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How to strengthen the European Semester?

Cinzia Alcidi and Daniel Gros

Abstract

The emphasis of the European Semester should shift from economic policy coordination – intended as the process through which member states commit to common rules and recommendations adopted by the Council of the European Union under the surveillance of the European Commission – to a stronger national ownership. Coordination of national policies may be essential at times of crisis, when cross-country spillover effects tend to be large, but it may not be very effective when economic conditions return to normal, as spillovers tend to be small and the incentives for governments to coordinate are diminished. Stronger national ownership should lead to better enforcement of commonly agreed rules, regardless of economic conditions and remove the perception that rules are hierarchically imposed. National ownership could be improved by involving the national fiscal councils and the national productivity boards explicitly in the elaboration of EU recommendations for national governments. This should be done without increasing the complexity of an already complicated EU governance system of governance or damaging their reputation as independent bodies.

Reforms aimed at improving the structural functioning of EU's economies are of critical importance for member states, yet the reasons why specific reforms should be embedded in the Semester are not always clear. Moreover, strengthening the Semester by further linking the EU budget to reforms undertaken in the member states is fine in theory but very difficult to implement in practice. Reforms cannot be 'bought' as such and it would be extremely difficult to measure the implementation of so-called country-specific recommendations (CSRs) with sufficient precision to make implementation a condition for funds.

The primary role of the Commission should remain to foster coordination in case of economic crisis and to provide technical support for reforms when needed.

Keywords: European semester, Policy coordination, Reforms

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Executive Summary

- Established in 2010, as part of the European Union's economic governance framework, the European Semester is a cycle of economic and fiscal policy coordination within the EU. During the European Semester, member states align their budgetary and economic policies with the objectives and rules agreed at the EU level. The first European Semester cycle took place in 2011.

- Having assessed the governments' plans, the European Commission presents each member state with a set of country-specific recommendations (CSRs), along with an overarching Communication. The recommendations focus on what can realistically be achieved over the next 12-18 months. The recommendations adapt priorities identified at EU level (in the Commission's Annual Growth Survey) to the national level. They do the same for the euro area.

- The European Semester was created in response to the crisis and had the notable purpose of strengthening economic policy coordination and surveillance of member states' fiscal and economic policies to prevent unsustainable policies. Over time, however, some of the policy tools used as part of the Semester have been expanded, without close attention being paid to why some policies that are national in character need to be monitored and coordinated at European level.

- During the acute financial crisis, the surveillance and coordination of economic policies were necessary as the spillover effects were large and in some cases the CSRs did have a decided impact. The incentive for coordination diminishes, however, as financial market tensions diminish, the economy recovers and spillovers become smaller.

- Beyond spillover effects, which in practice depend on the state of the economy and are often difficult to determine in size or even sign, the main argument to coordinate budgetary policies remains the single monetary policy. This makes surveillance of fiscal policies, to ensure sound fiscal positions, a key objective of the Semester. Experience has shown, however, that beyond times of crisis, this argument has not been sufficient to prevent unsustainable national economic policies.

- Looking forward, presenting the European Semester as essential for growth and convergence may turn out to be misleading and even undesirable if expectations cannot be met. CSRs, which are the main output of the Semester, have experienced declining implementation since the crisis has waned, even if the focus has shifted away from fiscal measures. The Semester mostly has an impact on smaller member states whose political bodies are genuinely interested in improving the economic performance of the country. Political bodies in larger member states are often too self-centred to take any external advice.

- The creation of national fiscal councils and (national) productivity boards constitute an implicit recognition of this problem. Their main purpose is to foster national ownership of sound policies, outside the political cycle. In principle, it would make sense to involve these national institutions in the European Semester process, so that the CSRs are jointly elaborated and endorsed by them. This change is already happening. There is a risk, however, that in the end the whole process is driven by national actors, but given the complex framework of the Semester, that the CSRs are still perceived as being imposed by the EU. This would not help enforcement. Moreover, it is important that such institutions are fully perceived as independent – not only of the government but also of the institutions at EU level.

- Formulating recommendations on structural policies and taking a multiannual approach make sense, as structural weaknesses in some member states constitute a fundamental problem for the sustainability of the Union as a whole. But these should be driven by national productivity boards and require policy coordination across member states.

- The EU can contribute to improving the structural features of member states by providing the necessary technical support to design and carry out reforms, following the same logic as the recently created 'structural reform support service'.

  - Specific links between the use of the EU budget and national reforms already exist in the form of *ex-ante* conditionality applied to EU-funded investments. Taking this approach further may be attractive at first sight, but both the principle and the implementation raise fundamental issues. It is very difficult in practice to assign a price to reforms and assess their implementation. In addition, if all countries require reforms, all countries should be the beneficiaries, not only those lagging behind. The latter is at odds with the fundamental principles of the EU budget for dealing with common challenges and fostering cohesion and convergence.

How to strengthen the European Semester?

Cinzia Alcidi and Daniel Gros

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1. Introduction

Introduced in 2010, in response to the debt crisis in the euro area, the European Semester sets the timeline for EU member countries to coordinate their economic policies throughout the year and address economic challenges. In this context, economic policy coordination is intended as the process by which member states commit to abide by common rules and guidance adopted by the member states in the Council of the European Union, under the surveillance of the European Commission. The Commission undertakes an analysis of the budget plans, macroeconomic conditions and structural reforms of member states[1] and provides guidance to them by issuing country specific recommendations (CSRs), which are the main output of the Semester. This process reflects a much wider concept of coordination than the one associated with the notion of fiscal stance, which has only been introduced recently.

Despite its short history, the European Semester has already been subject to change, both in terms of process and content, and more is yet to come. Indeed, the reflection paper on deepening the Economic and Monetary Union (EMU) published by the European Commission (2017) in May 2017, puts considerable emphasis on the European Semester as a key tool for policy coordination. In particular, the paper suggests that the Semester could be further reinforced by fostering cooperation and dialogue among member states at different levels to ensure stronger domestic ownership and to encourage a better implementation of reforms. In this framework, a closer link between the yearly process of the European Semester and a more multi-annual approach to reforms should also be envisaged. This should help to gauge divergences as well as to identify means to ensure proper re-convergence.

The strong emphasis on structural features and reforms is a new feature of the Semester, although supporting structural reforms to create jobs and growth has been one of the explicit objectives of the Semester since its inception.[2] Yet when it first introduced and during the early years of the crisis, the focus was almost exclusively on ensuring sound public finances. It should not be forgotten that the Semester was introduced at the same time as the Macroeconomic Imbalances Procedure (MIP) and the revised version of the Stability and Growth Pact (SGP), in the wake of the euro area crisis that started in Greece. At that point, building a framework to prevent large fiscal and other macroeconomic imbalances was a political priority and one that was considered as an economic necessity to rebuild market confidence.

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[1] In this framework, the Commission also monitors countries' progress towards the 'Europe 2020' targets.

[2] For more information on the European Semester, see https://ec.europa.eu/info/strategy/european-semester/framework/european-semester-why-and-how_en

In its original design, the Semester was a real semester, i.e. a six-month coordination cycle, ranging from March to September of each year, the period that corresponds to the preparatory phase of budget law in most countries. This was very much in line with the idea of a mechanism to coordinate, budgetary policies *ex-ante*.

Over time, as the pressure from financial markets started to abate and in light of the criticism of the austerity imposed by Brussels, often through the SGP (i.e. the activation of the excessive deficit procedure, under the corrective arm, and CSRs centred on fiscal consolidation objectives, in the preventive arm), the attention of the Semester gradually shifted to the more general issue of how to make economies more flexible and productive. As a result, the focus of the CSRs followed a similar pattern.

In 2015, the European Commission decided to streamline the functioning of the Semester. To this end, the length of the semester cycle has been extended by six months, making it a full one-year process, starting in November, with the Commission's annual growth survey, and ending in October of the following year, with the submission of the draft budgetary plans.[3] The purpose of this change was to give national governments more time to involve national parliaments, social partners and other stakeholders in the discussion of the policy measures to be included in the national budgets. The (additional) six-month period - after the publication of the CSRs, in June - is often called the national semester. This change aimed to make the process less top-down and to encourage interaction between the Commission and the member states to increase national ownership of the policies set out in the Semester and, ultimately, the legitimacy of the process. The changes introduced in 2015 also included other aspects. First, the number of CSRs was drastically reduced (see section 2), focusing on more targeted, integrated recommendations, i.e. embedding several related aspects in the same recommendation. For instance, social considerations and objectives, which are now more prominent, are mainstreamed into recommendations that are often formally focused on other issues, such as labour market policy and education. Second, the Annual Growth Survey now also contains a range of social and employment indicators. Third, CSRs were also introduced - for the whole euro area.

The European Semester Spring package 2017, consistent with the Reflection paper, hints at another future change: an increased emphasis on the multiannual dimension of the recommendations**.** The need for a multiannual perspective in the assessment of the implementation of CSRs seems justified in order to provide a clearer picture of the progress made with recommendations adopted earlier. A longer timeframe should allow for the fact that, especially in the case of reforms, implementation takes time, often more than one year, and cannot be fully monitored in a single-year perspective.

[3] In this new setting, two key documents – the reports prepared as part of the MIP and the working documents supporting the CSRs – are merged into single country reports, which are released about three months earlier than before.

This gradual extension of the Semester's time horizon from six months to one year, to potentially a multiannual framework, mirrors changes in the economic situation of the Union and its policy priorities. While at the onset of the crisis ensuring fiscal stability through fiscal consolidation measures and structural reforms (mostly labour market and pensions) was the main concern, the need for financial sector stability became the priority when the crisis spread across countries. Boosting growth and jobs and tackling the social consequences of the crisis became the priorities after 2015.

The changes that are now under discussion seem to be moving away from the urgency of dealing with (large) cyclical swings in the economy to focus on structural weaknesses in the member states. These range from the functioning of the economy to the administrative capacity of different levels of government and improving resilience to future shocks.

It is not clear whether this shift is also an implicit acknowledgement that the enforcement of the policy coordination is weak and there are no conditions in place to induce improvement in the near future. As will be shown in section 2, the degree of implementation of CSRs has always been low, especially in recent years. It well known that the Semester procedures[4] are considered by ministries in most member states as an administrative burden and, at political level, a constraint on national sovereignty rather than as a tool to deliver stability and growth.

The creation of Independent Fiscal Institutions (IFIs) could be read as an attempt to test whether a decentralised system of monitoring and surveillance could deliver better results than a centralised system of coordination under the auspices of the Commission. As will be discussed in the paper, it is still too early to say whether this is the case.

Against this background, the paper investigates the changing nature of the Semester, the drivers of such changes and possible ways forward. It offers a note of caution about holding high expectations of what the Semester can deliver.

The rest of the paper is structured as follows. Section 2 offers an illustration of the shift in the focus of the CSRs and provides an account of the degree of implementation since the creation of the European Semester. Section 3 focuses on the concept of economic policy coordination and its rationale. This is important because, according to the original design, the integrated system of rules introduced by the Six- and Two-Packs is grounded in the European Semester, which sets the timeline for policy coordination and surveillance in the EU. Economic literature offers an understanding of the reasons why coordination makes sense and why it could fail. Section 4 discusses the Commission's new proposal to strengthen the Semester and the idea of coordinating structural reforms. Section 5 considers the concept of national ownership and assesses the role of national independent institutions. The final section concludes.

[4] The preparation of the National Reform Programmes and Stability/Convergence Programmes.

2. The European semester and CSRs

This section focuses on the CSRs and has a two-fold objective. First, it aims to illustrate the evolution of the CSRs and the gradual shift in their focus. Second, it provides an overview of the degree of implementation since the start of the Semester, both by policy area and at the member state level.

2.1 The evolution of the Semester and the focus of CSRs

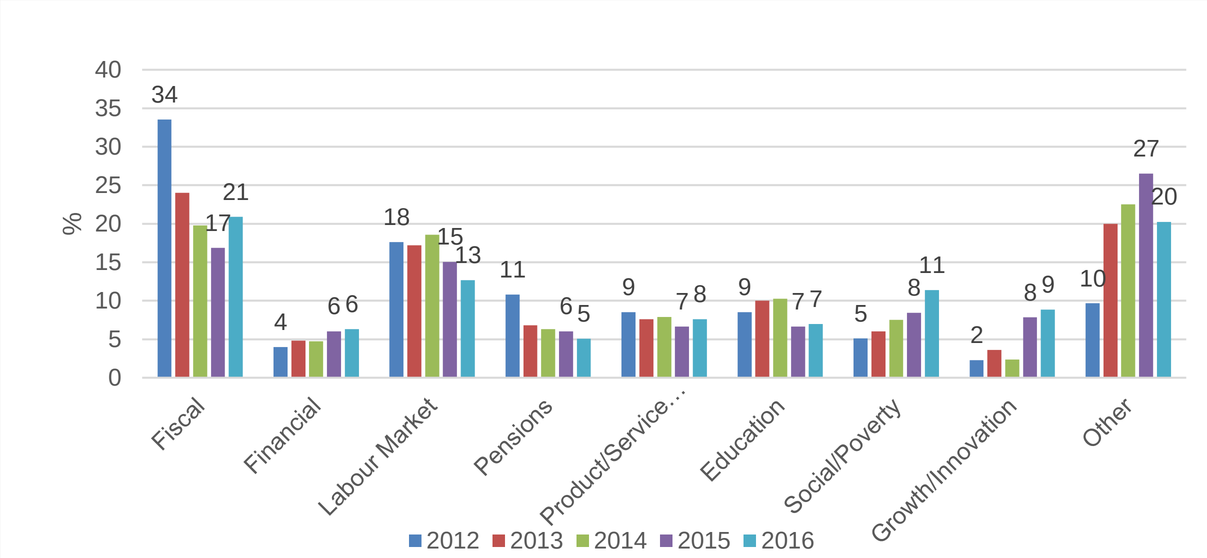
As mentioned in the introduction, since its creation in 2010, the European Semester has undergone many changes and this is expected to continue. Some of these changes are reflected in certain features of the main output of the Semester, namely the CSRs.

The first visible change, before and after 2015, is in the number of CSRs. A simple counting, by heading, shows a drastic reduction of CSRs from 253 in 2015 to 166 in the following year.[5] It should be noted that counting recommendations is somewhat arbitrary as many CSRs now embed several sub-recommendations and group precise actions with general exhortations. This is especially the case for the structural recommendations (e.g. "pass this law" is often combined with "do something more efficiently"). This change also makes it difficult to assess any shift in the focus of the CSRs in terms of policy areas, and some degree of judgement is unavoidable.

Bearing this caveat in mind, Figure 1 depicts the share of CSRs by policy area over the period 2012-16. It shows a clear reduction in the CSRs in the area fiscal policy, as well in labour market and pensions reforms. By contrast, CSRs targeting the financial sector as well as social, poverty, and growth and innovation measures are on a growing trend, while remaining a small part of total CSRs. The category 'other' exhibits not only the largest increase over time but has become (one of) the biggest.

[5] This count is based on the list of CSRs per country, also considering sub-recommendations.

Figure 1. Number of CSRs by policy area (% of total by year, 2012-16)



Source: Own configuration based on European Parliament EGOV papers on implementation of CSRs (see references).

These trends seem to be consistent with changes in the economic environment and the shift in the policy priority from fiscal consolidation and fiscal stability, as urged at the onset of the debt crisis, to the need for financial sector stability and labour market reforms when the crisis spread across countries, and, lastly, to boosting growth and jobs and tackling the social consequences of the crisis after 2015.

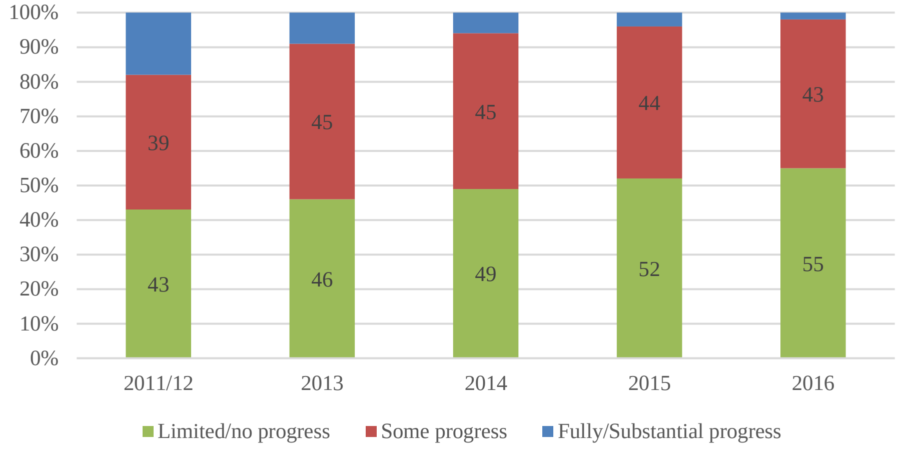
2.2 The track record of implementation of CSRs by policy area

It is widely recognised that the implementation record of the CSRs has been uneven. Measuring the degree of implementation of qualitative recommendations is a difficult and always imprecise task. But all the metrics used to date arrive at similar results: only a small fraction of all recommendations is fully implemented.[6]

Figure 2 presents an overview of the degree of implementation of CSRs over time and suggests a clear decline in the share of recommendations that are fully implemented and an increase in those showing limited or no progress.

[6] CSRs are divided into three categories related to the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and the EU 2020 national objectives (the so-called 'integrated guidelines'). Policy recommendations regarding fiscal policy fall under the objective of meeting SGP rules, and provide numbered targets (MTOs and required fiscal efforts). They can be considered as the most quantifiable recommendations because they mention a specific adjustment, but they tend to be non-specific on the measures needed to attain them. On the other hand, recommendations based on the MIP tend to differ greatly, being more or less specific.

Figure 2. Degree of implementation of country specific recommendations, total



Source: Own configuration based on European Parliament EGOV papers on implementation of CSRs (see references).

It is a matter of fact that enforcement mechanisms do not exist in relation to the economic policy recommendations, except for the excessive deficit procedure (EDP) and the excessive imbalances procedure (EIP).[7] Hence, the implementation of CSRs by member states cannot be enforced and depends on the willingness of national governments to take responsibility. While this helps to explain the low degree of implementation of CSRs, it does not explain why the implementation ratio is in decline.

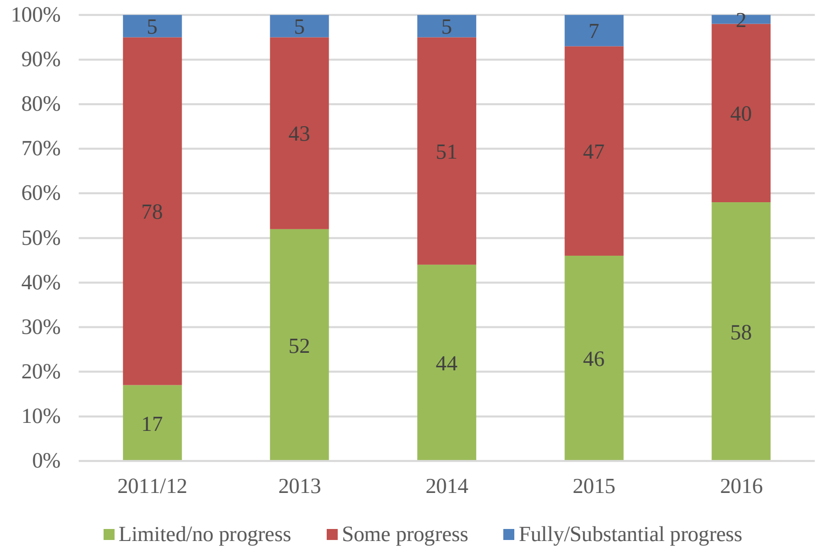
To better understand this point, we focus on specific categories of CSRs and on the behaviour of member states. Figure 3 is based on a simplified grouping of CSRs[8] and focuses on the degree of implementation of MIP-related CSRs. It should be noted that the definition of MIP-CSRs is quite wide and has become the predominant group in recent years. In practice, MIP-CSRs encompass recommendations of a very different nature. As highlighted in the introduction, one of the changes introduced in 2015 was the more integrated nature of CSRs; as a result, MIP-CSRs could include improvement in the judicial system as this is also a condition for improving competitiveness.

Figure 3 suggests that the rate of full/substantial implementation is very low and the limited/no progress category has become the largest. The category 'some progress' is now about half of what it was in 2012.

[7] Indeed, the CSRs are the preventive arm of the SGP and MIP. In the case of the SGP, the procedure can be stepped up and could lead to sanctions.

[8] CSRs are grouped into three broad categories: Stability and Growth Pact, MIP and others.

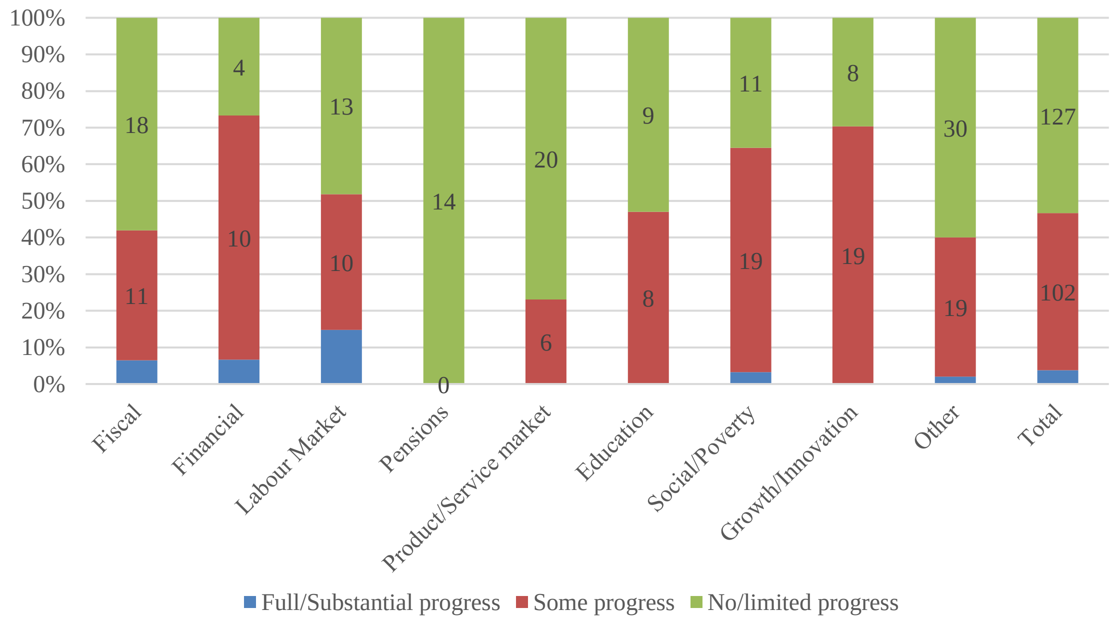
Figure 3. Degree of implementation of CSR under MIP



Source: Own configuration based on data from European Parliament (2017), "At a Glance: Implementation of Country Specific Recommendations under MIP", (http://www.europarl.europa.eu/RegData/etudes/ATAG/2015/542650/IPOL_ATA(2015)542650_EN.pdf).

Figure 4 attempts to provide more detail on the degree of implementation of CSRs by policy area, following the same criterion to identify CSRs as in Figure 1, focusing only on the latest available year, which is 2016.

Figure 4. Degree of implementation of CSRs by policy area, 2016



Source: Own configuration based on European Parliament EGOV papers on implementation of CSRs (see European Parliament, 2013, 2014 a&b, 2015 a&b, 2016 a&b and 2017 a,b,c&d).

Consistent with the broad picture emerging from Figure 3, few reforms have been fully implemented. Moreover, there are some policy areas where implementation has been particularly poor, most notably pensions and product/service markets reforms. By contrast, financial stability and growth and innovation are the two areas with the largest share of CSRs that have shown some progress in the implementation.

The Commission Communication on the 2017 European Semester, issued in May 2017, proposes that the assessment of the implementation of CSRs should be made both from a yearly and a multiannual perspective. The emphasis on the multiannual dimension relates particularly to structural reforms and acknowledges that they take time, usually more than one year, to be adopted, implemented and to show their effect. Based on this observation, the Commission made a new assessment of the implementation of the CSRs. As shown in Figure 5, the exercise reveals that around two-thirds of CSRs issued until 2016 have been implemented with at least ‘some progress”.[9]

Figure 5. Multiannual perspective of CSRs implementation: Yearly assessment (left) versus multiannual assessment (right)

* 2011-2012 CSRs: Different assessment categories
** The overall assessment of the country-specific recommendations related to fiscal policy includes compliance with the Stability and Growth Pact.

Source: European Commission, May 2017 (http://europa.eu/rapid/press-release_MEMO-17-1339_en.htm).

This new approach leads to a more favourable picture regarding member states' implementation of recommendations than does the yearly assessment. While a multiannual framework makes sense in theory, the Commission has not published the details of the methodology, which makes it difficult to assess the value of the new approach.

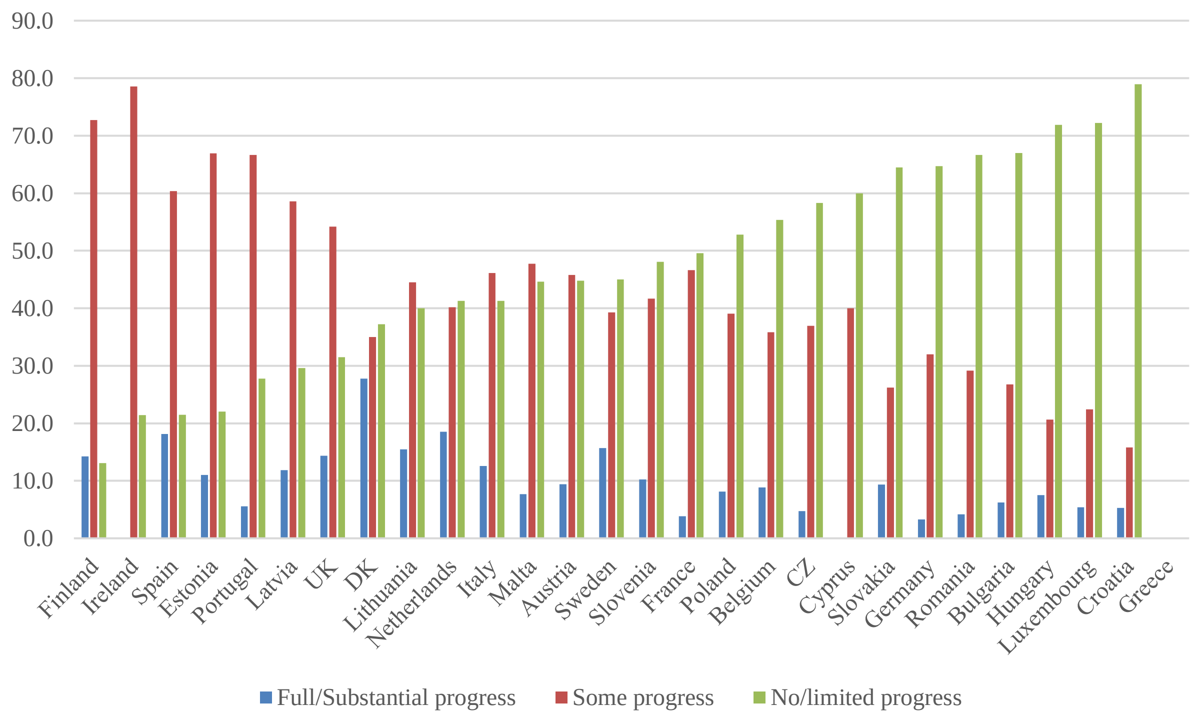
[9] The methodology is currently not available.

2.3 The track record of CSRs implementation by member state

In order to understand the reason for the low implementation rate, we look at the behaviour of member states. Alcidi & Gros (2015) note that implementation tends to vary with the size of the country. Large countries have the lowest record of implementation.

Figure 6 shows the average degree of implementation by member state between 2012 and 2016. Among the euro area member states, Germany and Luxembourg have the largest shares of no/limited progress in the implementation of the recommendations. Countries that had an adjustment programme, such as Portugal and Ireland, or were under strain, such as Spain, exhibit more than 60% of CSRs with some progress. Clearly none of the large countries is an exemplary model when it comes to implementing CSRs, although oddly enough the UK seems to be an exception. Small countries seem to comply more.

Figure 6. Implementation of CSRs by country, average rate 2012-16



Note: Countries are sorted according to the limited/no progress, from smallest to largest.
Source: Own configuration based on European Parliament documents.

From a procedural point of view, the Semester in general and the CSRs in particular are considered by the administrations of most member states as a heavy burden. From a content perspective, it is often perceived at the political level as a constraint on the ability of elected national governments to choose what is best for their country according to the interest of the people they represent. This seems to be the case, especially in large countries or for those that were not hit by the crisis.

For this reason, as will be argued in more detail in section 5, the possibility of relying on national institutions that are independent of the government and the political cycle, but that are also perceived as fully national, to monitor economic policy developments is important in order to prevent the emergence of imbalances of a different nature.

2.4 A case of structural reform: The Jobs Act in Italy

As the surprisingly good score of the UK in the implementation of reforms might suggest, it is unclear to what extent measures taken by national governments are driven by CSRs or by the domestic agenda. It is quite unrealistic to expect, especially after Brexit, that the implementation of CSRs would represent a priority for the UK government. More likely, there was a certain alignment between the position of the government and what was recommended within the framework of the Semester. This reasoning could also be applied to other cases.

Labour market reforms in the direction of combating segmentation of the market and removing rigidities were the *leitmotiv* of the CSRs for Italy between 2011 and 2014, as highlighted in the box below.

Box 1. Italy CSRs on labour market reforms

2011: Reinforce measures to combat segmentation in the labour market, also by reviewing selected aspects of employment protection legislation including the dismissal rules and procedures and reviewing the currently fragmented unemployment benefit system taking into account the budgetary constraints.

2012: Adopt labour market reform as a priority to tackle the segmentation of the labour market and establish an integrated unemployment benefit scheme.

2013: Ensure the effective implementation of the labour market and wage-setting reforms to allow better alignment of wages to productivity.

2014: Evaluate, by the end of 2014, the impact of the labour market and wage-setting reforms on job creation, dismissal procedures, labour market duality and cost competitiveness, and assess the need for additional action.

Source: European Parliament (2014b).

The Italian labour reform came in 2014 with the so-called Jobs Act. Law 183 intended to fundamentally change Italian industrial relations. It is unclear to what extent this was the result of the European process of policy coordination or the attempt to complete a reform process that had begun in the mid-1990s. It has three key elements. First, it introduced a new type of contract, the *contratto a tutele crescenti* – implying a substantial reduction in a firm's obligation to reinstate workers they had invalidly fired. Second, the law weakened the legal constraints on firms intending to monitor workers through electronic devices; and third, it introduced new incentives for firm to use temporary contracts.

It is still difficult to assess the impact of such reforms on Italy's economy, given the relative newness of the regime, but it is also difficult to disentangle the effect of the reform from other factors. First results, as reported in Fana et al. (2017), suggest that the expected boost in employment growth has not materialised, and an increase in the share of temporary contracts over the open-ended ones is observed, as is also an increase in part-time contracts among new permanent positions.

Based on this example, we ask the following questions: What would be the rationale for coordinating such reforms at EU level? What kind of spillover effects should we expect? The next section attempts to provide an overview of the theoretical setting for policy coordination. In addition, in the context of a new potential framework whereby EU funds could be used to financially support the implementation of reforms, we ask how could this reform be "priced". We address this question in section 4.1.

3. Economic policy coordination: Rationale and limits

The Six-and the Two-Packs, introduced in 2011, represent the legal framework to reinforce both fiscal and macroeconomic surveillance via the European Semester for Economic Policy Coordination, under which budget plans and reform programmes are scrutinised *ex ante* by the Commission. They are intended to ensure that fiscal targets are not jeopardised and excessive macroeconomic imbalances are prevented. What was the rationale for such a change?

3.1 The rationale

In the context of a monetary union in which monetary sovereignty has been relinquished, if one excludes forms of common and centralised resources, the coordination of national economic policies is widely considered as desirable to reduce the spillover effects emerging from country-specific disturbances, i.e. asymmetric shocks. This coordination serves as the tool to internalise externalities and its absence leads to suboptimal outcomes.

Most of the existing literature on spillover effects in the context of EMU has focused on fiscal externalities, namely a situation in which the source of the shocks is fiscal policy. Few pieces of research consider potential spillover effects that are generated by different sources, in particular structural reforms. One rare example is the report on spillover effects by the European Commission (2006), which focuses on fiscal structural reforms, namely the reform of pensions or taxation systems. Since such reforms affect domestic prices, wages and labour supply, they could be the source of a cross-country spillover effect. However, obtaining approval of such reforms tends to entail a long political process, whose implementation is gradual and the effects appear with a time lag. These features make it very difficult to measure and isolate the effects of specific reforms on the domestic economy and even much less the effect on other countries.

The literature on cross-country spillover effects mostly considers how a fiscal policy shock in one country could spill over to other countries and affect output and prices. This can occur through different channels: namely the trade channel (imports), the price channel (relative price changes), the interest rate channel (the common interest rate changes in response to a situation specific to one country) and, in special cases such as deep recessions or crises, the financial market channel (e.g. contagion).[10] [11] In the framework of this literature, an *ex-ante* cooperative approach that reduces the discretionary use of fiscal policy could lead to a superior outcome for the Union as a whole. This is one of main arguments underlying the Maastricht design of fiscal governance and fiscal rules in EMU.

At the inception of EMU, it was thought that at most it would face moderate asymmetric shocks, made rare by a common commitment to fiscal soundness. Reality turned out to be different. On the one hand, unlike what was assumed in the fiscal governance framework, not only do fiscal shocks matter; on the other hand, member states' commitment to sound fiscal policies, through policy coordination, was not so strong after all.

In practice, the degree of fiscal coordination that is achieved depends on the trade-off between the specific needs of each national government, reflecting political preferences, national constraints or specific shocks, and the sign and magnitude of the spillovers.[12] A key problem is that the latter tend to be uncertain and the national perspective tends to be dominant.

While cross-country spillover effects are the reason why fiscal coordination is desirable, shocks of a different nature, e.g. demand versus supply and temporary versus permanent, tend to impact other countries in different ways and are transmitted through different channels. Even the sign of their impact can vary depending on the state of the economy. The crisis has shown that additional non-traditional channels may exist in turbulent times, with financial market mechanisms likely to play a prominent role, and that traditional channels may work in a different way according to the macroeconomic and financial circumstances as they interact with other channels.

In normal times, the spillover effects of a fiscal shock (either negative or positive) could be of either sign, as argued in Belke & Gros (2009). Belke & Osowski (2016) estimate that in the EMU, fiscal spillover tends to be of a limited size, although in some country groups the impact can be larger. In this case, it seems that the rationale for coordination is limited. In special cases, such as when monetary policy is at zero lower bound and the economy is in a 'liquidity' trap, or in the case of a financial crisis, the nature of the spillover effects changes radically. For instance, in the case of a financial or banking crisis, dysfunctional markets tend to amplify shocks, driven by panic or herd behaviour. Under these circumstances, an expansionary fiscal stance could be

[10] See Alcidi et al. (2015) for a detailed overview on fiscal spillover effects.

[11] This argument is consistent with the approach at EU level. The European Commission, when explaining why ex ante fiscal coordination is desirable, uses the following argument: "Major economic reforms in one member state can cause economic spillover effects on other member states. Such spillover effects are all the more relevant in an Economic and Monetary Union, as the crisis has underlined. Major economic reforms can produce economic spillover effects on other member states via trade and competitiveness and via financial markets".

[12] See Alesina &Wacziarg, 1999.

desirable for the Union, if monetary policy is at zero lower bound and this helps propagate the positive effects of the stimulus, or disastrous if the policy is perceived as jeopardising the solvability of one member state.

Overall, it appears that the nature of these spillover effects changes according to the regime under which the economy works. From an economic point of view, this implies that the rationale for policy coordination changes from one regime to another.

3.2 The limits

One conclusion we can draw from the section above is that one size does not fit all. The degree of economic policy coordination should be adapted to different economic circumstances, but it is almost impossible to design a rules-based system that can account for such different circumstances. In fact, the system of fiscal governance that emerged after 2010 attempts to do so by designing different procedures (EDP, MIP, in-depth review and country adjustment programme), which entail different degrees of intrusion from the central level into national fiscal policy. This varies according to the potential spillover effects that economic conditions in one country could have on others and on the Union as a whole.[13]

Besides the design of the coordination mechanisms, the experience of the crisis has shown that economic policy coordination, including enforcement, is difficult to achieve *ex-ante* for a number of reasons. There are economic, political economy and legitimacy considerations that can explain such an outcome.

From an economic point of view, even assuming that maximum coordination can be achieved, as explained above, little is known about how spillover effects work. This is particularly the case when they are driven by financial markets and when they are triggered by structural reforms. This means that gains from policy cooperation are likely to be small and/or uncertain. Therefore, either coordination does not happen or it happens only in very dramatic situations, when the spillover effects have started to materialise. In these cases, coordination is often forced and costly.

Related to this consideration is the political economy perspective, which ponders the likely short-term costs and the potential long-term gains. In this perspective, incumbent politicians may perceive the political cost of undertaking difficult structural reforms or budget cuts to be higher than the benefits of ensuring long-term sustainability. Likewise, certain measures may be recognised as important for the Union, but not deemed necessary for the country they represent. This may also lead to a lack of coordination.

Finally, yet importantly, legitimacy consideration can lead to an impasse in the coordination process. Commitments leading to policy coordination are legitimised by the fact that the Treaties, in which coordination is embedded, were signed by democratically elected countries.

[13] See Alcidi et al. (2014).

Moreover, EU decisions are adopted in the Council by the member states, which are backed by national parliaments. However, democratic expression in member states, for instance through referenda, could lead to a rejection of the commitments derived by such Treaties or decisions. This is a typical time-inconsistency problem, which could lead to an existential crisis, as happened after 2010.

Overall, for all these reasons, economic policy coordination that ultimately relies on the will of governments to cooperate is likely to fail in a number of circumstances.

4. What future for the European Semester?

For the two main reasons explained above, namely the low implementation of CSRs and the limits to coordination, it may not be strategically wise to exaggerate what can be achieved through policy coordination in the framework of the European Semester. By contrast, the European Commission's reflection paper seems to have chosen the opposite approach, by stressing the role of the Semester with reference to three points.

First, the paper (European Commission (2017c) presents the Semester as a tool to "foster further the cooperation and dialogue with member states, involving also national parliaments, social partners, National Productivity Boards and other stakeholders, to ensure stronger domestic ownership and encourage better reform implementation". In fact, the idea to involve national stakeholders is not pursued or made concrete in the document. Besides the extension of the Semester cycle to the promote participation of national stakeholders, which has already happened, it is unclear what else could be done in terms of further dialogue and what this could deliver.

Second, the document also claims that "[n]ational policies matter for convergence, but their coordination under the European Semester is essential to maximise their effectiveness"; and third "[t]he success of the Europe 2020 strategy crucially depends on member states coordinating their efforts". There is no empirical evidence or theoretical argument to prove that policy coordination leads to convergence or that the success of the EU2020 strategy "crucially depends" on the coordination efforts of member states.

Of course, this does not mean that national policies are unimportant or that EU2020 objectives are negligible. Policies aiming to improve the structure of the economy in member states are of crucial importance. The weak link is the coordination argument.

Let us consider an example. Why would the convergence and the success of the Europe 2020 Strategy depend on the coordination of German efforts to "[s]timulate competition in business services and regulated professions" and on Italian action to "[p]romptly adopt and implement the pending law on competition and address the remaining restrictions to competition"? As argued above, even for fiscal policy the need for coordination is not self-evident outside exceptional periods of crisis. Estimates suggest that a fiscal expansion in Germany has almost no effect in Spain.[14] The effects of a product market reform (PMR) are likely to be even smaller, apart from the problem that we are not able to measure them, not even in the country in which they take place. In addition, the PMR in Germany, other than opening a domestic market to more competition, potentially from other countries, should result in higher German competitiveness. It is unclear whether this would favour cross-country convergence.

It should be recognised that enlarging the scope of the European Semester to include any policy under the general umbrella of EU policy coordination cannot be justified by the need for cross-country coordination.

4.1 EU budget for structural reforms

In the framework of the new discussion on the reforms and the Semester. The Commission's Reflection Paper refers to the possibility of envisaging schemes whereby reforms in member states are supported by the EU budget.

This proposal is consistent with the findings of recent literature[15] presenting evidence that structural reforms can have short-run costs – and long-run benefits – and for this reason should be accompanied by supportive fiscal policy. This argument is reinforced by the fact that reforms are even more costly in times of crisis, when they could even amplify the recession and fiscal policy is unlikely to be expansionary, but this is also the time when reforms are more likely to occur, given the political momentum. Following this argument, mechanisms to financially support member states undertaking reforms can make sense, from an economic point of view.

Financial support for reforms is not a new idea. It was first presented in 2012, in the European Commission (2012) proposal for "A blueprint for a deep and genuine economic and monetary union: Launching a European Debate", and embedded in the contractual arrangements. In essence, it suggested that the implementation of structural reforms in euro area member states could be facilitated by setting up a mechanism of contractual arrangements to be agreed between the Commission and the state concerned. The system was supposed to be integrated into the European surveillance framework and designed to implement the CSRs, which typically focus on a sound fiscal position, competitiveness and financial stability, potentially requiring costly reforms. The reforms taken up in the contractual arrangements would be financially supported, in principle as part of the EU budget, as a complement to the discipline requirements. The proposal also contained a discussion of the procedure for granting financial support and potential withdrawal of support.

In the end, the contractual arrangements never saw the light of day. Other than a lack of sufficient political backing, a key issue related to the difficulty of 'pricing' each specific reform,

[14] See for instance Belke & Osowski (2016).

[15] See for instance IMF (2016).

but also to the question of how to assess the implementation of reforms and potentially take the decision to withdraw support.

That said, some specific forms “EU budget funds for reforms” already exist in practice. As explained in Box 1, since 2014, access to European Structural and Investment (ESI) Funds depends on meeting *ex-ante* certain conditions. The rationale for the *ex-ante* conditionality (ExAC) is that the effectiveness and the durability of the impact of public investment can be negatively affected by regulatory, administrative and institutional weaknesses. In the 2014-20 programming period of the ESI Funds, addressing such flows is set as requisite for making the investment possible. Conditions are of a different nature and can include specific reforms contained in the CSRs. The narrative evidence, based on the European Commission’s analysis reported in the Box 1, suggests that the approach has been quite successful. Therefore, it may be tempting to interpret this achievement as a signal that the approach should be taken further and EU budget funds should be used to support reforms at large, outside ESI.

It should be noted, however, that the examples reported refer to very specific policy areas, matters or measures at local level. The reforms considered are often relevant for the particular use of the conditional funds considered; they are never structural reforms having large geographical and cross-sectoral impacts. In the case of very broad reforms, e.g. improving the efficiency of the public administration or increasing the flexibility of the labour market, which are most common in the European Semester, a potential link with the use of EU budget funds and the reforms will be less straightforward. This is also the case owing to the attempt to reduce the number of CSRs and streamline them. A “price” should be assigned to any reform and its implementation assessed, with the funds potentially withdrawn if the assessment is negative. These are all very difficult tasks.

More fundamentally, such conditionality may appear debatable because of the nature of reforms and who is the beneficiary. One could question whether any country could potentially benefit from this mechanism. If one assumes that different countries should be treated differently, on which basis could a discriminatory approach be justified? If, by contrast, countries should all be treated equally when they implement a structural reform, one could question whether this is an appropriate use of the common funds. For instance, should EU funds be made conditional on the adoption of a law on competition or any other law? Should Germany and Romania benefit from it in the same way?

While the EU budget has evolved dramatically over time in terms of structure, procedures and objectives, economic convergence and cohesion remain key objectives.

Box 1. Ex-ante conditionality in the ESI Funds

One of the key reforms for the 2014-20 programming period of the ESI Funds was the introduction of the *ex-ante* conditionality (ExAC). While linked to support from the ESI Funds, conditionality aims to tackle persistent bottlenecks to the efficient implementation of investment projects, both at horizontal and sectoral level. *Ex-ante* conditionality provides an incentive for member states to implement structural changes and policy reforms, including those linked to the relevant country-specific recommendations.

There are 48 kinds of ExAC established in the legislative framework of the ESI Funds.

These include: i) conditions linked to horizontal aspects of programme implementation, applicable to all ESI Funds, ii) sector-specific conditions for relevant investment areas eligible for support under cohesion policy (co-financed by the European Regional Development Fund, the European Social Fund and the Cohesion Fund) and iii) conditions linked to the use of two specific Funds, i.e. the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund.

Meeting such conditions should contribute to improve the functioning of certain sectors, and the incentive provided by the future access to funds should work in a positive way.

While a full accounting and assessment of this new instrument does not yet exist, the Commission has collected narrative evidence based on the experience of several member states.* According to this evidence, ExAC is coherent with the European Semester and has triggered the following reforms:

- addressed delays and shortcomings in transposition of the EU *acquis* (e.g. in the energy, water and waste sectors);
- helped improve policy frameworks, thereby improving the quality and legality of relevant investments, not only those co-financed by ESI Funds;
- supported the implementation of EU climate policies;
- despite the absence of a legal link between CSRs and ExACs, in several MS, they speeded up execution of reforms and provided the foundation for additional reforms, including strengthening a national employment agency and specific health and educational initiatives;
- aimed to ensure that funding was targeted to the people more in need; and
- resulted in improved coordination between national and regional authorities in the MS, improving the communication flow among ministries, agencies, regional and local level government and other stakeholders.

*See European Commission (2017b).

Ex-post conditionality appears even more difficult to devise and apply. The Stability and Growth Pact (SGP) foresees the possibility of fines in case of non-compliance with the commitments to meet the Council recommendations. This mechanism is very similar in principle to *ex-post* conditionality. Historically no fines have ever been imposed under the SGP. Under the new fiscal framework introduced after 2010, the failure of a member state to comply with EU economic governance procedures (EDP and MIP), will trigger – in addition to a pecuniary sanction – a procedure for the partial or total suspension of the ESI Funds.[16]

Such kinds of measures were envisaged for Hungary in 2012 and Portugal and Spain in 2016. Since Hungary is not part of the euro area, the Commission could only propose a suspension of ESI Funds, whereas for Spain and Portugal pecuniary sanctions were also triggered.

In 2012, the Council decided to withhold cohesion fund money for Hungary and suspend the scheduled commitments.[17] As soon as the Hungarian government reacted with corrective measures, the suspension of commitments from the fund was lifted.[18]

Despite a Council decision asserting a lack of effective action under the EDP, in 2016, Spain and Portugal received a symbolic fine of €0.[19] Following that and in accordance with EU fiscal framework, the Commission opened a consultation (Structured Dialogue) with the European Parliament to discuss the suspension of part or all of the commitments or payments for the programmes related to the ESI Funds.[20] In the end, a majority of the Members of the European Parliament opposed the Commission's proposition and the suspension did not take place.

These cases show how difficult and unlikely it is to impose ex-post measures, even in the case of the SGP, where one can judge implementation on relatively clear numerical targets (e.g. deficit or debt). As mentioned above, for most CSRs that entail structural reforms there is no clear metric for assessing the implementation, nor a clear timetable, making it excessively difficult to sanction the non-implementation of CSRs with a pecuniary measure like the withdrawal of funds.

4.2 EU administrative support for reforms

The difficulty of designing an effective system of monetary incentives and punishment inducing EU member states to introduce reforms does not mean that reforms are not important. There

[16] Under the EDP, sanctions are (automatically) enacted in the event of repeated failure of a member state to take action in response to the Council's recommendations. Following a Council decision establishing that no effective action has been taken under the EDP, the European Commission is under an obligation to also propose the partial or total suspension of payments and commitments under the ESI. A structured dialogue with the European Parliament is required in this case. Under the MIP, the trigger is the failure to submit a sufficient corrective action plan following two successive recommendations from the Council.

[17] 7513/12 Press Release Council Conclusions, 3153rd Council meeting, Economic and Financial Affairs, Brussels, 13 March 2012 (http://www.consilium.europa.eu/press/councilmeetings?pagenum=2 - consulted 13 April 2012).

[18] See Commission announcement (http://ec.europa.eu/economy_finance/articles/sgp/2012-05-30-edp_en.htm).

[19] Council decision 12-07-2016 (www.consilium.europa.eu/en/press/press-releases/2016/07/12-portugal-spain-excessive-deficit/).

[20] See Council press release (www.consilium.europa.eu/en/press/press-releases/2016/08/08-excessive-deficit-portugal-spain/).

is widespread consensus that many member states need structural reforms to improve their functioning (e.g. higher output and employment) and their resilience.

However, 'structural reforms' is a vast notion, which contains many different policy measures. In theory, structural reforms can be grouped into measures leading to (possibly large) redistributive effects (e.g. liberalisation of regulated sectors, reform of the labour market, pensions and taxation) and those aiming to improve efficiency (e.g. reform of the judicial system or the public administration).

For the first group of reforms not only national ownership must be ensured, but such decisions have to be taken by a democratically elected government and reflect domestic political preferences. The EU cannot and should not perform that role.

The second group of reforms can also have some redistributive side effects, but they chiefly focus on removing inefficiencies hindering administrative and institutional capacity. This is where the EU can play a role and provide support. The newly established Commission Structural Reform Support Service has been assigned precisely that task: "to help EU countries build more effective institutions, stronger governance frameworks and efficient public administrations. Such support reinforces the capacity of EU countries to design and implement policies to support job creation and sustainable growth."[21]

The experience of the crisis, not least the one in Greece, and of the Task Force for Greece has shown that passing laws in Parliament is not a sufficient condition for policy measures to deliver, if the administrative system is not able to implement changes. In general, member states with better institutional and administrative capacity proved to be either more resilient to large shocks or to be able to respond and overcome them more rapidly.

5. National independent institutions, national ownership and the Semester

Independent fiscal institutions (IFIs), or national fiscal councils, were created as part of the EU governance framework as a consequence of the Fiscal Compact, which is the fiscal component of the Treaty on Stability Coordination and Governance (TSCG), with the task of activating correction mechanisms in case of deviations from the balanced budget principle. But they are also part of the prescription of the Six- and Two-Pack. Despite different traditions, design and approaches, as of today, each euro area country, as well as several non-euro area member states, have an IFI.[22]

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[21] https://ec.europa.eu/info/departments/structural-reform-support-service_en#responsibilities

[22] IFIs display a large heterogeneity across countries. In Austria the set-up of a national independent institution monitoring the government budgetary policies dates back to the 1970s. Italy and Greece were the last two countries to set up such an institution in 2014 and 2015, respectively. Despite institutional differences, all IFIs have a common mandate to improve fiscal policymaking and promote sound fiscal policy. In practice, this means producing or endorsing forecasts, monitoring the implementation of fiscal rules (many different kinds), assessing

The rationale for having such institutions, which de facto duplicate some of the monitoring tasks that are part of the Commission's portfolio (fiscal arm) in the framework of the Semester, is to help impose discipline on national governments from inside the country. This should enhance the ownership of prudent fiscal policy and, as by-product, their legitimacy, which are two critical issues explaining the limited success of the Semester on fiscal matters.

In principle, IFIs have also an advantage relative to the European Commission. They should have a better knowledge of the country and easier access to critical information. Moreover, they should be able to count on favourable public opinion to safeguard their independence in monitoring fiscal policy and allow them to reject potential political pressures. This naturally assumes that they are totally independent (i.e. as regards appointment procedures, resources and access to information) from the political decision-making procedures.

The experience of IFIs is still too short to evaluate their achievements. Jankovics and Sherwood (2017) argue that IFIs seem to have already played a useful role in national budgetary processes, although some challenges remain. These relate to potential limits to independence safeguards and to access to information, as well as to the quality of the process of endorsement of government macroeconomic forecasts and possible conciliatory mechanisms. In countries where these institutions are young and the reputational cost to governments that defy IFIs' recommendations is low, these challenges may be particularly strong.

In principle, the national productivity boards (originally proposed by the European Commission as national competitiveness boards, in the follow-up to the Five Presidents Report in 2015)[23] as defined by the Council,[24] should be equivalent to the IFIs, but with a focus on a country's performance and policies in the field of competitiveness. Not all member states at present have a domestic productivity board, but it is already envisaged that such institutions, once operative in all countries, should provide inputs to the Commission in the context of the European Semester.

The creation of such institutions and their involvement in the Semester signal an attempt, more or less explicit, to move towards a more decentralised approach in the monitoring and surveillance activities, which are currently embedded in the European Semester and under the Commission's control.

There are two explanations for this shift. The first is based on short-term considerations and relates to the fact that as the effects of the crisis abate, the rationale for policy coordination declines and there is less willingness to give the Commission a role. The second reason is more

long-term sustainability, triggering correction mechanisms in case of deviation from fiscal targets and advising the government in relation to emerging risks. See European Parliament (2017e) for a complete overview of national fiscal bodies.

[23] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0601&from=EN

[24] www.consilium.europa.eu/en/press/press-releases/2016/09/20-national-productivity-boards/?utm_source=dsms-auto&utm_medium=email&utm_campaign=National+productivity+boards+backed+by+Council

fundamental and relates to the fact that for a number of reasons, as illustrated in section 3, economic policy coordination in the EU suffers important limitations, given its institutional setting. The Semester is largely perceived as a burden and a constraint on domestic choices and rules are only partially enforced. A decentralised approach clearly aims to eliminate such perceptions, possibly preserving the commitment and increasing the enforcement to sound fiscal policy through national ownership. However, the design still poses issues.

National ownership is a widely used concept but its meaning is rather unclear. Vanheuverzwijn & Crespy (2017) attempt to define it by identifying three degrees of participation by national actors in the European Semester. Cognitive ownership is the lowest level and refers to the awareness by national actors of the Semester; political ownership, by contrast, implies an agreement over political objectives and a willingness to implement them. Lastly, institutional ownership denotes a situation in which national actors can shape policy-making outcomes. The recent innovations of the Semester towards fostering the dialogue with national stakeholders and having national independent institutions providing inputs in the Semester seem to go in the direction of more political and even institutional ownership.

In this framework, the risk is that CSRs, which are driven by inputs coming from the national level, appear as an external (EU) product imposed on national governments and with which they have to comply. This scenario has two drawbacks. The first is that the Semester becomes a complicated game with little value added. National independent institutions should directly interact with their government. The second is that the involvement of the national independent institutions in the Semester may have a negative effect on the 'reputation' of IFIs, as national independent bodies, which could then be perceived as an arm of the EU operating in the national territory.

While the objective of improving national ownership is very important, certain procedures could lead to perverse effects. Therefore, on the one hand, one should avoid the danger of duplication of tasks and further complication of an already-complex framework and, on the other hand, to preserve the independence of national independent institutions from both the national government and from the EU. This would require that they exercise true operational independence (i.e. as regards appointment procedures, resources, access to information, etc.).

A last issue relates to how to reconcile the need to demonstrate national ownership with the need for coordination, understood as the common good of the Union, over and beyond the member states. The role of the Commission should consist of ensuring that the common interest is taken into consideration, vis-á-vis the national perspective defended by national institutions. As argued in section 3, this may be challenging but it is particularly relevant in times of crisis.

6. Conclusions

The European Semester was created in response to the crisis and had a specific purpose. The policy tools used as part of the Semester have been revisited, however, and the set of policies included in the process has expanded over time. Conversely, the reasons why some policies, typically national ones, need to be monitored and coordinated at European level seem to be less important. This may result in an even-lower incentive for member states to engage in economic policy coordination.

During the acute financial crisis, the supervision and coordination of economic policies were necessary because the spillover effects were large and in some cases the CSRs did have an impact. The incentive to coordinate are lowering, however, as it is now less likely that action by any one country will have a measurable impact on its partners, or on the system as a whole. In the context of a monetary union, this does not mean that coordination of fiscal policy, intended as a commitment to sound fiscal policy and an acceptance of surveillance, is unnecessary outside times of crisis. Experience has shown, however, that this argument has not been sufficient to deliver the coordination of national economic policies or the enforcement of rules.

Looking ahead, presenting the European Semester (ES) as essential for achieving growth and convergence may turn out not to be desirable, unless such expectations can be met. CSRs, which are the main output of the ES, have seen decreasing implementation since the crisis has receded, even if the focus has shifted away from fiscal measures.

The emphasis of the European Semester should shift from economic policy coordination to national ownership. In principle, this could be done by involving national, independent institutions in the formulation and monitoring of implementation of the CSRs. But this should occur without becoming a formal and complex game whereby governments decide the policy, the EU formulates the CSRs and governments have to implement them. This would not help ownership, or the implementation of rules. It is important that such institutions are fully perceived as independent – not only of the government but also of the EU level.

Linking the budget to the reforms in the framework of the Semester should be avoided. The EU budget should be used to deal with common challenges and foster cohesion and convergence among EU regions.

Moreover, reforms as such cannot be 'bought'; it would be extremely difficult to measure the implementation of the CSRs precisely enough to make implementation a condition for certain funds. The role of the EU in relation to the reforms should consist of providing technical support to achieve the capacity in individual member state to design, manage and deliver on their own reform agendas.

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