a need for more executive powers at EU level, especially so as to be able to react swiftly to any emerging crisis. In addition, an effective system also needs to have accountability mechanisms. In national systems, this is usually performed by the legislative. But with co-legislators, the Council cannot hold itself to account if it also has an executive role. There is also now a greater role for national parliaments, which can create additional uncertainty: who, in the end, holds the executive to account? The Council, the EP, the national parliaments, or a combination of these?

Currently, most member state governments are unwilling to relinquish control of executive powers in politically highly sensitive areas to the Commission, insisting that the final decision-making power should be retained at national level or, at the very least, in the Council. But there is no effective way in which two bodies can share this kind of executive power. While co-legislation can work due to its sequential nature and the absence of acute time pressure, co-executive power shared by Council and Commission is likely to create uncertainty and delay that can be very costly in a crisis. The only way out is to vest powers in a supranational body, whether it be the Commission or another construction. There is thus a need to construct a grand political bargain based on the wishes of the population that provides an acceptable deal, including institutional and treaty change. But further far-reaching steps seem highly unlikely at the moment, so at the very least it will take time until the political environment is right. So, what can be done in the meantime, in addition to preparing for such a bargain?

Improving output legitimacy[3]

One short-term measure may be to improve the effectiveness of the EU institutions, especially the Commission, in delivering their policy priorities, thereby improving so-called output legitimacy. But the Commission is not necessarily structured efficiently: a long-standing issue, aggravated by the recent enlargements of the EU, is the number of commissioners. While the EU treaties have provided for a reduction in the number of commissioners to enable the EU to cope with successive enlargements, it has proven to be impossible to get the political agreement for countries to give up the principle of one commissioner (at least) per country. Equally, having 'junior' and 'senior' commissioners, in line with similar arrangements in many national governments, does not seem to be acceptable to many member states, with some of the smaller states worried they would perpetually end up with junior posts.

The number of commissioners increasingly leads to a strong 'silo' mentality, with each member of the College virtually autonomous when it comes to their own portfolio's competences, and where inter-service consultations and infrequent top-down direction from the Commission president is insufficient to break the overall pattern. Eventually this leads to a lack of coherence and focus, and in the worst cases can give rise to uncertainty about the overall direction and may even create outright contradictions. There is, however, a way of potentially overcoming these difficulties. This would be through building on the existing structure: creating clusters of commissioners around vice-presidents.

In previous publications[4], we have suggested a possible distribution of priorities for vice-presidents and clusters of commissioners to ensure that the structure of the Commission mirrors the overarching challenges of the EU. The new structure of the Juncker Commission does partially reflect these suggestions, with seven vice-presidents covering broad thematic areas without a specific portfolio. However, there is one crucial difference: in an attempt to maintain flexibility (and possibly to assuage the member states' fears that this would create 'junior' commissioners), the clusters of commissioners differ for each broad policy area, with many commissioners contributing to more than one area. In other words, there is no clear cluster structure but a matrix, as well as numerous overlaps between the vice-presidents themselves and between vice-presidents and commissioners, both in terms of portfolio content and in terms of the supporting bureaucracy. At the very least, this will require the clear definition of which commissioner is ultimately responsible for what and who reports to whom at the outset of the Commission, but even so, the structure might well prove ineffective without a clear hierarchy. This new way of working will also require effective coordination between the president and the vice-presidents, guided by a common purpose and vision.

A more political Commission

If, in the end, this works, it will improve output legitimacy and, at the same time, will turn the Commission into a more political instrument, with clear-cut political priorities and the ability to better deliver and implement them, which raises fears over the politicisation of the Commission as discussed earlier on.

But politicisation should not be seen as a negative process. For a long time, many convinced Europeans have lamented that the EU is remote from its citizens, that democracy is not functioning as it should at EU level and that there is no engagement with EU policy debates. While current governance/political developments certainly do not answer all the questions posed of EU democracy, at least it is a starting point to get citizens more interested in EU policy decisions.

Even if it were desirable, it seems unlikely that we could go back to a 'golden age' where the Commission does not get involved in politics. The Commission is already highly politicised and, increasingly, the EU needs a Commission able to make executive decisions that can be implemented across the EU. This means a move from governance to government, from a rules-based legalistic system to one driven by political preferences, underpinned by mechanisms of legitimacy and direct accountability.

But to do this, democracy at EU level also needs to be further developed to facilitate engagement. In addition to the existing mechanisms of representative democracy, which are still struggling with low engagement and participation, there is a need to develop a more accessible, informed participatory democracy by utilising new technologies and building bespoke mechanisms for citizens to have input on EU decision-making, such as developing an EU version of 'liquid democracy', where citizens can be involved directly in EU policy. In addition, there needs to be a clear mechanism to hold the Commission to account for its executive/political decisions, a role the EP could increasingly play. Improving democracy at EU level will also require the finding of a solution to deal with the differences between member states, especially the Euro *ins* and *outs*, with a need to find a way of re-invigorating differentiated integration. While progress is certainly possible, in the end, decision-making and accountability at EU level will only be as effective as member states allow it to be.

By and large, the EU could start to introduce some of the changes proposed here in the near future, without major changes to the institutions or the EU treaties. However, the elephant in the room is the question of what member states want the EU to do and how far they are willing to make the necessary changes, especially if they require the further pooling of sovereignty in some areas.

Fabian Zuleeg is Chief Executive and Chief Economist at the European Policy Centre (EPC).

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1 This article is reproduced from the CIDOB publication 'Redesigning European Monetary Union Governance in light of the Eurozone Crisis', published in 2015. It builds on Zuleeg (September 2014).

2 Theoretically, the lack of implementation of CSRs might have some consequences, for example in terms of EU structural and investment funds. But it is difficult to envisage this being implemented strictly.

3 The following sections draw on Zuleeg (7 March 2014).

4 See Zuleeg (9 September 2014).

European Policy Centre
14-16 rue du Trône, 1000 Brussels, Belgium
Tel: +32 (0)2 231 03 40 - Fax: +32 (0)2 231 07 04
email: info@epc.eu - twitter: @epc_eu

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DISCUSSION PAPER

Growth for Europe – Is the Juncker Plan the answer?

Jan David Schneider

Executive Summary

The euro area is still suffering from low growth and high unemployment. For the recovery to become a reality, there needs to be a balance between fiscal discipline, supply side improvements and actions aimed at stimulating demand and growth. Increasing investment, both private and public, are important components in overcoming the recession.

This becomes especially clear when comparing investment dynamics during the crisis with pre-crisis levels. Total investment is still much lower than before the crisis and public investment is well below its pre-crisis peak as well.

In late November 2014, European Commission President Jean-Claude Juncker submitted a long-awaited proposal for a European Investment Plan that aims to stimulate private investment. Apart from the creation of the new European Fund for Strategic Investment (EFSI), through which private investors will receive public guarantees, the investment plan also aims to provide project assistance and improve the Single Market by removing sector-specific or other financial barriers to investment.

While generally perceived as a first positive step towards increasing private investment, some commentators have expressed reservations about the plan. These include, among others, the lack of fresh money for the initial contributions to EFSI. Since a substantial amount of these contributions is reshuffled from other places in the European budget, the question was raised whether EFSI can fund additional projects or just replicates investment projects that would have happened without the plan. Other criticism relates to the high estimate of the expected leverage ratio of 1:15, and to the risk that the plan will only have a limited impact on stressed economies.

The Juncker Plan addresses private investment, but so far there really is no clear strategy to stimulate productive public investment on the European and national level. Countries with fiscal space are reluctant to engage in higher spending, while those willing and in need of it the most are restricted by the rules. Member States and the Commission should therefore discuss options for further improving the euro area's economic governance.

In addition to urging countries with fiscal space to increase investing in national public goods, investment could be treated with budget flexibility. One could, for instance, upgrade the importance of public

investment in the European Semester. Additional deficit granted for public investment purposes could be attached to certain Country-Specific Recommendations. Another solution would be to allow some form of budget flexibility, such as the formulation of a new Golden Rule for productive public investment becoming part of the Stability and Growth Pact's application. Besides relying on a larger amount of flexibility in the rules, the Financial Transaction Tax (FTT) could be another solution to fund investment in European public goods.

It will also be necessary to overcome the mistrust among Member States that is preventing further action. The political bargain of stronger conditionality, such as through contractual arrangements, could improve the situation. Increased trust will also be an important condition for tackling long-reaching economic governance reforms such as the creation of a Fiscal Capacity, which could take the form of a macroeconomic shock insurance. Such a Fiscal Capacity could make a real difference in providing the necessary funding to maintain productive public investment, even in times of deep recessions.

The proposals presented do not attempt to be conclusive, but shall rather be an input for a wider debate on how to increase growth and employment in Europe. The paper draws heavily on the discussion of a Workshop on Growth and Investment, which the European Policy Centre (EPC) hosted on 10 December 2014 under Chatham-House Rule, with a group of economists and representatives from the European institutions.

Introduction

The current one-sided strategy of combining fiscal consolidation and structural reform to improve market confidence and restore competitiveness, thereby leading Europe to economic recovery, has proven to be insufficient. It is now clear that there needs to be a balance between fiscal discipline, supply side improvements and actions aimed at stimulating demand and growth especially since the euro area is still suffering from low growth and high unemployment, which is leading to political challenges. What the European economy desperately needs are economic impulses that can increase growth and prosperity. Monetary policy alone cannot drive the recovery. Aware of its limitations, European Central Bank (ECB) President Mario Draghi, for instance, notes that[1]:

> *Monetary Policy alone […] cannot overcome financial market fragmentation in the euro area. Fragmentation across national borders also reflects underlying imbalances and institutional deficiencies. Overcoming these require determined structural reforms on the side of national governments to improve the business environment and setting incentives to invest, with the aim to boost productivity, create new jobs and raise the growth potential of the economy.*

Thus, structural reforms' focus should be on raising growth potential, not on fiscal consolidation. But further action is needed. Some commentators have stressed that stimulating consumption could be a way to go, given that the stronger recoveries in the US and also the UK were predominantly driven by strong domestic household consumption. Raising wages in surplus countries, especially Germany, could indeed be a way to increase euro area consumption. Legrain (2014), for instance, advocates to put a stop to the current period of German wage restraints, with today's real wages being lower than in 1999 while productivity has increased by 17.8%. Not only would raising wages in Germany increase consumption but it would also be a contribution towards reducing euro area differences in competitiveness.

Part of a comprehensive growth strategy should also encompass further action to increase private and public investment. In late November 2014 European Commission President Jean-Claude Juncker submitted the new Commission's proposal for a European Investment Plan that aims to stimulate private investment. The plan is a first step to close the large investment gap that the eurozone has built up since the crisis. However, what is missing so far is a clear plan or strategy for stimulating productive public investment at a

European and national level. Countries with fiscal space are reluctant to engage in higher spending, while those willing, and in need of it the most, are restricted by the economic governance rules. A modern European version of a New Deal could be the answer, with a focus on large-scale investment in public goods.[2]

The remainder of the paper will first provide some reasoning for increasing private and public investment. Then a first preliminary assessment of the Juncker Plan will be made, followed by several proposals for increasing growth through higher public investment. The Discussion Paper also takes into account recent developments underway to implement the Juncker Plan as well as further highlights some of the recommendations on increasing investment that the EPC has featured in the past.

The proposals presented do not attempt to be conclusive but shall rather be an input for a wider debate on how to increase growth and employment in Europe. The paper draws heavily on the discussion of a Workshop on Growth and Investment, which the European Policy Centre (EPC) hosted on 10 December 2014 under Chatham-House Rule, with a group of economists and representatives from the European institutions. The opinions are therefore not necessarily those of the author of this Discussion Paper but rather reflect the wider debate of the Workshop.

The case for higher investment

Total investment in the euro area remains below its pre-crisis level; this applies to both private non-residential and public investment. Claeys, Hüttl, *et al.* (2014), for instance, estimate the total investment gap to be EUR 260 billion for the EU15 in 2014 by comparing the trend of total investment for the period 1970-2014 with actual total investment in 2014. While public investment is close to its trend value, one can observe a substantial decline when contrasting current public investment to its 2009 peak.

The investment slump during the crisis has been even more severe in stressed economies than in the core; and financing conditions have deteriorated more for SMEs than for larger corporations (see e.g. Barkbu *et al.* 2015). While the stronger than usual recession and the weak growth outlook for the euro area may explain some of the decline in investment, Barkbu *et al.* (2015) show that other factors need to be considered to fully explain the euro area's weak investment dynamics. According to their assessment these factors are 'elevated financing costs and limited access to finance as a result of financial fragmentation, high corporate leverage, and policy uncertainty' (p. 5). The Juncker Plan is therefore an important contribution to overcome some of these factors on the way to higher growth. Once growth picks up investments are also expected to recover further (Barkbu *et al.* 2015). Some Workshop participants, however, questioned whether the Juncker Plan alone will be sufficient as such an initiator.

Many participants at the Workshop also stressed that boosting productive public investment either at national level or by providing a more favourable framework at European level could also accelerate the recovery. Public investment in innovation, infrastructure or basic R&D is much needed, as there are necessary complements to private investment in these fields.[3] In the energy sector, for example, public investment in energy systems and infrastructure are necessary prerequisites to attract private capital. Rather than increased government spending reducing private sector investment – known as crowding out – well-designed and targeted public investment can stimulate private investment.

Crowding out as an argument against productive public investment becomes even less credible with monetary policy operating at the zero (nominal) lower bound, *i.e.* short-term nominal interest rates are at or close to zero causing a liquidity trap. In Keynesian economics a liquidity trap is a situation where ordinary monetary policy has no effect. In normal times, when interest rates are not at the zero lower bound, fiscal policy raises interest rates, which cause private investment to fall. This form of crowding out does not occur in a liquidity trap, where fiscal policy is not going to raise interest rates.

Another argument for increasing public investment (or other public spending for that matter) is the relationship between the size of fiscal multipliers and the business cycle. Fiscal multipliers measure how an economy's income level is affected by government spending. If, for example, a fiscal multiplier is higher than one, this means that, in total, national income increases by more than the additional spending. For example, Gechert *et al.* (2015), show that fiscal multipliers are significantly higher during recessions than in normal times or boom periods. This means that every euro of additional government spending leads to a cycle of consumption and wealth creation that results in an overall higher national income. Taking stock of this fact, Wren-Lewis (2015) argues that respecting a certain chronology for tackling large negative output gaps[4] and budget deficits would be much more effective towards restoring growth: Balancing budgets and closing the output gap at the same time is harmful. Since at the lower zero bound fiscal policy is the only effective tool to close the output gap, policy-makers should, generally speaking, deal with the output gap first. Once the recovery gains momentum and growth is restored budget deficits can be reduced.

The EU Investment Plan – Stimulating private investment

Many consider the Juncker investment plan an important change in direction.[5] Until recently there have been no substantive efforts to address the eurozone's demand problems. The focus has rather been on supply side reforms, *i.e.* structural reforms (although the term structural is actually too broad to define the kind of reforms that have been and were supposed to be undertaken by some countries). Part of the missing demand stems from sluggish investment but low consumption has also been a problem. Addressing the public and private investment gap should therefore be seen as one component of fostering growth in the eurozone, rather than the only policy response.

The Juncker Plan is one of the first crisis efforts that mainly builds on community resources/funding and it may provide a momentum for other measures that will lead to Europe's recovery. The plan aims to stimulate private investment through issuing public guarantees, providing project assistance and improving the Single Market by removing sector specific and other financial barriers to investment. Its objective is to support investment in strategic infrastructure, improve financing conditions for SMEs and middle capitalisation companies, as well as fostering EU competitiveness.

The plan has three pillars: (1) providing financial support through the newly created European Fund for Strategic Investment (EFSI), (2) the creation of a project pipeline and provision of technical support to investors and Member States, and (3) promoting structural reform and strengthening the Single Market. Most attention in the public discourse has, however, been given to the first (two) strand(s).

EFSI will receive EU guarantees of EUR 16 billion, composed of EUR 3.3 billion from the Connecting Europe Facility, EUR 2.7 billion from Horizon 2020 and EUR 2 billion from the EU's budget margins. An additional EUR 8 billion are guaranteed from the EU budget without any pre-financing. Finally, the European Investment Bank (EIB) contributes another EUR 5 billion euro. Hence, EFSI will have an initial input of EUR 21 billion.

These funds are then leveraged by an estimated factor 15, thus, in total, the plan aims to generate EUR 315 billion of investment over the next three years (2015-17). EFSI will therefore provide a public guarantee of 1/15, or 6.7%. Out of the EUR 315 billion around three quarters (EUR 240 billion) will be dedicated to long-term investment, with the remaining EUR 75 billion going towards SME and mid-cap financing (European Commission 2014).

EFSI's governance structure will reflect the contributions made to the fund. A Steering Board will decide on the overall orientation, the investment guidelines, the risk profile, strategic policies and asset allocations of the fund. Votes are based on the size of contributions. Hence, for the moment only the European Commission and the EIB have voting rights until the fund generates other contributions, for example from Member States. An Investment Committee, which will consist of independent market experts and which is accountable to the Steering Board, will be in charge of the actual project selection. The Committee shall ensure that projects will be viable and that the public support does not crowd out private investment. (European Commission 2015a)

Furthermore, a European Investment Project Pipeline will provide investors with knowledge on existing and future projects. The EU Task Force on Investment, which identifies key projects and potential barriers to investment has already asked Member States to submit potential projects that are supposed to fulfil the following criteria (with priority given to the second criteria): (1) EU value added; (2) Economic viability and high socio-economic returns, (3) timely execution of projects (within the 2015-17 period). On 9 December 2014, the Task Force reported that Member States have already identified 2000 potential projects worth EUR 1.3 trillion.

On 10 March, the European Council has given its approval to implement the Juncker Plan. With the European Parliament's approval expected by June, EFSI is scheduled to be operational for project financing by the end of this summer. The EIB estimates that the full system will be up and running by the end of 2015. The plan is then supposed to operate for four years, with a review after three years.

All it seems?

The Juncker Plan has been criticised for its lack in providing substantial additional money. In light of the EU's annual investment gap, EUR 21 billion seems indeed rather limited. The European Commission emphasises that the aim is to offer financing solutions that crowd-in investors. EFSI will not provide grants or subsidies but financial products that will be junior to those of private investors (European Commission 2015a), so the Plan can only be considered a success if it generates significant private investment. However, some have expressed concerns that due to the reshuffling of funding from Horizon 2020, EFSI may even provide a hindrance to long-term growth. The question needs to be raised why initial contributions to EFSI had to be taken from exactly these kinds of budget positions.

In addition, whether the investment plan will be able to attract projects that would not have happened without the Commission's new initiative, remains to be seen. The Juncker Plan really needs to be measured against the return that the EUR 21 billion in initial contributions could have achieved in its former frameworks such as Horizon 2020 or under normal EIB lending practice. It will be difficult to determine whether EFSI will be able to largely fund additional investment or if a large amount of the selected projects would have been funded by the private sector or even by national/EU money in any case. While the plan is likely to deliver somewhat higher investment, the economic impact of the Juncker Proposal may be limited if the projects miss additionality.

Furthermore, the European Commission has set itself a high benchmark. Horizon 2020, for instance, provides funding to long-term, high-return projects. The Task Force will therefore need to choose rather high-return, high-risk projects to make a real difference. The Investment Committee needs to be able to identify these types of projects. It is therefore important that the Task Force will consist of EIB experts rather than politicians.

A closer look at the project proposals that the European Commission collected from Member States further leads to the conclusion that Member States have listed those types of projects that could not be financed on national level. After receiving the project proposals, the European Commission emphasised that these project lists 'do not pre-judge financing commitments by the Commission or the EIB' (European Commission 2015a). This raises the question whether the project pipeline will consist of enough viable projects.

Other more technical criticism has been expressed towards the plan's targeted leverage ratio of 1:15. While an overall multiplier of 18 has been achieved by the EIB in the past, the decomposition of the multiplier is a novelty, which led some experts to evaluate the proposed leverage ratio as overly ambitious and unrealistic to achieve in practice. Every initial euro contributed to the fund is expected to create two additional euros of subordinate debt. In turn, every euro of subordinated debt is then estimated to create four additional euros in senior debt through private sector investment. Thus, a total multiplier of 15 is estimated (composed as x3 x5). Although higher multipliers have been realised in the past, some Workshop participants stressed that, when these levels of leverage where achieved, the composition was different (for instance: x6 x3) and therefore the multiplier from subordinated debt to senior debt may be too high.

Geographical allocation and Member State contributions

The Juncker Plan does not specify any form of geographical allocation. The design of the mechanism could therefore disproportionally benefit specific countries or regions. Even if a sufficient amount of viable projects can be found, without any form of quota, more economically stable regions could receive the majority of projects. Investors would for instance need to take into consideration the higher political uncertainty in countries like Greece, which makes investment projects less attractive in comparison to core economies. This could lead to a weaker than hoped for economic impact in theses countries that are most in need of additional economic stimulus. Part of the plan is to provide technical assistance to help private investors to identify worthy projects in crisis-ridden countries and to help governments to make their proposals more attractive (European Commission 2015a). Previous examples of such Task Forces, such as the Greek Task Force, are however no promising precedents.

The plan encourages Member States to chip in with national resources but provides rather limited incentives to do so. At the time of writing, several countries have announced to complement the plan with additional funding through their national investment banks. Germany, France and Italy will each provide EUR 8 billion and Spain pledged an additional EUR 1.5 billion. But are the funds channelled through the promotional banks additional funds or were they already dedicated to projects that would have been financed without EFSI?

Furthermore, the plan allows for Member State contributions to be neutralised with regards to their treatment in the Stability and Growth Pact. The European Commission (2015b) phrased this rather vaguely:

> *In the case that the reference value of a 3% deficit is not respected, the Commission will not launch an Excessive Deficit Procedure if it is due to the contribution, provided the deviation is small and expected to be temporary. When assessing respect of the debt criterion, contributions to EFSI will not be taken into account.*

Project selection and risk levels

The plan has been criticised for not promoting social investment projects such as in education, and for not requiring any criteria of sustainability. For instance, EFSI could fund controversial projects such as the UK's Hinkley Point nuclear project, whose proposal has been submitted by the UK government.

However, addressing the strained financial situation of SMEs by distributing roughly one quarter of the EFSI funding to SMEs and mid-caps has been welcomed. But the plan does not provide a strong focus on investments in sectors that can create significantly higher employment. Studies[6] have shown that around half of all newly created jobs are generated in young firms. While the majority of employment is still to be found in older companies, young firms are the only group with a positive net effect on employment. Those young firms that also exhibit a high growth potential (also known as gazelles) contribute to the creation of new jobs even more. Thus, a further focus on gazelles and venture capital, in particular in the periphery, could make the investment plan an active contributor to overcoming high unemployment levels.

While it may be in the Commission's interest to focus on 'shovel-ready' projects that will be quickly implementable so that the plan can deliver results as quickly as possible, the first wave of finance should not exclude those types of projects that need more time to be implemented but are already at an advanced planning stage. Several commentators have even questioned the availability of a sufficient amount of 'shovel-ready' projects with the necessary risk level.

Another question in this regard is whether private investors would invest in projects that were selected by the European Commission based on the required set of criteria, such as European value added and high socio-economic return. Some Workshop participants suggested that these criteria may apply to the selection of public investment, but are irrelevant for private investors. The Juncker Plan's project selection process could also lead to competitive distortions, as the more projects of a private sector nature there are, the more uncertain it becomes whether the Investment Committee is able to select the right projects (Claeys, Sapir, *et al.* 2014).

As for the risks that the plan can cover, the initial EUR 21 billion will be subordinated to private investors debt and will thus serve as a first loss tranche. The Juncker Plan therefore allows the EIB to finance projects that it otherwise couldn't support without threatening its triple-A rating. For the moment, however, it is not clear whether the guarantee will be large enough to absorb all types of losses. EFSI projects need to have higher risk levels than the usual investments funded by the EIB and private investors. Claeys, Sapir, *et al.* (2014) suggest that EFSI should finance very risky projects because it is likely that they will not be financed in the current environment, also because the guarantee would have a larger positive effect for riskier projects. Others have argued that EFSI will not be able to shoulder enough risk. Very high-risk projects would need to be funded by the public sector instead.

Success or limited impact?

Strengthening the Single Market – the third pillar of the Juncker Plan – has so far received less attention than the other two pillars. This is probably due to the fact that this agenda is not something fundamentally new. In all fairness, the European Commission seems to be aware of some of the Juncker Plan's limitations. 'The Investment Plan will not solve all our economic problems. It will not change the whole world. But if implemented efficiently, it will change Europe in a very permanent and positive direction,' Vice-President Katainen emphasised in January (Vincenti 2015). It remains to be seen if such a limited impact will apply to the Single Market pillar. There is a risk that the actions undertaken under this third pillar become one of the many endeavours of the last years to 'complete' the Single Market.

Should this limited impact materialise, the immense amount of time and energy that this plan has already and – once EFSI will be fully operational – will have absorbed, could eventually lead to loosing valuable time for overcoming the recession. Rather than providing momentum for further actions, the plan could lead to stagnation. In this regard, some commentators have argued that the creation of entirely new institutions such as EFSI is not necessary. Holland (2014) for instance stresses that the EIB could instead, in cooperation with the European Investment Fund, finance a large amount of projects that already have planning approval.

How to deliver stronger public investment?

One of the strongest criticisms expressed towards the plan has been the fact that it does not address the shortage in public investment but only improves the conditions for private investment. In this regard, some Workshop participants have stressed that an increase in public investment can only be part of national spending and may be very difficult to be carried out at the European level, given the fewer European public goods that could be invested in and the expected political resistance. Rather than granting some form of flexibility for, at the moment rather unlikely, large national contributions to EFSI, public investment, particularly including social investment such as in education, could be granted some form of budget flexibility within the Stability and Growth Pact. Given the low interest rates and the fiscal space that some Member States have, funding public goods through low-interest debt may be a more viable solution for fostering a European recovery.

The quickest and legislatively least complicated solution would be, for those Member States that have room for manoeuvre, to agree on investing more strongly in national public goods such as education, health or infrastructure. This would provide a boost to internal demand and could in turn help more fiscally restrained countries in raising their internal demand without waiting for lengthy implementation processes, such as for the establishment of EFSI. The degree to which these positive spill-overs would materialise may, however, be debatable. Some Workshop participants argued that investing in public goods in one Member State will not have a significant beneficial impact on other countries' growth. Therefore, European solutions for higher public investment would also be needed.

However, despite lacklustre growth and the apparent investment gap in the euro area, including in countries like Germany, there seems to be little prospect of this type of ad-hoc stimulus being generated. The strong focus of Chancellor Merkel's government on keeping budgets in balance – celebrating the historic achievement of the 'black zero' in the current recessionary circumstances – renders such a solution unlikely. In this regard, it seems paradoxical that despite record low interest rates Member States will not, cannot or are not granted to make use of cheap financing for public investment.

Flexibility and Golden Rule

Contrary to ad-hoc stimulus, there have been requests by many to adjust European economic governance rules to allow for more flexibility (see e.g. Schneider *et al.* 2014). One way would be to upgrade the importance of public investment in the European Semester. Additional deficit granted for investment could be attached to certain Country-Specific Recommendations. This type of provision would also strengthen the European Semester process, which has been criticised for having too little impact on Member States' policy.

Member States would then have an incentive to not reduce public investment spending in order to reach the SGP's deficit goals. This practice has been very common among European governments during the crisis despite various studies highlighting the detrimental effects on growth. Cournède *et al.* (2014) show that attempting fiscal consolidation through compression of public investments is a rather bad idea. Within 17 categories, the authors rank public investment among one of the worst choices for fiscal consolidation, with only spending on health services in kind, social security contributions, childcare and family, and education being even more inimical to economic growth. From a growth perspective, fiscal consolidation would instead be better achieved by cutting spending on subsidies and pensions or increasing property taxes. At an EPC Policy Dialogue on 24 February 2015 OECD Chief Economist Catherine L. Mann explained why governments opt for cutting public investments despite these findings: since public investment concerns no particularly strong interest group it is therefore an easy candidate for budget cuts.

Another idea about budget flexibility is the formulation of a new Golden Rule for productive public investment becoming part of the Stability and Growth Pact's application. Some Workshop participants considered that such a Golden Rule would grant countries more leeway to counter the crisis. Regarding specific proposals, Maystadt (2014) would define such a rule for countries that are subject to the deficit reduction rule, *i.e.* Member States that exceed the 60% debt to GDP ratio. The former EIB President further specifies three criteria that would need to be fulfilled to qualify for this form of flexibility: Firstly, eligible projects should be in the European interest. This may be interpreted as a way to ensure that the cross-border impact of investment projects is maximised and to create some form of area-wide stimulus. Secondly, Maystadt (2014) would include a criterion for profitability, *i.e.* to fix a minimum amount of economic return. However, if this economic return criterion also contains some requirement for including social investment, such as in education and health, this would require some European framework for measuring these social returns of public investment, something that the EPC has called for in the past (see e.g. Schneider *et al.* 2014).[7] Thirdly, in contrast to the Juncker Plan, a criterion of some form of sustainability should be specified.

A sort of Golden Rule for investment could take other shapes as well. Some have argued that additional investment between, for instance, 1/2% and 1% could be granted as additional deficit. While this ruling would allow Member States to dedicate more revenue towards public investment, a simple addition to the deficit threshold without any further rules would effectively lead to an increase of the 3% deficit criterion. Then Member States could just shift their expenditure without dedicating more funding to public investment. This form of discussion would then lead to a very different discussion, namely the one on softening the Stability and Growth Pact.

Some Workshop participants proposed to reduce the deficit criterion from say 3 to 2.4%, and allow for an additional 0.6% for investment spending. Such a provision would prevent a simple increase of the deficit criterion but would of course effectively decrease budget flexibility. The benefit in comparison to the current rules would be that Member States gain an incentive to either maintain or redistribute their budget priorities to more growth inducing spending, similar to the proposal to integrate public investment into the European Semester.

More flexibility in whatever form will, however, come at a price. Since the crisis, the underlying political bargain of solidarity within the eurozone always entailed some form of conditionality to comply with structural reforms and fiscal consolidation. As the Greek case shows, compliance with this trade-off has so far been mixed. For this reason, some Workshop participants emphasised that the proposal for contractual arrangements could be revived, *i.e.* some form of financial support in exchange for (investment-enhancing) structural reform.[8] However, as we have argued in the past, for instance in Schneider *et al.* (2014), this form of enforcing conditionality could be unpopular if it is seen as a way of exerting control from the centre. Furthermore the process could easily become too bureaucratic with little real impact on economic growth, also because finding the right scale of projects may be difficult.

From an entirely different perspective on flexibility, some experts argue that there are already higher deficits granted. According to the recent European Commission (2015c) Winter Forecast, the French deficit for both 2015 and 2016 is expected to be 4.1% and so well above the 3% threshold. Some Workshop participants argued that this shows the Fiscal Compact and the rule of balanced budgets is already handled more flexibly. More fiscally resolute countries thus seem to show a silent tolerance to accept higher deficits in other countries. As long as these countries do not receive any form of fiscal transfers from the community, such as through the European Stability Mechanism (ESM), no real objection is raised. From this viewpoint, changes in the euro area's economic governance structure are therefore less necessary. It is, however, questionable if this larger fiscal space will also result in higher investment.

The euro area's fundamental political economy problem and how this is preventing higher investment

Whatever form flexibility would take, pursuing one of the above proposals would certainly be a change from the current prevailing economic strategy. The German government has been severely criticised by many across Europe for its strong position on fiscal consolidation, thereby neglecting the euro area's demand problem, including the (public) investment gap. Despite the perceived large discrepancy between austerity proponents and those demanding more economic stimulus, these positions might be balanced out if there was not a large trust issue among EU Member States. Countries like Germany, the Netherlands or Finland do not have enough faith in Italy's, France's or the periphery's ability to reform. In the latter group, there is even mistrust amongst each other. This fundamental political economy problem has so far been a strong impediment towards achieving a proper recovery.

So far the German governments, *i.e.* the last three Merkel cabinets, have only done what was absolutely necessary and unavoidable to save the euro – the bare minimum to prevent immediate disintegration. Chancellor Merkel's strategy of 'muddling through' can either be regarded as visionless or just as a reflection of a fundamental German dilemma: without sufficient trust in the capability and willingness of other euro countries to engage in reforms and to create better conditions for potential growth, there is no basis for granting more fiscal stimulus by, for instance, agreeing to create higher flexibility in the rules, which could lead to higher levels of public investment.

There is no perfect recipe but some form of conditionality could be a solution. But the most powerful impulse would probably be a better-coordinated approach between France and Italy to credibly signal their commitment to economic reform. This could stimulate the more fiscally resolute countries to be more lenient with regards to respecting the Stability and Growth Pact, or even in providing further support, for example through a Fiscal Capacity. Even though opinions may differ substantively on the necessity of structural reform – after all, Germany's track record of labour market rigidities and red tape in service markets is high – this is what Germany would need in order to feel comfortable in providing more fiscal stimulus.

The Financial Transaction Tax (FTT)[9]

Other than relying on a larger amount of flexibility in the rules, the Financial Transaction Tax (FTT) could be a way to generate substantial revenues that could be used for increasing public investment. After the breakdown of negotiations in December 2014, the prospect for realising an FTT were improved in January 2015 when negotiations between the eleven participating Member States were revived and the launch date (1 January 2016) finally decided.

However, many questions remain. The European Commission initially proposed to levy a tax of 0.1% on the exchange of bonds and shares. Derivative transactions were supposed to be taxed at 0.01%. Especially the proposition to tax derivatives was subject to intense debate between several participating countries. While being generally in favour of a European FTT, the French government has been reluctant to accept the taxation of all types of derivatives in order to protect the interest of large French banks. It is still unclear what the final taxable base of the FTT will be. Furthermore, there is still no clear agreement on the level of tax rates and the final use of the revenues.

Regarding the usage of revenues Majocchi (2014) suggests that rather than distributing FTT revenues to the participating Member States, these could go towards a European Fund for Growth and Employment. This could be a way to provide substantial funding for investment in European public goods.

A Fiscal Capacity

The proposals presented so far will not be sufficient to create a genuine Economic and Monetary Union (EMU). The current system of fiscal policy coordination, which was set out under the Maastricht Treaty, is not adequate to deal with large regional economic shocks. The Fiscal Capacity, as outlined in the Four-President-Report 'Towards a genuine economic and monetary union', which was led by former European Council President Herman Van Rompuy (2012), could be a way to improve EMU in the medium term. From the debate on the Fiscal Capacity several variations emerged; some of them could make a real difference in providing necessary funding to maintain productive public investment, even in times of deep recessions.[10]

One part of the debate concerns the creation of a European unemployment insurance that could for instance ensure a minimum amount of protection in case of severe economic shocks. If such insurance would have been in place before the onset of the euro area crisis it could have cushioned the severe social implications that emerged from high unemployment in Europe's stressed economies. Establishing such a form of fiscal risk sharing in the EU is, however, rather difficult due the to large differences in national labour markets; so there would need to be some form of harmonisation. Furthermore, the macroeconomic scale that such insurance could achieve would be limited and the effect on mitigating regional shocks may be rather weak.[11] Moreover, for the purpose of maintaining public investment in times of crisis, other types of Fiscal Capacities are necessary.

Probably the best way to remedy insufficient fiscal responses in the face of regional fiscal shocks as observed in the European periphery would be to set up some type of macroeconomic insurance mechanism. This could help to maintain productive public investment and other essential spending in deep recessions. Such a scheme could rely on a measure of the business cycle, such as output gaps. Through this measure participating Member States' payments to and contributions from the insurance mechanism could be determined.

While this could be an elegant solution to account for insufficient fiscal responses in times of crisis, operating such a mechanism in practice could be very difficult. The calculation of the output gap is subject to many uncertainties and estimates vary substantively dependant on the chosen estimation methodology, of which there are many. Furthermore, historical revision of national account data, which provide inputs for calculating output gaps, can significantly change estimates retrospectively. These uncertainties would then make calculating contributions to such a scheme difficult, especially in real-time and even more so for forecasting them.

One important characteristic for such a mechanism – especially important for its political feasibility – would be the adherence to address cyclical variations only. The insurance scheme should thus not result in unidirectional or permanent transfers between Member States. In practice this would mean that transfers exchanged via the mechanism would balance over the medium term. If we take Germany as an example, the scheme would have resulted in transfers to the German federal budget in the recession years in the early 2000s and to positive support payments during the heights of the sovereign debt crisis. Enderlein *et al.* (2013) show that Germany's net transfers to such a scheme could well have been close to zero during the period 1999-2014.

This type of Fiscal Capacity could therefore be an attractive contribution to improving EMU in the medium term. Such a stability fund would be particularly helpful to provide countries with limited fiscal space to engage in fiscal policy and to also maintain an adequate level of productive public investment. For it to become a reality it would be helpful if output gap estimates could be made more reliable as a policy indicator.

Conclusion

This paper provided an input to the current discussion on how to increase private and public investment in the euro area. Increasing investment is an important component in overcoming low growth and high unemployment in Europe as total investment is still lower than before the crisis and also public investment is well below its pre-crisis peak.

The Juncker Plan is therefore a first positive step towards spurring private investment. The success of the plan will be dependent on whether the Commission can address the reservations that were expressed towards it. These include, among others, the lack in providing substantial additional money, achieving the high leverage ratio of 1:15 or the risk that the plan will only have a limited impact in stressed economies.

Member States and the Commission should also discuss options for increasing productive public investment. In addition to urging countries with fiscal space to increase investment in national public goods, these could entail a form of budget flexibility in the Stability and Growth Pact, including some form of a new Golden Rule or an upgrade of the importance of public investment in the European Semester.

But the current focus on investment also bears a risk. During the Workshop, one participant drew a parallel between today's discussions around investment and those anticipating the Lisbon agenda devised in 2000. Back then, the buzzword used to be 'Innovation'. We know today that innovation wasn't the magic solution to all of Europe's problems. We therefore need to be wary of 'Investment' becoming the new 'Innovation'. Working further towards creating a Fiscal Capacity and on improving the euro area's current economic governance framework are two goals that need to be pursued at the same time.

In this regard, it will be necessary to overcome the mistrust between Member States, which is currently preventing further action. The political bargain of stronger conditionality such as through contractual arrangements could improve the situation. Increased trust will be an important condition for tackling further economic governance reforms such as the Fiscal Capacity.

Jan David Schneider is an Economic Research Assistant at the European Policy Centre (EPC).

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Endnotes

1 Introductory remarks by ECB President Mario Draghi at the European Parliament's Economic and Monetary Affairs Committee on 17 November 2014.
2 For EPC proposals on a New Deal for Europe see for instance Zuleeg & Emmanouilidis (2011) and Zuleeg (2014).
3 See Schneider *et al.* (2014) for a more detailed description of the complementarity of public and private investment.
4 Output gaps describe the difference between actual and potential output. Potential output indicates the highest level of output that can be sustained over the long run. In recessions output gaps are negative as the economy operates below its capacity.
5 The EPC has with its proposal for a European Investment Guarantee Scheme (EIGS) argued for a similar scheme: Using limited public funds, the EIGS could provide a form of public guarantee for private investment. For an overview see e.g. Zuleeg (2013).
6 For an introduction see e.g. Machado & Wilson (2014).
7 In this regard, the EPC is currently carrying out a project on the economic and societal returns on social investment, which is planned to be launched in the second half of 2015.
8 The proposal was for instance set out in the European Commission's (2013) proposal for a Convergence and Competitiveness Instrument (CCI).
9 For an overview of the European Commission's initial proposal for a European FTT see for instance Schneider (2014).
10 For a more detailed overview of the Fiscal Capacity see for instance Schneider *et al.* (2014).
11 For an assessment of a European unemployment insurance see for instance Wolff (2012).

European Policy Centre
14-16 rue du Trône, 1000 Brussels, Belgium
Tel: +32 (0)2 231 03 40 - Fax: +32 (0)2 231 07 04
email: info@epc.eu - twitter: @epc_eu

www.epc.eu

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