Contractual Arrangements: The Way Forward

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Structural reform and economic integration

Jeffrey Sachs has argued that the ability to succeed in policy reform has two critical components. One is of course the capacity of the country itself to reform, but equally important, he adds, is the role of the outside world in helping the country to overcome the crisis. He goes so far as to write that a country or an economy "cannot be transformed without the generous and farsighted involvement of the international community."[1]

The point, it seems to me, is that policy reform cannot be limited to the national stage for the same reason that economic agents cannot but operate beyond national borders: if the economic structure being reformed cuts across national borders, then structural reform must also, to a considerable extent, be looked at from a larger perspective. This is all more the case for the European Union, where economic integration has been proceeding apace for a number of decades already, but where member states still find it difficult to accept that a valid constituency exists beyond their borders, that a significant constituency is European rather than national.

Policy reform is so difficult because powerful groups will be made worse off as a result, at least in the short run. There is considerable incongruity between the national political process, where these interest groups play a decisive role, and the economic logic of policy reform.[2] How can we expect to implement significant changes on the way markets work while relying solely on national political agents? The logic of markets is no longer strictly national.

Prime Minister Enrico Letta is therefore right when he stipulates that "interdependence requires responsibility."[3] The reforms to tackle rigidities in the European economy are complex and difficult to implement. This is all more reason not to leave them hostage to national political circumstances. We do not see the Single Market and the European economy as a patchwork of national economic blocks. It makes little sense, then, when trying to enhance its growth potential, to make reforms depend on financial investments which are, in some cases, utterly impossible or a political economy logic which sacrifices economic reform to powerful interest groups. There is a countercyclical concern here: the investment needed to support structural reform should be available

[1] Jeffrey Sachs, "Life in the Economic Emergency Room," in John Williamson (ed.), *The Political Economy of Policy Reform* (Washington, DC: Institute for International Economics, 1994), 504.
[2] See my "What Are Structural Reforms?" *European View*, 2013.
[3] Keynote address from Enrico Letta, Prime Minister of Italy for the Bruegel Annual Dinner 2013, September 10, 2013.

when it is most needed and most effective, not when it is too late for a reform program to be viably implemented (or can only be implemented at great social cost).

European policymakers have recognized this early on, turning structural reform into a crucial element of the European Semester. In this matter, however, economic coordination has so far proved relatively weak. The main concern is that member states will not accept full responsibility for implementing a given reform program. Ownership would be enhanced if governments were allowed to complete reforms sooner than they would be able to do on their own and if the cost of addressing their short term impact is minimized. Clearly, the best way to involve national stakeholders such as social partners and national parliaments is to smooth the edges around structural reform and make it much easier to carry out than is the case at present.

As presented by the Commission Blueprint, the implementation of structural reforms in the euro area states would be facilitated by setting up a mechanism of contractual arrangements to be agreed between them and the Commission. This new system would be built on the existing European surveillance framework, namely the procedure for the prevention and correction of macroeconomic imbalances. It encompasses both the ideas of mutually agreed contracts and that of a solidarity financial mechanism.[4] Embedded in the European Semester, the arrangements would be designed to implement the Country Specific Recommendations, which typically focus on enhancing adjustment capacity, competitiveness and promote financial stability. The rationale for the new instrument was clearly presented: the interdependence of countries participating in a common market and a single currency means that each has a vital stake that key weaknesses in particular national economies be fully and quickly removed.

Contractual arrangements would seem to be an apt way to make structural reform work at the European level, which is where it must be attempted. Let us see how and why. First, we revisit the existing instruments, such as the European Semester. Second, we move to the political and social logic of the new contractual arrangements and solidarity mechanisms. We conclude with the main desirable traits aimed at enhancing greater European economic integration.

The European Semester as the right framework for these arrangements

Introduced in June 2010, the European Semester is meant to be an EU-level policy coordination tool contributing towards the broader European Union aims of strengthening economic governance and greater policy coordination. It intends to provide a more integrated surveillance framework for the implementation of fiscal policies under the Stability and Growth Pact as well as the implementation of structural reforms through National Reform Programs.

[4] Communication from the Commission, *A blueprint for a deep and genuine economic and monetary union - Launching a European Debate*, COM(2012) 777 final, November 28, 2012, 21.

The crisis has shown that lasting financial and economic divergences, if not corrected in due time, may threaten the financial stability of the euro area as a whole. The promotion of high level critical structural reforms is an integral part of Europe's global competitive advantage. As the Commission has repeatedly pointed out, delaying necessary reforms in one member state because of short term negative domestic impacts can have negative and damaging spillover effects on other member states. Structural reform is a common responsibility.

Ownership is in fact closely connected to feasibility. If the hurdle for implementing structural reforms remains too high, it is likely that member states will never be fully committed to realizing a number of crucial policy goals, or to lose heart as they attempt to realize them. By contrast, if the goal is within reach, greater involvement by social partners and civil society in the process is to be expected.

The social dimension of the EMU

The rationale for contractual arrangements and associated solidarity mechanisms: 1) facilitate and support reforms in key areas for growth and jobs that are important for the smooth functioning of EMU as a whole; 2) facilitate and support sound policies before countries face severe economic difficulties. In this respect, a system of economic partnerships should be conceived as an investment mechanism. It encourages reform by reducing short term costs, which are predominantly social costs, in some cases profoundly disruptive of the social fabric. Additionally, financial support could be geared toward the social dimension of the EMU, providing resources for structural reform in pensions, labor markets, vocational training and education systems.

The arrangements would be “home-grown,” while taking into account the shared analysis of the European Council and the Countries Specific Recommendations; they would flow from the National Reform Programs and be designed by member states with the full involvement of their parliaments, social partners and relevant stakeholders. Too often during the current crisis we have seen structural reforms split a country apart, with governments committed to reform while social partners and other relevant stakeholders take the opposite position. If structural reform is to be country-owned and not just government-owned, then rewards have to be clearly set out at the beginning.

Economic policy reforms towards competitiveness, growth and jobs are in the interest of member states and the European Union as a whole. They no doubt bring economic gains, but often these gains accrue in the medium and long term, most of the time beyond the usual electoral cycle. Partially for this reason, structural reform is often postponed until it can only be pursued at great social cost. This needs to be addressed.

The main desirable traits for contractual arrangements and solidarity mechanisms

– Legal basis: compatible with EU general framework, no need for amendments (on economic policy coordination - Articles 121 and 125 of the Treaty on the Functioning of the European Union; on systematic ex ante discussion and, where appropriate, coordination of major economic policy reforms - Article 11 of the Treaty on Stability, Coordination and Governance.)

– Nature of the arrangements: contractual; negotiated bilaterally between a member state and the European Commission, and approved by the Council.

– Type of arrangements (financial arrangements, e.g. grants, loans, guarantees): the preeminent need to address the issue of policy myopia may recommend a loan mechanism. Once the long term rewards have been reaped, a member state will be in a position to repay the loan. On the other hand, loans may not be attractive for member states benefitting from easy access to markets at what are already historically low rates.

– Legally binding or merely politically binding ("engagement politique"): binding nature of contractual arrangements: such arrangements could take the form of a politically binding commitment between a member states, the Commission and the Council. If a contractual arrangement were to be accompanied by a mechanism of financial support, a legally binding form would seem more appropriate.

– Scope: engage all euro area member states (except for member states under an excessive imbalances procedure or a macroeconomic adjustment program) and be open to non euro area member states. The possibility that no agreement will finally be reached must remain on the table.

– Eligible reforms: micro and social reforms. Criteria: Boost convergence and spillover effects

– Democratic legitimacy: need to involve national parliaments and social partners.

– Preventive feature: contractual arrangements are not adjustment programs. They are open to all member states and not simply those under economic strain. This should help avoid stigmatization. These are structural reform instruments for normal times.

– Assessments: comprehensive ex ante and ex post assessments.

– Avoid moral hazard: financial support often raises concerns about moral hazard. Reforms must not be delayed in expectation of financial support at a later stage. Deadweight is a second concern, with financial support being wasted on reforms that would have been implemented anyway. To allay such concerns, conditionality and monitoring based on rigorous indicators are essential, and the Commission has in fact started working on a number of promising indicators and metrics. Financial support could be conditional on the implementation of a set of mutually agreed specific reforms. Financial assistance is uniquely capable of anchoring such conditionality, since it would be disbursed in tranches or, in the case of a loan, the interest rate subsidy could be paid out at the end of the implementation phase.

– Avoid bureaucratization: contractual arrangements should not lead to an increased bureaucratic burden on the EU administration

– Avoid duplication of instruments and initiatives: Macroeconomic Adjustment Program (Regulation (EU) 472/2013, 21.05.2013); Corrective Action Plan (Regulation (EU) 1176/2011, 16.11.2011); Economic Partnership Program presented by Member States under an excessive deficit procedure (Regulation (EU) 473/2013. Contractual arrangements have a different nature: structural reform instruments.