One positive effect of the euro crisis is that it has provoked Europe to engage in a profound debate on the form and degree of federalism it needs. Even if, until recently, many would have argued that Europe is not a federal state, the EU already has many elements of such a governance model in place, of which European citizens are hardly aware. Many competences are uniquely attributed to the EU. Legislation in several fields of EU competence can be adopted with a qualified majority of member states. Only in a few areas, such as taxation, is unanimity still required, even after the new Lisbon Treaty has come into effect. The same applies for changes to the EU Treaty itself.

Within the monetary union, it is even more important to establish a clear hierarchy of rules and a division of competences than for the single market. On the monetary policy side, this was well worked out in the Maastricht Treaty. On the fiscal policy side, however, this was less well developed in the Treaty, and was watered down in the 2003 review of the 1997 Stability and Growth Pact (SGP). In addition, member states started to hide behind their sovereignty when rules had to respected, or dealt with the problems too diplomatically, as if the eurozone was an intergovernmental construction. The EU is now engaged not only in updating the rules to improve economic governance in the ‘six-pack’, but it is also addressing broader elements in the ‘Euro-plus pact’ to strengthen economic convergence primarily between the member states of the eurozone.

The big question is whether the new rules are sufficiently comprehensive to ensure that economic and monetary union will be sustainable, and whether they will be well enforced and respected. Furthermore, the debate on the Euro-plus Pact has highlighted that further convergence is necessary, although there is no real agreement as to where this is needed, and where not. Unlike monetary union, economic union has never been clearly defined. The need for enhanced cooperation in the eurozone has also reinforced the old fears of constructing a ‘two-speed’ Europe.

The purpose of this paper is to make an assessment of what has been put on the table in response to the euro crisis – and what more needs to be done. We start with a brief assessment of the measures taken in the ‘six-pack’ and the debate on the Euro-plus Pact. We then discuss some operational elements of the European Stability Mechanism and address the question whether the EU is a transfer union. We conclude by proposing a pragmatic agenda of items on which the EU could advance towards a more federal economic union.

Karel Lannoo is Chief Executive Officer at CEPS. Comments by Cinzia Alcidi, Marco Incerti, Jorge Núñez Ferrer and Jacques Pelkmans are gratefully acknowledged.

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The ‘Six-pack’ and the Euro-plus Pact

With the measures referred to as ‘Six-pack’, the EU proposed to improve European governance, by correcting the weaknesses of the Growth and Stability Pact and broadening the macroeconomic elements of the Maastricht criteria. The package, which is composed of six different measures grouped under three different areas of action, was adopted by the European Parliament and the EU Council under the co-decision procedure. Reactions from member states demonstrated the sensitivity to allocating more powers to the EU in this domain. The question remains whether the rules will be sufficiently comprehensive and properly enforced once they are in place, as this is one of the flaws revealed by the current crisis.

The six different measures consist of the European Semester for strengthened coordination of economic and budgetary policies, a framework for preventing and correcting excessive government deficits (a ‘reinforced’ Stability and Growth Pact) and a framework for preventing and correcting macroeconomic imbalances. The measures are subdivided between the preventive – aimed at preventing a crisis of public finances from happening again – and the corrective – intended to give appropriate incentives to member states to return to the right path. Included amongst the latter are semi-automatic sanctions imposed by the European Commission in instances where the rules are not respected and that can only be cancelled by a decision taken by a qualified majority of member states in the EU Council, the ‘reverse majority’.

The European Commission is assigned a crucial role in the ‘six-pack’ for macroeconomic and fiscal surveillance, which has ruffled feathers in many member states. France and Germany, which were behind the weakening of the Pact in 2003, had strong reservations regarding the automaticity of sanctions. Other states argue that the adoption of national budgets is a unique responsibility of national parliaments, which cannot be overruled by an unelected administration. It is evident, however, that only a closer monitoring of fiscal policies can help to prevent future fiscal crises in the eurozone, and that a central body needs to be clearly appointed in charge and given overriding powers.

In addition to these measures, EU governments have also, at the insistence of Germany, embarked on introducing a broader set of measures aimed at improving the competitiveness of the EU and the eurozone member states. Better monitoring of certain indicators in the different member states should prevent the EU, and in particular the eurozone, from falling into the same situation again. This concern led to the creation in March 2010 of the Van Rompuy Group, named after the President of the European Council, and in March 2011 to the adoption of the Euro-plus Pact by the 17 eurozone member states, and six other non-eurozone states. The outcome of both initiatives, however, indicates that a broader debate about the nature of economic union would be required before agreement on specific detailed measures, as discussed below, can be achieved.

The report of the Van Rompuy Group (published in October 2010) underscored the measures proposed by the European Commission in the ‘six-pack’, such as the preventive and corrective measures, and the automaticity of sanctions. It proposed the use of a limited number of indicators as measures to prevent imbalances between EU member states, and particularly between the eurozone members. The report also stressed the need to make the crisis management framework a permanent feature. But a proposal to institute a Committee of Wise Men to monitor and make recommendations on the state of the European economies was not retained.

The Van Rompuy Group’s recommendations were superseded by the Deauville compromise reached between the heads of state and government of France and Germany meeting the same day as the report was published. In return for delaying the automaticity of warnings and sanctions, France agreed with Germany for a revision of the EU Treaty’s ‘no bail-out’ clause, and the creation of a permanent crisis management mechanism with the participation of the private sector. The compromise showed that, above all, the larger member states object to a more federal nature of the EU. In its readings of the ‘six-pack’, however, the European Parliament insisted on the automaticity of sanctions, requested a permanent economic dialogue with the finance ministers and demanded increased powers for the European Commission in...
gathering information. It should be recalled that the Parliament had no role at all under the 1997 SGP, a ‘federal’ anomaly, but that its role in the initial Commission proposals to improve economic governance was also very limited.\(^2\)

The federal nature of the economic governance package continued to be critical. In early 2011, the German government proposed the adoption of a ‘Competitiveness Pact’ in return for its support to the extension of the firepower of the European Financial Stability Facility (see below). Three quantifiable indicators would function as benchmarks to judge the competitiveness of eurozone member states, and states would begin work on a series of six measures to enhance competitiveness in the areas of labour markets, tax and fiscal policy. These measures include the abolishment of automatic wage indexation, the mutual recognition of diplomas, a harmonised corporate tax base and the introduction of national bank resolution regimes. Some of these measures are pure single market matters, however, and should in fact apply to the EU as a whole (see the table in the Annex).

The ‘Euro-plus Pact’, as it was later denominated, was signed on March 11th by the 17 eurozone and six other non-eurozone member states. However, it would have been preferable if the list of measures had resulted from an open debate on the rationale of economic union, and what initiatives could be better coordinated at EU rather than at national level. Instead, the measures came as a result of the explicit demand by one member state, and on the basis of a flawed concept of what constitutes ‘competitiveness’. The idea behind the Pact is that higher productivity leads to higher competitiveness, which is not always supported in reality (see Gros, 2011). The actual system of economic governance that is emerging thus consists of debtor countries being obliged to accept prescriptions on fiscal policy and structural reforms imposed by creditor countries, which are free to conduct their economic policy without any meaningful interference.\(^3\) In addition, the gap between the eurozone and non-eurozone countries is being widened, even if six non-eurozone member states signed-up to the Pact.

A complete anomaly is that the progress on and compliance with the Euro-plus Pact will be monitored by the Heads of State and Government (HoSG). This directly contradicts the conventional EU structure, in which the European Commission acts as the guardian of the EU Treaties, and underlines the tensions that exist between the Commission and most member states. Moreover, HoSG does not exist as a structure, which immediately raises the question whether the Pact will be monitored at all.

**The European Stability Mechanism**

By its nature, the European Stability Mechanism (ESM) combines both federal and intergovernmental elements. It is federal as it uses the reputation and ratings of the best sovereigns of the EU to borrow in the market and to lend to member states with financing problems. But the decision-making is intergovernmental: every eurozone member state must agree on the scheme and ratify the Treaty change, and decisions to provide loans are also taken by unanimity. In addition, liability to the fund is limited to the amount of each country’s share of the capital.

The ESM was the (provisional) conclusion to more than one year of sovereign crisis in the EU, and should become a €500 billion permanent fund from 2013 onwards. It will take over the functions of the temporary €60 billion Treaty-based European Financial Stability Mechanism Fund (EFSM) and the €440 billion intergovernmental European Financial Stability Facility (EFSF) created in May 2010 to deal with the widening problems in Europe’s southern

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1 On the automaticity of sanctions, the EP compromise foresees that in case the Council does not adopt a Commission recommendation in the first instance, or does not take a vote at all, the Commission shall, after a cooling-off period of one month, again put forward the same decision. This recommendation is adopted automatically, unless within 10 days a majority of the eurozone countries rejects it. The vote of the member state(s) concerned would not count (http://www.europarl.europa.eu/en/headlines/content/20110429FCS18371/html/Economic-governance-package-explained).

2 The EP role in the original Commission proposals for the six-pack of 29 September 2010 was also very limited (http://ec.europa.eu/economy_finance/articles/eu_economic_situation/201009-eu-economic-governance-proposals_en.htm).

3 See editorial by Cinzia Alcidi and Karel Lannoo, “Competitiveness with 17 or 27”, CEPS Newsletter, March 2011.
The European Financial Stability Mechanism (EFSM), created in April 2010 as a temporary financing mechanism of €60 billion loans for Greece, Portugal and Ireland, is based upon an EU Treaty facility to allow financial assistance to a member state in difficulties. Under the EFSM, the borrower is the European Union.

Initially, the EFSF did not allow the fund to directly intervene in secondary bond markets, but this was changed at the Eurozone Council of 21 July 2011. The Council allowed for intervention, but only on the condition that it was undertaken “by mutual agreement of the EFSF/ESM Member States to avoid contagion” (the initial draft of the Euro Council conclusions had even mentioned “unanimous” agreement). This restriction does not augur well, however, for the future of the EFSF, given the disagreements on this subject in the European Central Bank, and the limited size of the fund as compared to the amounts of outstanding debt of the troubled southern European member states and Ireland. Also the ESM will be allowed to buy bonds in the secondary markets.

The Council of 21 July furthermore decided that the EFSF can also participate in bank recapitalisations “to address contagion”. This was confirmed at the 26 October 2011 Eurozone summit meeting, but only as a resort, if private and national funding sources are exhausted. But the full lessons of the 2008 episode with bank rescues will have to be taken into account, as the Council stated, meaning that such recapitalisation will have to be administered at EU level in full compliance with EU state aid rules. This again emphasises the need for the complete integration of the EFSF into the Community structure, which is unclear for the time being.

A transfer union and fiscal federalism

As a result of the large rescue packages for peripheral EU member states, the public debate in some northern member states has characterised the EU as a ‘transfer union’. It is argued that the EU could only continue to exist as a result of large transfers from the north to the south. In reality, however, such transfers have only occurred so far in the context of the EU budget (structural and cohesion funds), and, in the sphere of the euro-crisis, are loans to troubled states, albeit at preferential rates. The transfer would only materialise in the event of non-repayment.

From a fiscal point of view, the EU today is still far cry from a genuine federal construction. While, in the sense of fiscal federalism, redistribution takes place at the EU level, it only concerns a very limited part of total public spending. The EU budget represents less than 1% of the EU’s GDP, compared to about 20% in the US. Moreover, around 40% is spent on the Common Agricultural Policy and rural development, with direct payments to farmers accounting for approximately 80% of the costs. There is really no plausible rationale for this policy under the theory of fiscal federalism, i.e. that it can be done better at EU than at the local level. The other large chunk of spending, under regional and structural programmes, could be considered as genuinely federal. However, many

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4 The European Financial Stability Mechanism (EFSM), created in April 2010 as a temporary financing mechanism of €60 billion loans for Greece, Portugal and Ireland, is based upon an EU Treaty facility to allow financial assistance to a member state in difficulties. Under the EFSM, the borrower is the European Union.

5 Term Sheet on the European Stability Mechanism, 21 March 2011.

6 Statement by the Heads of State or Government of the euro area and EU institutions, EU Council, 21 July 2011, p. 3.

7 “The ESM can purchase the bonds of a Member State, which is experiencing severe financing problems, on the primary market, with the objective of maximizing the cost efficiency of the support. Conditions and modalities under which bond purchasing would be conducted will be specified in the Decision on the terms and conditions of financial assistance.” The latter provision implies that this should also be decided upon by mutual agreement. See Term Sheet on the European Stability Mechanism, 21 March 2011.
other forms of spending could, in a ‘federal’ sense, be better assigned at the EU level, as they could be more efficiently allocated. This is for example the case for spending on research and development, cross-border infrastructures, external actions, defence or elements of industrial policy. The EU has a large R&D programme, the Framework Programme for Research, but again, this fund represents only about 7% of national spending on R&D. For the other areas, the budget offers some support, but they are very limited in comparison to national expenditures or the real needs for an efficient policy.

Hence, to label the EU as a ‘transfer union’ is a complete misnomer in the current circumstances. What could usefully be done however at this time, as also with a debate on economic union, would be to engage the EU member states in a healthy exploration of fiscal federalism, i.e. whether and how to establish a normative framework for the assignment of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions. This could demonstrate, in the context of the huge current budgetary constraints for governments and the upcoming EU financial perspectives 2014-2021, that efficiency gains could be realised by allocating expenditure differently in the EU.

But expenditure also means resources. The EU budget is not very federal in its sources either. The largest part of the EU budget is limited to a small share of the gross national income (maximum 1.04%) of the member states, and increasingly comes from direct contributions from the member states (accounting for about 60% of the EU budget). The EU has recently launched a debate for one or more new own resources, but it is very unlikely that the member states will be willing to open a discussion on the subject. Recent EU budget discussions have proven to be very acrimonious, with insistence by some parties on numerous exceptions, which makes it almost impossible to work out who gets what (see Haug et al., 2011). Current budgetary constraints make it doubtful that big changes will be made in the next round of the EU financial perspectives expected to start in 2012. And the limited importance of own resources gives the EU member states easy leverage over the European Commission. An example of a possible new own resource for the EU budget, following the financial crisis, is a bank tax, or possibly a financial transaction tax, but this would disproportionately come from member states with large financial sectors, and thus seems difficult to implement in practice.9

A pragmatic agenda

Given the political sensitivities surrounding ‘more Europe’ at this stage and for the foreseeable future, the EU will have to extract the most it can out of the available federal instruments and institutions.

A broad role for the ECB and bank recapitalisation through the EFSF

Since the beginning of the financial crisis, the ECB has lowered its criteria for liquidity-providing operations to the financial sector, and with the start of the sovereign crisis, also started to directly buy government bonds in the markets. In so doing, the ECB has expanded its mandate from the maintenance of price stability to broader financial stability considerations. The purchase of bonds, however, has not been a consensual decision by the ECB, as evidenced most clearly by the recent departure of Jurgen Stark from its board.

The ECB was initially characterised as a central bank with a narrow mandate, i.e. the maintenance of price stability. The financial crisis, however, has shown that a central bank that myopically focuses on price stability may actually fuel asset price bubbles through a process of excessive credit creation, as was the case in the run-up to the crisis in several eurozone member states, but also in the US. A trade-off may thus exist between price stability and financial stability, which requires a central bank to also monitor the evolution of credit expansion and asset prices (De Grauwe & Gros, 2009). How financial stability is defined and what this means for the operational framework of the ECB remain open questions, however. In general terms, a

9 The European Commission proposed a transaction tax on 28 September 2011, but it is very unlikely that this will be approved by all the member states, and may thus be approved as ‘enhanced cooperation’, which will make it even less effective.
broadening of the mandate would require the identification of monetary tools (other than the interest rate) to be used in order to avoid excessive credit creation, as well as a closer involvement of the ECB in financial supervision. The latter has already taken place with the creation of the European Systemic Risk Board within the ECB.

Pro-active intervention of the ECB in capital markets, however, meets fundamental opposition in some circles and member states, particularly in Germany. It has been argued that this exceeds the mandate of the ECB, reduces the disciplinary mechanism of capital markets and fuels inflation. Prominent German policy-makers, including the Head of State Christian Wulff and Bundesbank President Jens Weidmann, have openly voiced this view.10 Weidmann has also stated that the democratic and accountability framework would not justify such initiatives. Others have argued that the ‘runs’ on the sovereign debt can only be countered in this way, as, within a monetary union, member states do not dispose of the means to stop such dynamics, or prevent the movement of funds to other countries.11 The open disagreements about bond purchases, however, have a very damaging impact on the markets.

A European form of a Troubled Asset Relief Programme (TARP), as implemented in the US in 2008 in response to the financial crisis, has been suggested by some.12 Through a euro-TARP, banks with low levels of capitalisation and/or large exposures to distressed sovereigns could be refinanced by the EFSF. In return, banks would have to maintain their credit lines and loan portfolios, while a central supervisory entity would closely monitor bank risks. It has been proposed that banks will need to finance the governments concerned at the ECB’s discount rate until the market stabilises. Assisted banks will also have to respect conditions imposed by the EU’s state aid authorities regarding the non-discriminatory and temporary nature of aid and the need for adequate remuneration. The decision of October 26th, however took a very distorted picture of the capital needs of the banking sector in using a risk-weighted assets capital ratio (Tier 1), with limited adjustments for sovereign exposures (see Lannoo, 2011b). This again benefitted the banks of the two largest eurozone member states.

**Strict application of the new six-pack rules**

The implementation of the new SGP will need to be vigorously monitored. Much goodwill has been lost by the EU as monitor of the pact over the last two years, and it will take huge efforts to regain it. The slightest infringement of the new rules will require immediate action. The EU Commissioner in charge will need to be capable of taking a strong position as soon as a problem becomes apparent, without having to wait for an EU Council decision on the subject.

Given the doubts about the legitimacy of the centre to exercise control over largely local fiscal powers, the European Parliament should also play a stronger role in this domain, in much the same way it does vis-à-vis the ‘Six-pack’. The EP specifically proposed the possibility to demand testimonies from national finance ministers. In addition, an elected official of the eurozone should bear political responsibility for enforcing the Pact, which could be performed by a national finance minister or a politician appointed by and accountable to the European Parliament. S/he could be a Vice-President of the European Commission, and chair the Ecofin meetings, in the same way that the High Representative chairs the Foreign Affairs Councils. This would be a better solution than a Eurozone Council President, as proposed by the October 2011 European Council.

**Full means for new supervisory authorities**

In response to the problems revealed in adequately supervising the financial sector, the EU made substantial changes in the supervisory structure through the creation of European supervisory authorities (ESAs). These new entities can be considered as embryonic federal supervisory authorities, as they have effectively been attributed powers that were revealed to be lacking and that can better be executed at European level. These include EU-wide collection and exchange of supervisory information, mediation between national supervisors and formal delegation of tasks, and the monitoring of

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10 See for example the remarks of Jens Weidmann, as quoted in the Frankfurter Allgemeine, 19 September 2011.
national supervisory authorities. The ESAs can take decisions on individual cases in exceptional circumstances in emergency situations and carry out some unique supervisory tasks, which at present are most developed for the European Securities and Markets Authority (ESMA) (see Lannoo, 2011c).

It is widely agreed, however, that the ESAs’ current resources are not sufficient for these tasks, a problem that should be addressed rapidly if the EU wants these authorities to live up to the expectations. The tasks are huge, and doubts are growing as a result of, for example, the delays with the licensing of rating agents by ESMA, the quality of the second stress test carried out by EBA and the reluctance of national supervisory authorities to let the ESAs grow into their new roles. The European Commission and national supervisory authorities should therefore urgently second temporary experts to the ESAs, and intervene as necessary when tensions arise between national and EU authorities.

An EU-wide deposit guarantee and bank resolution fund

An EU-wide deposit insurance and bank resolution fund should be established as soon as possible to assist banks in trouble. Unfortunately, the planned amendments to the deposit guarantee schemes Directive have removed crucial elements of the Commission’s proposal that would have allowed for some form of co-financing between schemes. These developments are not particularly encouraging for the prospects of a possible EU-wide bank resolution scheme, on which a proposal is expected before the end of this year.

Harmonisation of deposit guarantee schemes in the EU was first covered by a 1994 EU Directive. Amendments in 2008 brought the minimum level of protection to €100,000, but left further harmonisation to be addressed at a later stage. The July 2010 Commission draft proposed 1) faster pay-out, 2) minimum ex-ante funding, 3) better spending and 4) mutual borrowing amongst different schemes. Discussions in the context of the first reading have regretfully indicated that member states and the European Parliament do not agree on more EU-wide harmonisation in this domain, which would have eliminated many of the distortions among the member states. Both institutions scrapped the possibility of borrowing between schemes, which would have been a first step towards an EU-wide scheme. Also the use of the fund for other purposes than depositor protection appears to have been rejected.

It should be recalled that in September 2008 the Dutch Ministry of Finance initiated a proposal for a European bail-out fund, and informally discussed this with the French Ministry of Finance. The proposal, however, was firmly rejected by the German government ahead of the G-4 Elysée Summit of 4 October 2008. EU governments preferred to resort to large national bail-out programmes, the consequences of which are still being felt today. Through the European Financial Stability Facility and the decision of the October 26th Council, the EU now has the structure in place for a truly European support fund for the banking sector, which it did not have in 2008. It should put this into motion as soon as possible, taking into account the lessons from the 2008 crisis and applying EU state aid rules. A eurozone recapitalisation fund would be much more effective in limiting distortions to the functioning of the single market, compared to the current arrangement of ad hoc guarantees and support mechanisms. These funds should be conditional on the introduction of structural reforms, as well as temporary and remunerated.

In addition to a European TARP, a eurozone-wide deposit-guarantee scheme should also be created. All banks in the eurozone would be obliged to participate in a pre-funded scheme and to pay a premium based on their retail deposit base. Such a fund could, over time, be merged with a European TARP to become a market-funded, EU-wide bank resolution scheme.

Completing the Single Market and furthering the debate on economic union

The European Commission is committed to complete the single market, further to the Monti report (see Monti, 2010). The report lists 12 priority areas comprising some 50 different proposals, to foster growth and employment. It covers the digital single market, intellectual property, public procurement, corporate taxation, labour mobility and some measures that were also raised in the Euro-plus Pact. This should bring the EU a step closer to an economic union,
although the debate on the Single Market Act has not been phrased in this sense. In addition, the overlap with some Euro-plus Pact items is confusing and left unexplained.

A full economic union, however, is much more than the Single Market Act. An economic union would imply further integration of labour markets and a harmonisation of pension systems, an EU industrial policy and an integrated market for professional services and a much higher degree of harmonisation of direct and indirect taxes. It would be useful for the EU to stimulate a healthy debate on economic union beyond the single market, if only to alert citizens to how much remains to be done, or to how un-integrated the EU still is.

Conclusion

The EU, and even more the monetary union, can only continue to exist if it functions as a federal union, with a clear hierarchy of rules. The sovereign debt crisis has been caused by a multiplicity of causes, but too much sovereignty and too little federalism presented insurmountable obstacles to finding a swift and effective solution when it first erupted and before it became a systemic crisis of the union. The solutions proposed to date reinforce the federal part somewhat, but there is still too much sovereignty and power-politics. In addition, there are overlaps between the rules applying to the eurozone and to the EU as a whole, which is very confusing.

As circumstances do not allow for more far-reaching reforms at this stage, European policymakers will need to extract the maximum out of the available federal instruments and institutions. At the same time, the EU institutions will need to streamline the rules and clarify the priorities. The European Commission will need to be extremely vigilant in observing the revamped Growth and Stability Pact to regain confidence amongst the member states and EU citizens. The Parliament will need to demonstrate that accountability effectively exists at EU level, and that economic governance is not in the hands of an unaccountable administration. The ECB needs to take a broad interpretation of its mandate to ensure not only price stability, but also financial stability, in cooperation with the EFSF.

Encouraging eurozone member states to continue harbouring the illusion of state sovereignty does not help to overcome the current crisis. The statement contained in the October European Council conclusions that member states will honour “their own individual sovereign signatures” allows member states to take monetary union hostage to national ‘sovereignty’. This indeed almost happened with the aborted proposal to hold a public referendum in Greece. The sooner it is acknowledged that the nation state can no longer exercise monetary sovereignty within EMU, the better.

References


Annex: Economic convergence proposals compared

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| Monitoring                                 | Heads of State and Government                                                  | European Commission                                                              |                                                                                  |