Governing imbalances in the economic and monetary union

A political economy analysis of the macroeconomic imbalance procedure

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How can the euro area protect itself from future economic crisis? The framework governing the euro has been significantly expanded in recent years. Among the key innovations is the Macroeconomic Imbalance Procedure (MIP), whereby the EU monitors economic vulnerabilities among Member States and issues policy recommendations to address them. In this thesis, David Bokhorst traces the implementation process of different recommendations in Belgium, Italy, France, the Netherlands, and Germany. He presents a holistic assessment of how the MIP works in practice and analyses the effects it has on policymaking in the Member States.

David Bokhorst is a political scientist by training. He has studied the process of European integration ever since he became involved with the European Youth Parliament as a teenager. After his studies, David worked in public affairs in Brussels, as a teacher at Tilburg University and as a researcher at the Clingendael Institute. After finishing the PhD he became an EU-advisor for the committee on Finance in the Dutch national parliament, but remained affiliated to the University of Amsterdam.
GOVERNING IMBALANCES
IN THE ECONOMIC AND MONETARY UNION
A POLITICAL ECONOMY ANALYSIS OF THE MACROECONOMIC IMBALANCE PROCEDURE

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Governing Imbalances in the Economic and Monetary Union
A Political Economy Analysis of the Macroeconomic Imbalance Procedure
Promotiecommissie

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# Table of Contents

Acknowledgements  

Chapter 1: Debating the MIP  
1.1. A general introduction: why should we study the MIP?  
1.2 The debate on governance  
1.3 The debate on effectiveness and future evolution  
1.4 The debate on content  
1.5 Research focus  

Chapter 2: Analysing the MIP  
2.1 Research questions and conceptualisation  
2.2 Research strategy  
2.3 Case selection  
2.4 Summary  

Part I: Horizontal Analysis  

Chapter 3: The origin and evolution of the MIP  
3.1 The rise of imbalances in the EMU  
3.2 The perceived need for strengthened economic surveillance  
3.3 Designing the MIP  
3.4 From a rigid to an interactive approach  
3.5 A political approach  
3.5 Conclusion  

Chapter 4: The governance of the MIP  
4.1 Introduction  
4.2 How does the MIP function on paper?
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.2.1 The purpose of the MIP</td>
<td>80</td>
</tr>
<tr>
<td>4.2.2 The annual cycle of the MIP</td>
<td>82</td>
</tr>
<tr>
<td>4.2.3 The Excessive Imbalance Procedure and the likelihood of sanctions</td>
<td>84</td>
</tr>
<tr>
<td>4.2.4 Alternative compliance mechanisms</td>
<td>93</td>
</tr>
<tr>
<td>4.3 Institutional setting</td>
<td>95</td>
</tr>
<tr>
<td>4.3.1 Which actors are involved in the MIP?</td>
<td>95</td>
</tr>
<tr>
<td>4.3.2 Inside the Council: tools, tasks, and tensions</td>
<td>98</td>
</tr>
<tr>
<td>4.4 Conclusion</td>
<td>103</td>
</tr>
<tr>
<td>Chapter 5: Scope and content of the MIP</td>
<td>105</td>
</tr>
<tr>
<td>5.1 Introduction</td>
<td>105</td>
</tr>
<tr>
<td>5.2 Scope and content: an overview</td>
<td>106</td>
</tr>
<tr>
<td>5.3 Has the MIP become overextended?</td>
<td>113</td>
</tr>
<tr>
<td>5.4 Does the MIP have an ideological direction?</td>
<td>118</td>
</tr>
<tr>
<td>5.5 Conclusion</td>
<td>124</td>
</tr>
<tr>
<td>Part II: In-Depth Case Studies</td>
<td>125</td>
</tr>
<tr>
<td>Chapter 6: Wage Indexation in Belgium</td>
<td>127</td>
</tr>
<tr>
<td>6.1 Introduction</td>
<td>127</td>
</tr>
<tr>
<td>6.2 Belgian wages as a macroeconomic imbalance</td>
<td>129</td>
</tr>
<tr>
<td>6.3 The practice of wage indexation and domestic debate</td>
<td>136</td>
</tr>
<tr>
<td>6.4 Tracing the process: the Di Rupo government</td>
<td>141</td>
</tr>
<tr>
<td>6.5 Tracing the process II: the Michel government</td>
<td>149</td>
</tr>
<tr>
<td>6.6 Analysis: the continued controversy over the role of wages in EMU</td>
<td>155</td>
</tr>
<tr>
<td>6.7 Conclusion</td>
<td>160</td>
</tr>
<tr>
<td>Chapter 7: The Liberalisation of Professional Services in Italy</td>
<td>161</td>
</tr>
<tr>
<td>7.1 Introduction</td>
<td>161</td>
</tr>
<tr>
<td>7.2 Italy’s high debt/low growth imbalance</td>
<td>163</td>
</tr>
<tr>
<td>7.3 Professional orders and pre-crisis reform</td>
<td>167</td>
</tr>
</tbody>
</table>
10.4 Germany under MIP surveillance  
   10.4.1 The MIP as agenda setter 278  
   10.4.2 The investment gap and associated policy responses 282  
10.5 Analysing the role of the MIP in Germany 287  
10.6 Conclusion 293  

Chapter 11: What we learn from the analysis 295  
11.1 Is the MIP hierarchical? 295  
11.2 Does the MIP have an effect on national policymaking? 299  
   11.2.1 Substantive effects 299  
   11.2.2 Procedural effects 307  
11.3 Unpacking causality: mechanisms and determinants 310  
   11.3.1 The MIP as an instrument of external pressure 310  
   11.3.2 The MIP as an instrument of cognitive shift 313  
   11.3.3 What are the key determinants of the MIP’s capacity to affect domestic policymaking? 317  
11.4 What else do the case studies show? 319  
11.5 Schematic summary of effects (simplified) 322  

Chapter 12: Conclusions and reflections 323  
12.1 General conclusions 323  
12.2 Reflections: The MIP and euro area legitimacy 328  
12.3 Reflections: Is the MIP effective? 331  
12.4 Reflections: The MIP and reforming the EMU 337  
   12.4.1 Option 1: maintain the status quo 337  
   12.4.2 Option 2: reorganise and reorient 338  
   12.4.3 Option 3: conditionality-based procedures 339  

Literature 345  
Annex 1: The Semester cycle 380  
Annex 3: Coding methodology 382
List of abbreviations 384
List of interviews 387
Summary 389
Samenvatting 397
About four years ago I received an email asking me whether I might be interested in doing a PhD. At the time, I was hesitant as I thought it would be monotonous and lonely to work on a single project for such a long time. Instead, what I found was a very lively academic community and lots of dynamism. The journey turned out to be intellectually stimulating, far from lonely and above all a lot of fun. I have many people to thank for this.

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Chapter 1

Debating the MIP

1.1. A general introduction: why should we study the MIP?

The crisis in the euro area has been tremendously expensive. It has been expensive in terms of the money spent to sustain the financial system; expensive in terms of loss of welfare and the rise of unemployment; expensive in terms of political capital invested into finding solutions; expensive in terms of legitimacy lost for the euro project, the deepening of cleavages between European Union (EU) Member States; and expensive in terms of the loss of confidence in ruling elites. At the moment of writing, the economic mood looks brighter. Growth has returned to Europe. But, the crisis has been long and deep and many of the structural vulnerabilities, such as high levels of debt, remain. It is therefore imperative to try and draw the right lessons from the crisis and evaluate the strength of the mechanisms that should prevent crises in the future.

The crisis showed that the institutions governing the euro were not up to the task. They failed to prevent the crisis from emerging in the first place, and when the crisis hit they failed to prevent it from escalating. Perhaps most significantly, the euro area turmoil demonstrated that the governance framework was overly narrow: it focused mainly on Member States’ government finances, setting limits on public debt and budget deficit levels. While the crisis certainly revolved around escalating problems in governments’ finances, its causes were much broader. Observers pointed out that financial instability and macroeconomic imbalances – such as trade deficits or high private debt levels – played an important part in the build-up of the problems. If a future crisis of this magnitude were to be avoided, the scope of the EMU’s governance frameworks would have to be broadened.

In recent years, EU policymakers have altered this governance framework significantly. They set up the European Stability Mechanism (ESM) as a permanent bailout fund for struggling economies, with a firepower of 500 billion euro. The European Central Bank (ECB) has taken unprecedented steps to calm the markets by an expansion of its monetary policy toolkit. It now also has a role as supervisor of EU’s most significant banks. Policymakers expanded existing investment facilities and set-up a new European
Fund for Strategic Investments. They revised fiscal rules and broadened supervision with the European Semester for fiscal and socioeconomic policy coordination. Since the crisis, we speak of an EMU 2.0.

Macroeconomic imbalances stand out as an important post-crisis policy focus. After all, the situation in Greece, Cyprus, Portugal, Spain and Ireland has shown what happens when imbalances in the economy spiral out of control during a period of financial distress. These imbalances had their roots in the pre-crisis years when public and private debt levels rose significantly, without contributing in a meaningful way to economic development. The bailout packages for these states and their attached conditionality, consisting of budget cuts and economic reforms, showed how troublesome corrective action on imbalances can be.

One important post-crisis innovation in the governance framework is thus the Macroeconomic Imbalance Procedure (MIP), which specifically aims at preventing unsustainable imbalances within Member States. The MIP tries to detect the rise of such imbalances from an early stage and give guidance on how to prevent and correct them through economic policy recommendations, so-called Country Specific Recommendations (CSRs). The MIP significantly broadens economic surveillance to almost any area of the economy. As such, it is an important new element in EU’s crisis prevention toolkit. Before discussing the MIP it should be noted that all Member States of the EU fall under the scope of the MIP, but this thesis focuses on the Member States of the EMU, for whom the MIP applies more strictly. Secondly, countries that have received financial assistance – Greece, Cyprus, Ireland, and Portugal – were not subject to the MIP during their financial assistance package, but received recommendations related to the corrective Economic Adjustment Programmes (EAP) (Spain is an exception). Finally, it should be clear that the MIP is part of the overarching European Semester (hereafter Semester). All Member States receive Semester CSRs, but only some of these CSRs are linked to the MIP. Since the Semester and MIP are very much entangled the two terms are sometimes used intermittently in this chapter to reflect the literature, which does not always make the distinction between the two very clearly.

To show what imbalances are and how the MIP can address them we can look at the example of Spain. The Spanish economy grew significantly in the years between the introduction of the euro and the crisis (roughly: 2000 – 2007). Sovereign debt to GDP fell with 24 percentage points, more than any other in the EMU. The labour market expanded and unemployment fell to historically low levels (8% in 2007). The introduction of the euro
gave Spain access to capital and this resulted in a long period of strong economic growth (Manasse, 2018). Under the pre-crisis EMU framework (with a focus on fiscal rules) Spain did perfectly well. But this growth turned out to be based on weak macroeconomic fundamentals. Growth was financed by foreign capital, banks from Northern EU states started investing massively in the Spanish construction sector and tourism branch, because big profits were to be made. This dynamic showed up as a current account deficit: a macroeconomic imbalance. The investment resulted in a construction boom. One in five now worked in the construction sector and a massive share of these under temporary contracts. The investment did not contribute much to the building up of productive capacity and technological capabilities for the Spanish economy. And when financial panic hit the euro area the markets lost faith in the strength of the Spanish economy, capital flows reversed and unemployment skyrocketed, especially in the construction sector, which was left to dry. The government had to step in and as a result sovereign debt increased significantly.

How much cheaper (in terms of money, legitimacy, social hardship, etc.) would it have been had the authorities intervened earlier to counter this distortive trend? Now, with the MIP, the European Commission (hereafter the Commission) monitors developments in the current account and Spain receives CSRs on its labour market, on financial supervision and on issues that should strengthen the competitiveness and productive capacities of the Spanish economy, such as product and services markets. Spain now presents a National Reform Programme (NRP) on these issues every year. The Commission assesses the NRP and issues the CSRs for the Member States. These reports are discussed in the Council of the EU and the European Council (from now on Council), which also endorses the CSRs. And the more severe are the imbalances, the stricter the MIP becomes in terms of monitoring, whereby insufficient action on excessive imbalances could potentially lead to financial sanctions in order to avoid possible escalation to crisis.

As this framework may contribute to crisis prevention, it is crucial to investigate the MIPs’ (potential) effects. As identified above, the crisis was so expensive that we better hope to prevent similar problems in the future. At the same time, the MIP is not without its controversial aspects. In hindsight we know that trends in the Spanish economy were unsustainable, but real time evaluation is notoriously difficult. Imbalances are the outcome of market processes, which are often only indirectly affected by government policies. Defining the policies to address imbalances is problematic. An imbalance procedure assumes that we know what a balanced economy looks like. But there is no such thing as a unique optimal institutional setting to support growth or
an optimum balance between flexible and secure labour market settings to make it more stable. Different settings can give different comparative advantages depending on the industrial specialisation of an economy. Successful policies rely to a significant extent on conformity with the domestic context and ownership by local actors. It is by no means clear that adopting blueprints from international experience provides for the best way to make an economy resilient. In other words: we cannot ex-ante assume that the Commission has superior knowledge on these issues. These considerations apply to the MIP’s content.

There are also issues pertaining to the MIP’s governance. Had the EU intervened coercively in the booming Spanish economy before the crisis, local politicians would probably not have been happy and resisted the Commission’s interference. The CSRs are based on economic expertise, rather than a democratic mandate. But the issues that the MIP touches upon are deeply political. The CSRs that address imbalances go to the heart of national democracy, such as pension policy, wage-setting institutions or tax policies. On many of these issues, the competences of the EU are limited and the role of social partners is protected. These are not issues where Member States are very willing to give up competences to the EU. But with the MIP and its possibility of sanctions, the EU institutions gain a more prominent role on these issues than ever before and the principle of subsidiarity becomes more blurred. It is therefore pertinent to know whether Member States have now become constrained in all these sensitive domains? It would be problematic if EU knowledge would assume a dominant position over national reservations and sensitivities in a policy debate, not least because the EU institutions do not have the same level of institutional capabilities to be held accountable if policies fail. Or, should we see the MIP more as a cooperative framework, where the EU institutions try to convince rather than to coerce Member States to adopt policies to prevent imbalances? In other words: how should we characterise what mode of governance the MIP is?

And finally, the MIP should be viewed within the wider context of the evolving EMU. The reason why policymakers believe that national policies require frameworks such as the MIP is not just to prevent crisis, but also because they are convinced that being part of a common currency requires a level of joint responsibility. The EMU is economically and financially integrated and has a web of common institutions and solidarity mechanisms, which therefore requires of its Members that they ‘shall regard their economic policies as a matter of common concern’ (Art. 121 TFEU). But we find vast disagreement over what this common responsibility should entail. There are no straightforward answers to questions of whether a smooth functioning EMU should facilitate democratic diversity
or requires convergence on issues such as prices and wages. Should Germany under the MIP invest more and should France reign in government expenditure only because a common currency requires this to be so? Should Italy be put under strict control because of high public debt or would this be unhelpful for Italian politicians who seek to garner the support needed to implement reforms? Or should the architecture that governs the EMU be reformed altogether, solidarity mechanisms enhanced and convergence made binding? From the start of the crisis, EU leaders have looked for alternative ways to govern the euro (Van Rompuy et al., 2012; Juncker et al., 2015a). When studying the MIP, account should be taken of this broader debate on the evolving nature of the EMU.

Since the birth of the MIP, the issues of its content, mode of governance, effectiveness and broader evolution have also received critical scrutiny in the academic literature on European economic governance. With regard to its content, many scholars argue that the MIP reflects a neoliberal worldview, with its policy recommendations generally favouring austerity, wage restraint, and flexible labour markets. Yet it is far from clear that the MIP’s policy recommendations can be neatly linked to a clear policy paradigm, nor that the MIP has stayed the same since its birth. With regard to its mode of governance, scholars have argued that through the MIP, EU institutions have gained a more intrusive role in steering Member State policies. However, it is not obvious that the MIP actually works in a top-down, hierarchical fashion. Finally, some scholars have concluded that the MIP is ineffective as Member States score low on implementation levels, whilst there is divergence between the North and the South on indicators such as GDP, wages, consumption and investment. These classifications on a lack of implementation feed the debate on the future evolution of the EMU. But the MIP’s effects may be subtler than this, meaning we should be careful in drawing hard lessons from implementation levels.

This chapter will critically review much of this literature within the debates on these considerations. There are unspoken and sometimes explicit assumptions build into the ideas and classifications of how the MIP works in the debates. This chapter tries to make these assumptions explicit so that they can be tested. As often with European governance, we can suspect that the procedure works differently in practice than on paper. This chapter will argue that in order to assess the true character of the MIP one needs to analyse recommendations in their national political context and talk to the actors involved. Studying Commission documents alone is insufficient to understand the everyday operation of the MIP. It will reveal little about the intricacies and more subtle effects involved in the MIP. As a matter of fact, throughout this thesis I will show how the practical operation of the MIP differs in substantial ways from how the MIP is depicted in much of the literature. For this chapter, the key argument is that the debate
lacks a sufficient empirical basis and that a different research strategy is necessary to analyse the MIP. One that includes the economic context, the domestic political context and one that shows how the MIP is used by actors in practice. Chapter two will set out a detailed research strategy to do so on the basis of the following two main research questions:

» On governance: How hierarchical is the MIP?
» On effects: Does the MIP have effects on domestic policymaking? And if so, through which channels and mechanisms? What are the key determinants of the MIP’s capacity to affect domestic policymaking?

And while the research strategy is focused specifically on answering these two main questions, the analysis will also serve to answer two secondary questions:

» On content: What does the analysis tell us about whether the MIP has a neoliberal bias in its recommendations?
» On evolution: What does the analysis tell us about the debate on the reform of the EMU?

This thesis consists of two qualitative research parts: a horizontal part that gives a general overview of the MIP’s historical trajectory and evolution (chapter three), its practical functioning (chapter four) and its scope and substantive policy content (chapter five), and secondly a vertical part; five in-depth case studies to trace the effects of the MIP on domestic policy-making and determine its governance characteristics empirically (chapters six to ten). Each case study chapter aims to tell a country-specific and issue-specific story, developing a causal narrative based on analysing political and economic context and assessing the role of the MIP CSRs in the domestic context. The last two chapters will make a cross-case analysis, present a general conclusion and reflect upon this conclusion in terms of what the findings mean for the debate on the future of EMU. Readers with limited time and advanced knowledge of the debate on the euro crisis and the precise working of the MIP are advised to focus on the case studies, as this represents the core of the thesis.

1.2 The debate on governance

A first debate that can be distinguished concerns the question how we should classify the

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1 These questions are secondary in the sense that the research strategy is focused on answering the first two. If the secondary questions were included as main questions a different strategy would have to be designed. Chapter two will seek to better explain this differentiation.
Chapter 1: Debating the MIP

MIP as a mode of governance. Criticisms in this debate typically revolve around issues of competence, accountability and discretion. As stated in the introduction, monitoring under the MIP can become stricter if imbalances are more severe and Member States do not sufficiently address them, but the CSRs do not follow from a democratic mandate. The recommendations stop short of direct legally enforceable regulations, they are not immediately binding. But they do impose constraints on government action and raise the cost of inaction on these issues.

Many commentators have perceived the MIP as a move towards a more hierarchical governance architecture. It was deliberately introduced to strengthen monitoring and peer pressure and harden commitment to structural reforms. And it introduces clear elements of hard law in the form of financial sanctions in a domain that has traditionally been governed in the EU by non-hierarchical coordination. A more hierarchical European framework would, so the critics claim, reduce the scope for domestic decision-making, without introducing sufficient democratic control mechanisms at the European level as a substitute. Hierarchy as a concept to characterize modes of governance comes from the debate on new modes of governance (NMG). The next chapter will further unpack this term; for now it suffices to understand it as the hardening of soft governance or as an increase of constraint on national democratic decision making.

In the first years after its introduction, many authors interpreted the new economic governance framework, including the MIP, as a significant move to hierarchy. With the MIP, the EU institutions have gained a more visible and intrusive role in steering Member State policies (De la Porte and Heins; 2014). Legal scholars have criticised the MIP as overly discretionary, without sufficient legal and political accountability mechanisms, and thus (further) departing from the principle of European integration through law (Chalmers, 2012; Joerges and Weimer, 2012; Dawson, 2015). Political scientists have described the new framework in terms of a move towards executive dominance (Curtin, 2014) or ‘democracy under surveillance’ (Degryse, 2012). Others have criticised its reliance on rules and numbers that threaten democratic deliberation (Schmidt, 2015; Ryner, 2015). Describing the EMU in more general terms, Offe talks of the euro as entrapped in a technocratic democratic dilemma (2014). And Streeck describes the rise of technocratic economic governance as a de-democratised form of capitalism (2014). Focusing on the specifics of the MIP, Scharpf has classified the corrective arm for excessive imbalances as ‘a legally and politically unconstrained expert regime’ (2013; 12). Finally, many have commented on the lack of possibilities for parliamentary oversight and the general blow to public support from the new economic governance framework (e.g. Hallerberg, Marzinotto and Wolff, 2012; Hefflter and Wessels, 2013; Alcidi et al., 2014; Cramme and
Authors assume that the MIP – as an important part of the new framework – involves a significant step in the concentration of power towards the EU institutions. This raises legitimacy issues since there is no direct possibility for parliamentary or legal control over the decisions made within the MIP. Some of the starker classifications in the debate should also be understood from the temporal context. The EMU was in full-blown crisis in 2012 and 2013, there was a heavy debate on austerity and the bail-out packages in these days and the MIP was a new instrument so that scholars studied its legal design more than its practical operation. In these years EU officials talked of a significant hardening of economic governance and the Commission even referred to itself as the economic government of Europe (see chapter three). Over the years some of the classifications have become somewhat more nuanced, especially since the Juncker Commission struck a different tone focused on dialogue and national ownership and started introducing flexibility in the approach (EC, 2015). And since it turned out that the corrective arm was not opened for countries in economic difficulty. This approach of granting leeway and engaging in constructive dialogue has also been confirmed by empirical work on the Semester (Bekker, 2016). Some authors concluded that the MIP did not contain the level of obligation and legal rigour as assumed by some of the authors mentioned above (Hodson, 2018).

Yet, the criticisms remain relevant, especially since the idea that the EMU and its governance framework are highly constraining is still very much alive (e.g. Scharpf, 2016; 2018; Rodrik, 2018). The economic governance framework might no longer be referred to as ‘executive federalism’ (Crum, 2013), but is still seen as putting national parliaments on the losing side of a two-level game between the national and European administrations, with economic decisions increasingly constrained (Crum, 2018). It is therefore worth unpacking the assumptions in the debate a bit further.

The MIP falls largely outside the scope of parliamentary control. Yet, the debate on constraints on national democratic decision-making should be seen against the background of a growing primacy of European responsibility since the crisis (Laffan, 2014). With responsibility is meant the duty of governments to ‘face up to collective challenges in the best interest of their own political community, considering the web of interrelationships with other relevant communities’ (Ferrera, 2016). The ‘collective’ in the euro area has been redefined as leaders found that socioeconomic, fiscal and financial policies in one country have spillover effects on another. In this debate one should balance arguments
of independence and interdependence, or constraint on national democracy with the purpose of the MIP. There is no such thing as the pure sovereignty of parliamentary decision-making and the alternative to MIP surveillance could be worse. The crisis has reaffirmed that markets can be vigilant when they lose trust and the resulting market processes can be highly constraining on national politics. Similarly, the conditionality packages for when Member States receive financial assistance, are also highly constraining. The MIP aims to prevent such situations. EU leaders have argued that the macroeconomic stability of the euro area, and structural reforms in Member States to attain this stability, are a legitimate concern of all participating members (e.g. Draghi, 2015).

Those authors who conceive of the MIP as constraining make implicit and explicit assumptions on the hierarchical character of the MIP, but also on whether it acts as a rival to parliamentary accountability and responsiveness to the electorate. Contrary to such claims, Ferrera (2016) argues that economic governance can in principle act as complementary, rather than rival form of accountability. It is precisely the relative insulation from domestic electoral circles that give these mechanisms additional value to parliamentary control (Zeitlin et al., 2014 make a similar argument). Politicians have to be responsive to voters, but that does not mean per se that the economic logic that follows from the recommendations should be ignored. Or in the words of Ferrera: ‘Effective democracy requires an appropriate balance between popular demands and elite expertise, supported by the best available knowledge (...) it can also be made to work at the service of political responsibility, without necessarily violating the democratic standard’ (2016). This conceptualisation of legitimacy as both responsiveness to voters and responsibility is mostly ascribed to the work of Mair, who argues there is increasing tension between these two aims of governing (2009). The MIP is typically involved with the responsibility part of the legitimacy axis. The build up of imbalances is a phenomenon that is not easily endogenously translated through voter preferences until it is too late and imbalances transform into a clear situation of crisis.

In the context of the MIP we can expand this legitimacy axis even further: the task of governing and policymaking goes beyond responsiveness and responsibility, it can also be understood as ‘collective puzzlement on society’s behalf’ (Heclo, 1974; 305 as used in the context of policy coordination by Vanhercke, 2015). In this regard, the MIP represents

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2 Whether policy coordination frameworks can be complementary to or threatens standard political and legal accountability structures has been a longstanding debate in the governance literature (Trubek and Trubek, 2007).
a novel new instrument for dealing with complex macroeconomic phenomena and involves a significant upgrade in analytical capacities of economic monitoring.

In general it has to be remembered that at every level of politics there is interaction with experts or technocracy. But indeed, such interaction on the basis of expertise sits uncomfortably with financial sanctions and strict hierarchy. However, the real question in judging the character of the MIP is what form does the interaction between the European and national levels take? The MIP might introduce hierarchical elements, such as a sanction procedure, in its design, but its use in practice remains to be tested. This thesis is based on the assumption that judgements of legitimacy concerns or complementarity to national accountability ultimately rely on whether the interaction indeed takes a more hierarchical form. A more hierarchical use of the MIP deepens potential legitimacy issues and vice versa. And to come back to the key argument, this requires a study of the behaviour of actors vis-à-vis the legal framework, rather than a study of the legal design as such. In other words, it requires a different research strategy.

Finally, it is certainly fair to judge the level of discretion that is allowed in the legal design, especially since it concerns policy areas where the competences of the EU are limited. This discussion has been reinvigorated with the Commission's more political approach. At the same time, it has to be remembered that not everything can be codified into legal texts; especially where it concerns the potential build up of macroeconomic risk there will always be an element of judgement. What matters is how discretion is exercised, for example, whether it follows transparent economic reflections that can also be challenged by the Member State. Again, there is the assumption here that an overly discretionary approach warrants more accountability.

1.3 The debate on effectiveness and future evolution

On the other side of the debate there are a number of economists and policymakers who argue that current mechanisms are still insufficient in inducing Member States to make the structural reforms that they see as necessary for macroeconomic stability in the euro area. This strand of literature moves away from analysis of the legal design and towards implementation scores of Member States on the CSRs. Especially those in the world of Brussels’ economic think tanks have lashed out at the MIP, which they see mostly as an empty shell. Some argue that peer pressure is failing and there is little we can expect from the MIP (Gros and Alcidi, 2015, (CEPS)). The MIP is seen as ‘a very weak
mechanism’ (Sapir and Wolff, 2015 (Bruegel)), or as ‘ineffective’ (Darvas and Leandro, 2015 (Bruegel)), or ‘fairly useless in practice’ (Claeys, 2017 (Bruegel)). The analysis that the recommendations do not find sufficient traction in the national capitals seems widely shared among policy advisors (Zuleeg, 2015; Enderlein and Haas, 2016; Banerji et al., 2015). Begg, a prominent scholar of economic coordination, even goes as far as claiming that if the MIP is not made more relevant to national policy-making it is open to the charge of irrelevance and ‘might as well be discontinued’ (Begg, 2018).

The classification of ineffectiveness or even irrelevance is to a large extent informed by assessments of the annual implementation scores on CSRs as provided by the Commission in the Country Reports. For example, Darvas and Leandro (2015) use an index of average implementation scores. These show a dispersed but on average low implementation rate: from 40% in 2011 to 29% in 2014 (for all Semester CSRs), with only a slightly higher implementation rate for CSRs that are linked to the MIP or SGP (a similar index is used in Deroose and Griesse, 2014, for overviews of CSR implementation see: Hradiský, 2016; 2017). The falling trend in implementation is generally ascribed to improvements in economic circumstances, which would lower incentives for reform. An update on implementation in 2015 saw the score drop to 25% (Darvas and Leandro, 2016). Efstathiou and Wolff use a more sophisticated analysis on the basis of sub-CSRs to account for differences within broader formulated CSRs, but their findings largely corroborate those of Darvas and Leandro. They do note that the decline in implementation rates since 2014 has been especially strong for Member States facing excessive imbalances, which they take as another sign of the MIP’s ineffectiveness (2018).

The Commission described implementation of CSRs as ‘uneven and often only limited’ and identifies the need for a stronger MIP in this context (EC, 2015a). In another policy paper, it warns that the euro area is experiencing significant reform fatigue among Member States (EC, 2016). For an overview of implementation see figures below:

Figure 1: Implementation of MIP-CSRs (ECA, 2018)
At the same time, there is the widely held view that more structural reforms are needed in the EMU to enhance resilience and counter divergence (Franks et al., 2018). As such, there have been repeated calls to strengthen the MIP. In a joint report, the five presidents of the EU institutions stress that much more needs to be done to make sure all Member States improve their competitiveness. The MIP is described as a vital device for the EMU, but the leaders also stress that it needs a more explicit role and that the corrective arm should be used more forcefully. For the medium term, the introduction of legally binding convergence standards could enhance structural reforms. Access to a possible new shock absorption mechanism for the euro area would be conditional upon progress on these standards (Juncker et al., 2015a). The assumption seems to be that more pressure or a more binding character of the recommendations would enhance effectiveness. The European Central Bank (ECB) is perhaps the most outspoken in this debate. One-third of all speeches by members of the executive board of the ECB refer to the need to implement structural reforms, as opposed to two per cent in the speeches of the Fed (Draghi, 2015). The ECB has consistently called upon the Commission to make more use of the corrective arm of the MIP in every cycle of the MIP to achieve result on structural reforms, even claiming in some years that the corrective arm should be opened up for all states that face excessive imbalances (ECB, 2012; 2013; 2014; 2015; 2016; 2017; 2018).³

In a joint paper on the future of the EMU, fourteen leading economists from France and Germany argue that the MIP has been largely ineffective since its inception. But, in

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³ Here it should be noted that the corrective arm in first instance leads to heavier monitoring and stronger commitments and only in a later instance can it lead to financial sanctions (see chapter four). The ECB is not calling upon the Commission to immediately impose financial sanctions, but believes that stronger monitoring under the corrective arm is a useful tool.
contrast to the ECB, they argue that penalisation under the MIP can be counterproductive both politically and economically. They do not list a reform of the MIP as among the priorities for the EMU, but argue in line with the five presidents that access to a future stabilisation function for the euro area should be conditional on compliance with the CSRs (Bénassy-Quéré et al., 2018; the conditionality argument is also made by the European Fiscal Board, 2017). This conditionality would alter the binding nature of the CSRs. A discussion note to the informal ECOFIN Council stated in this context that further risk sharing might require a higher degree of intrusiveness of coordination procedures (Estonian Presidency, 2017). Also for proposals to enhance the social character of the EMU, it has to be remembered that there is still a large difference in regressive and progressive welfare and tax systems among euro area Member States today. We can therefore assume that any expansion of solidarity mechanisms in the euro area that is significant, such as common insurance of welfare states against financial shocks, will go hand in hand with political calls for more binding convergence of social standards. Rather than MIP CSRs, countries could in such a situation face a type of reform contract.

There seem to be two assumptions in this debate. The first assumption is that the MIP is ineffective. The second is that giving the CSRs a more binding character, either by a more forceful approach of the EU institutions or by introducing types of conditionality, would enhance compliance. Firstly, the frame that the MIP is ineffective has by now become quite powerful due to influence of the authors mentioned above and their strong statements. Therefore their claims require a careful and lengthier analysis. The next few paragraphs will argue that the question of whether the MIP is an effective tool is riddled with methodological difficulties and normative assumptions. To start with: looking at ‘full implementation’ or ‘substantial progress’ on annual implementation scorecards is a questionable method of assessing effectiveness. Implementation is closely bound to the formulation of the CSR: a very precise CSR might get ‘full implementation’ (e.g. implement the pending law on competition frameworks), whereas ‘some progress’ on an openly formulated CSR can in practice imply that more has been done (e.g. ‘tackle remaining rigidities in the services industry’). If the implementation rate on highly specific 2013 CSRs is higher than on open 2017 CSRs, this does not tell us much about effectiveness.

A large part of the CSRs receives the label ‘some progress’, which commentators take as a sign of the overall ineffectiveness of the MIP. But what the Commission might consider as only ‘some progress’ can be considered a breakthrough at the national level. With the ‘some progress’ label, the Commission has an incentive to continue monitoring, whereas with ‘substantial progress’ a CSR is usually taken out the next
year, which gives an incentive to the former. Focusing on the implementation of a single
year is also problematic. As argued by the Employment Committee Chair: ‘If a CSR gets
implemented after four years due to the complexities of the national process, I would
still think this is a 100% implementation and not 25% as we are sometimes told – or tell
ourselves’ (Bevers, 2016).

Assessments of effectiveness also hide normative assumptions about what the role of
the EU should be in the reform process. Arguably the MIP is a more encompassing and
inclusive tool than procedures that come closest to it, such as the OECD's Going for
Growth reports or the IMF’s Article IV assessments or the pre-crisis BEPGs. The MIP
might be ineffective as opposed to a federal-type EU with more pronounced competences
or as opposed to the Economic Adjustment Programmes, but both comparisons are
speculative. The question is which yardstick we should use in determining effectiveness.
It depends on how you perceive the mission of the MIP. If it is perceived narrowly, as
an instrument that should deter Member States from running large current account
deficits, there is an argument to be made that it has been effective. Member States
have made progress on flow indicators (current account, unit labour cost, etc.) and are
generally going into the right direction when it comes to correcting imbalances, albeit
slowly (Pierluigi and Sondermann, 2018). If you take a broader perception of its mission,
that it should counter divergence in the euro area and a more rapid reduction of stock
imbalances such as high debt levels, there is an argument to be made that it has not been
effective.

Above all, the reforms that are introduced in Member States might correlate with
what the MIP has been recommending, but this tells us little about causality and thus
about effectiveness. Member States were introducing reforms in their labour markets
and product and services markets long before the MIP and will continue to do so
independently of the MIP. If the MIP has a high compliance rate, this could just as easily
mean that the CSRs are too general and if it has a low implementation rate it could mean
they are largely seen as irrelevant. Implementation scores, CSRs and national reforms
might have very little to do with one another. For example, the implementation analysis
of Efstathiou and Wolff shows that the UK has overall the second highest implementation
score on CSRs of the Semester after Finland (2018). Does this mean that the Semester is
highly effective in the UK? Case study research suggests that CSRs are mostly ignored

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4 The IMF argues that successful reforms are typically implemented in sequence as part of a
wave of reforms that reinforce each other (IMF, 2015). Labour market reforms are in general more prone to
partial and sequential reform, since each reform focuses on a different part of the labour market (Boeri,
and have very little traction among British policy-makers (Begg et al., 2017).

Implementation scores give a useful estimate of reform effort at Member State level when you assume that the Commission is right in setting out the necessary reform priorities. But even then it is very problematic to look in a quantified way at this issue. Estathio and Wolff suggest that the MIP is ineffective because the implementation rates have dropped from 2014 to 2016 among Member States with excessive imbalances. But this statement leaves out a lot of context: the composition of countries with imbalances changed; Cyprus and Portugal entered after having just reformed significantly under their adjustment programme; Slovenia exited after having reformed significantly in 2014; the number of CSRs and their formulation changed significantly in these years; the Italian Jobs Act counts as one data point in the analysis, but has domestically been perceived as a significant reform, etc. If the authors want to warn that in light of high debt levels and insufficient growth they believe more effort is needed on the CSRs by the Member States, than implementation scores are a way to support your argument. But as a way to substantiate claims that the MIP is fairly useless this methodology is highly questionable.

There is a difference in making statements about effectiveness, which are ultimately based on considerations about the role and purpose of mechanisms, and effects, which is a more empirical question. For example, a well-known criticism of the fiscal rules in the SGP is that they are ineffective because so many countries are able to breach the rules. France is seen as a clear case in point: it has been in the corrective arm of the SGP for many years without getting a sanction. The Netherlands on the other hand is seen as a country that holds the SGP in high regard, sticks to budgetary targets and introduced significant budget cuts when it was in the Excessive Deficit Procedure (the corrective arm of the SGP). We could argue that the SGP is effective in the Netherlands and ineffective in France. But, another way to think about this example is that the Netherlands already has a strong culture of fiscal prudence, with strong domestic institutions fiscal institutions and an intrinsic eagerness to maintain their triple-A status on government bonds. France might not have stuck to the rules, but the updates under the SGP in the Semester have had an effect on France. For example, the French parliament has traditionally been a weak player in the budgetary process, but has seen its involvement considerably increased with the Semester (Jančić 2016), there is now more transparency about fiscal policy choices in France. This is not to say that the SGP in France is effective, but one should also not ignore more subtle effects.
The question is whether the recommendations are of added value in the reform process of the Member States, whether actors find the MIP a useful framework to work with in order to address imbalances. Some argue that CSRs have had an effect in reform areas where Member States had trouble implementing reforms before, such as with labour market reforms in Italy and France (Crespy and Schmidt, 2017). Pisani-Ferry, who is close to European policy-makers in both countries, argues that CSRs are largely ignored in national capitals (2015; 2016). But there has been surprisingly little empirical research into whether and in what way the MIP has an influence on domestic policy agendas to support such claims. Notable exceptions are: Maatsch (2017) who analyses whether CSRs gain traction in parliamentary debates; Louvaris (2018), who has conducted in-depth process tracing into the effects of Semester recommendations in Belgium; Eihmanis (2017) has done the same for Latvia. Schreiber (2017) has traced the effects of the Semester on taxation policies in France. And Schulten and Mueller have looked at what has been recommended under the Semester in terms of wage setting (2015). However, to my knowledge, no attempt has been undertaken to study the implementation of MIP CSRs in a qualitative manner across cases and countries over time.

Finally, while the earlier cited Commission documents call for a stronger MIP, the Commission services also describe the MIP in more positive terms. In an evaluation of the MIP, they argue that the MIP contributed to a shared understanding among Member States and enhanced compliance, while Member States in general have responded constructively to monitoring, which led to more ambitious and targeted policy commitments with a statistically significant higher compliance rate among Member States with excessive imbalances (EC, 2016a). Commission officials (in a personal capacity) therefore hold that the MIP represents more than just a smokescreen (Bricongne and Turrini, 2017). In response to a questionnaire of the European Court of Auditors, only 10% of Member State representatives listed the MIP as ineffective; most respondents saw the MIP as ‘somewhat effective’ and as having ‘some impact’ on domestic policy debates (ECA, 2018). The picture thus seems more mixed than presented at the start of this section. But what are we to make of all these labels such as ‘some progress’ on implementation or ‘somewhat effective’? A qualitative case study approach could be a way of digging a bit deeper.

The second assumption is that a tougher approach in the MIP or changing the status of

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5 The report of the European Court of Auditors on the MIP is one of the most extensive evaluations of the MIP to date and will be used and cited on multiple occasions in this thesis. The work of the ECA is sometimes useful to support my arguments, but overall my conclusions and approach deviates significantly from the ECA report.
the CSRs would enhance compliance. But here we get back to the dilemmas as explained in the introduction and the legitimacy discussion above. There is a strong underlying assumption in this debate that the CSRs lead to good economic policy and that the problem of implementation lies with political economy obstacles (vested interests or low political incentives) that stand in the way and need to be overcome by introducing more stringency in the framework. But while EU institutions can make valuable suggestions and analyses there is no evidence to support the claim that they have superior knowledge. Would it be better if the Commission had unlimited power over structural reforms in deeply embedded socio-economic systems? Arguably not.

Even where the Commission might have good ideas about technical efficiency of reforms or pareto-improving conditions, it might not be the right actor to make such claims or insist on them. Implementation of reforms requires building societal consensus. A legalistic approach or carrots and sticks do not necessarily enhance such a process. Wyplosz argues in this context that intrusion in national affairs could be counterproductive, because it can trigger severe political backlash (2015). Many of the economists cited above will be aware of the need for ownership of reforms at national level, so that there cannot be severe intrusion, but still support reforms that enhance a more legalistic character of the recommendations, by introducing conditionality. A notable exception is Gros and Alcidi, who argue that reforms cannot be bought and that implementation of reforms cannot be measured precisely enough for any type of conditionality. In their view rigidity is best avoided and a focus on ownership and decentralised application (involvement of national institutions) would be the way to enhance effectiveness (2017).

1.4 The debate on content

A third strand of literature that can be identified focuses on the ideological orientation and political discourse behind the CSRs. In this debate authors have primarily feared a subordination of social goals under the economic governance framework. Many authors have commented more generally on the prominence of austerity in European economic governance, on the perceived resilience of neoliberal ideas, or on the negative social effects of structural reforms in the countries under financial assistance (e.g. Schmidt and Thatcher, 2014; Blyth, 2016; Matthijs, 2016; Johnston and Regan, 2017). Authors in this literature strand typically argue that economic governance is dominated by German economic ideas, which is incompatible with the particularities of different growth models. The social hardship that many states have experienced since the crisis is taken as evidence that the EU has handled the crisis in the wrong manner and on the basis of
flawed neoliberal ideas.

European leaders poured oil on the fire when they defined the euro crisis as a crisis of cost competitiveness caused by structural weaknesses and rigidities and hinted at the need for more flexible labour markets and ways to allow for wage restraint (Juncker, Tusk, Dijsselbloem and Draghi, 2015). These claims have been heavily criticised by scholars who dispute the significance of analyses based on the cost of labour and the economic benefit of wage cuts and labour market flexibility (e.g. Storm and Naastepad, 2016). This debate has also been present in the European Parliament, where parties started to introduce alternative growth orientations for the Semester (e.g. Timbeau et al., 2014). Finally, there has been strong criticism on the asymmetric character of the crisis response. Whereas the countries with a current account deficit have faced significant conditionality under the EAP, the MIP has been seen as a weak tool to force creditor nations to do their part with stimulating policies (De Grauwe, 2015).

When focusing on analyses of the content of the CSRs in particular, a number of authors have argued that social goals have been sacrificed in pursuit of fiscal goals and that the policies promoted by the Semester typically focus on welfare retrenchment rather than enhancement (Costamagna, 2013; Crespy and Menz, 2015). This subordination of social goals also holds for social actors who have seen their role diminished within the Semester framework (de la Porte and Heins, 2014; Greer and Jarman, 2016). Some would even go as far as describing the Semester as an ideological straightjacket in its subordination of social objectives to economic ones (Copeland and Daly, 2015). Scharpf describe the MIP as a way of enforcing structural convergence towards a Northern export-led growth model. The MIP should constrain the rise of domestic demand and wages or any other impediment to export competitiveness (2018). Darvas and Virhiala (2013) argue that the recommendations have not focused enough on demand management, investment, and symmetric correction of current account imbalances (in other words: a tougher approach on the surplus countries). Crespy and Vanheuverzwijn argue that the policy message of the CSRs consists of a core of neoliberal ideas around labour market flexibility and market liberalisation (2017).

On the other side of this debate we find a series of empirical assessments of the Semester by Zeitlin and Vanhercke (2014; 2015; 2018). They argue that the first years of the Semester

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6 The ideas on competitiveness will be critically reviewed in the case study chapters. Chapter ten discusses the tenuous link between competitiveness and current account imbalances, chapter six discusses the role of wages and chapter eight discusses flexible labour market policies.
confirmed the worst fears of social actors about the nature of the process and the content of the recommendations. But over the years a gradual process of socialization of the Semester has taken place. Social actors have gained a more prominent position within the framework and the content of the CSRs has become more social. Bekker confirms this trend and argues that also MIP CSRs promote social objectives, including issues around poverty and social exclusion (2015). In a later piece, Copeland and Daly dispute the findings of these authors by arguing that the type of social policy recommended under the Semester is skewed towards market making measures, rather than market correcting measures. They also describe the aim of achieving balanced budgets as central to the process and progress on social policy as conditional to this higher aim (2018). Dawson argues that a large number of social CSRs are placed under the MIP and the SGP. This would lead to a displacement of social objectives, since economic actors and objectives are assumed to be dominant under these procedures (2018).

An important assumption in this debate where it concerns the MIP is that there is a clear set of ideas driving the CSRs. The MIP would be part of a process of ideational diffusion. The more extreme variant of which is that this is not just diffusion, but there is something paradigmatic about it: it is driven by a clear neoliberal agenda. If this is the case it needs to be made explicit and specific so that it can be studied. But those who have attempted to codify CSRs in order to verify claims of this neoliberal or welfare retrenching agenda have suffered from serious methodological and conceptual difficulties and their evidence mostly points towards a confirmation of the gradual socialization thesis as set out by Zeitlin and Vanhercke.

1.5 Research focus

The literature review shows the various positions on issues relating to effects, governance, content and evolution. It has aimed to lay bare the implicit and explicit assumptions in the debate and argued that these require further testing. Whether problems of legitimacy or effectiveness arise - or to what extent they arise - ultimately depends on how the MIP is applied in practice. The criticisms on EU economic governance have been harsh. Both from the side of those who criticise hierarchy, rigidity or neoliberalism and those who believe the MIP is ineffective and needs to be reformed. Not completely unrelatedly, the euro suffers from stereotypes. By some the euro is seen as a suffocating straitjacket or inherently undemocratic. Others see it as governed by an ‘anything goes’ mentality, with a Commission that is too political and moral hazard looming and in total disregard of rules. These powerful images can be found in public debates all over Europe. But as far
as the specifics of the MIP is concerned, what is missing in the academic analysis so far is a systematic account of how it has been applied in practice, in order to determine its characteristics empirically. Some of the criticisms are also directed at the economic governance framework more generally, especially there were it concerns the perception of a constraining character. This study will analyse to what extent such criticisms hold up when focussing specifically on the functioning of the MIP.

This thesis defines the interaction between national politics and European frameworks as a key focus to understand the dynamics of the MIP. These two worlds are very much interlinked, but authors have not always accounted for both sides sufficiently when making arguments that hide implicit claims on causality or principal agent settings. For example, the EU has suffered from the image of inducing heavy austerity during the crisis. This is undoubtedly true, but this powerful image is not complete. National governments, controlled by national parliaments in almost every EU state (apart from the UK) introduced more fiscal rules and more stringency in the rules between 2010 and 2015 (Begg, 2018). Similarly, in 2012, the year that defined the austerity response of the EU, Member States put in a fiscal effort that on average substantially exceeded the requirements under the EU fiscal rules (Buti, 2017; p. 12). It is highly likely that fear of the bond-market spreads played a more important role in inducing change than the fear of sanctions from the EU. The point here is not to dispute that the SGP played a role in the pro-cyclical response to the crisis, but to argue that causal relations behind powerful narratives are sometimes more intricate than we might presume. In their analysis of contemporary euroscepticism, De Vries and McNamara have argued that there should be clarity and honesty about the degree to which the EU infringes on the laws and policy capacities of Member States (2018). As far as the MIP is concerned, this is not clear in the current literature.

Before we can draw the right lessons from the crisis and think about the future of the EMU we should understand and evaluate the mechanisms that currently govern the currency area. There has been significant study of the role of the EU institutions and domestic political context in macroeconomic governance in the states with an Economic Adjustment Plan (EAP, the policy requirements attached to financial support for: Greece, Cyprus, Ireland and Portugal) (e.g. Henning, 2017). But on the practical application of the MIP the literature is much thinner. Many authors would agree that the introduction of the MIP is a significant moment in European integration, but the literature that characterizes the MIP lacks a sufficient empirical basis. This study is based on the believe that we should not only study the institutional design of the MIP and/or take annual implementation rates at face value. To understand and evaluate the MIP’s real-world
effects, we have to trace its practical operation over multiple years and multiple cases. The next chapter will set out a research strategy to do so.
Chapter 2

Analysing the MIP

2.1 Research questions and conceptualisation

The literature review shows that the MIP has triggered a rich debate over the years. It also shows that participants in this debate draw completely different and sometimes contradictory conclusions in assessing the character of the MIP. Assessments of the MIP are influenced by normative positions on the role of the EU, assumptions about the character and content of the CSRs. They are based on the particular methodology that authors use, are time-bound and depend on whether scholars come from an economic, legal or political science background. The MIP touches on a wide range of issues and a wide range of countries. It is therefore not easy to come to a conclusive assessment of what it entails and how to characterize its functioning. Generic assessments of the MIP often leave out a lot of context. If the MIP is indeed discretionary, we would want to know how this discretion is exercised. If it is indeed hierarchical, we would want to know which elements are hierarchical and how these have affected national politics. Before making any judgement on legitimacy, we would need to know how much power is concentrated in the MIP, whether the MIP manages to have an influence on national politics at all and whether indeed national reservations are side-lined in practice. And if the MIP is indeed ineffective, we would want to know what makes it so: whether this lies in the particular type of arguments made by the Commission, whether it is too distant from parliamentarians, or whether the approach of the Commission has been too soft.

This thesis aims to test whether the ideas one can find in the literature about how the MIP functions also resonate with the empirics of its operation. To characterize the MIP in more precise terms, requires a more fine-grained research approach.

The empirical part of this thesis is not focused on the question whether the MIP is legitimate or effective, since these judgements rest on normative assumptions. We have no obvious yardstick to determine what we should realistically expect from the MIP. I will leave the normative assessments for after the conclusion. Rather this thesis takes a more fundamental approach: before making judgements on legitimacy, we should know to what extent the MIP represents a move towards hierarchical governance. And secondly, before making judgements on effectiveness or proposals on ways to strengthen
the instrument we first need to study which effects the MIP has had on domestic policy making. This boils down to the following two main research questions:

» Governance: How hierarchical is the MIP?
» Effects: Does the MIP have effects on domestic policymaking? And if so, through which channels and mechanisms? What are the key determinants of the MIP’s capacity to affect domestic policymaking?

The literature review also shows that there are questions concerning the perceived neoliberal character of the MIP and on the role of the MIP in the debate about the future of EMU. A secondary set of questions therefore runs as follows:

» Content: What does the analysis tell us about whether the MIP has a neoliberal bias in its recommendations?
» Evolution: What does the analysis tell us about the debate on the reform of the EMU?

These two questions have been phrased as secondary questions. That means that the research strategy is designed to answer the first two. If the secondary questions were the main questions, a different strategy would have to be chosen that devotes more attention to analysing social characteristics and various reform proposals. A strategy of case studies, process tracing and interviews is not necessarily the best strategy for answering these secondary questions. The empirical deficit is also larger for the main questions. Few have attempted to answer these main questions with a more fine-grained research strategy. However, in so far as this thesis analyses the MIP, it is worth also devoting some attention to what the cases and horizontal analysis tell us about these secondary questions. The fact that they serve as secondary questions implies that the conclusions about these questions will be more modest. Chapter five will deal more specifically with the methodological issues surrounding the question on the perceived neoliberal character of the MIP. The concluding chapter will review the debate on the reform of the EMU in light of the findings of this thesis. In addition to these secondary research questions and the specific attention that will be devoted to them in chapters five and the conclusion, the issues of content and evolution also play a role in the case studies. They may not feature as clear research questions, but in each case study the content of the CSR is analysed and critically reviewed and, wherever possible, linkages are made to debates about future evolution within the specific policy field.

The main research questions require a further conceptualisation of hierarchy and of effects. The concept of hierarchy comes from the debate on modes of governance. Hierarchical governance is traditionally understood as involving legislative acts or
executive decisions (e.g. Scharpf, 1997; Heritier & Lehmkuhl, 2008), but over the years various modes of governance have been introduced which can be classified as largely hierarchical or non-hierarchical. Legal scholars often classify governance mechanisms in terms of hard law and soft law. But as a dichotomy this is problematic, since there is a large grey area in between. For example, the transfer pricing guidelines of the OECD are not binding and can be classified as soft law. But they have gained such a reputation that they act as the de facto norm in the world of corporate taxation. In practice, it is difficult for companies to escape these guidelines and in certain OECD states courts even take the guidelines into account in their judgements (Vega, 2012). In cases of traditional hard law the enforcement may not always be so hard. The compliance literature finds considerable variation in enforcement and a lack of infringement procedures. Even when directives are fully transposed it does not always lead to practical implementation (Hartlapp and Falkner, 2009).

Or to stick closer to the topic, the SGP has hard law elements, such as the sanctions in the Excessive Deficit Procedure (EDP). But sanctions are very difficult to enforce, given the political costs of issuing them against a government and the uncertainty around optimal fiscal policy. In 2016 the Commission found Portugal to be non-compliant with the fiscal rules. In the end, the Commission decided not to impose sanctions. Instead the Commission would issue warnings and closely scrutinise and report on the fiscal effort for Portugal for months, with markets, media and rating agencies watching every step. Portugal found itself constantly on the defensive to prove that its budget had a clear economic logic and that it aimed to move into line with European fiscal requirements as soon as possible. The hard law instrument was not used, but it is very debatable whether the approach can be called ‘soft’. In any event, Portugal's budget was back in line with EU requirements the following year.

These examples show that enforcement of modes of governance in practice may depend on other elements than what terms such as hard law or soft law reveal. Graziano and Halpern argue in this context that ‘there is a continuous blurring between harder and softer governance elements, in which imposition and direct decision-making softens increasingly, while soft modes of governance, such as persuasion, naming and shaming, incentives and so on, become harder and prove more or less innovative and effective under specific circumstances’ (2016: 6). Sabel and Zeitlin argue in a similar fashion, claiming that European policy is increasingly deliberative, multilevel, departs from traditional accountability structures of representative democracy, but introduces a different type of accountability in terms of scrutiny by peers, and introduces both centrality (in the form of framework goals) as well as autonomy for lower-level units and agents who
coordinate, report and reflect on progress towards the framework goals. The types of governance arrangements one can find in the EU of today cannot be captured in terms of the distinction between soft or hard modes. Rather Sabel and Zeitlin speak of hybrid governance frameworks that typically combine more and less hierarchical features (2007). Fiscal governance in the EU can be seen as a hybrid governance framework (Armstrong, 2013), and arguably the MIP equally so.

Hierarchy is relevant when studying the MIP because it is the feature that distinguishes it from earlier coordination mechanisms. In theory, hierarchy should also distinguish MIP-related CSRs from CSRs that only have the Employment Guidelines and the Europe 2020 strategy as their legal basis. It is used in this research as a multidimensional concept in the constructivist sense: various features can contribute to making a governance instrument more or less hierarchical, depending on the behaviour of the actors involved. Several stricter indicator-based definitions of hierarchy have been tested in earlier stages of this research, but they proved unworkable in practice. More generally, features such as a strict legal interpretation or dismissing national reservations contribute to making an instrument more hierarchical, whereas flexibility and enhancing domestic ownership do the opposite. Dunlop and Radaelli speak in this context of a hierarchical mode when the EU institutions use policy instruments as a set of rules, and steer the process from the ‘top’ in the most predictable ways, minimizing negotiations and exceptions to the rules (2016).

In this thesis, the hierarchical character of the MIP will be analysed by studying first the design of the MIP. A detailed study of the functioning of the corrective arm of the MIP, and how it has been used so far, will examine how hierarchical the MIP is in its design. A high level of institutional adaptability and flexibility contributes to a less hierarchical character of the MIP in this context. Secondly, the behaviour and strategic choices of the actors involved will be studied both in general terms and within the case studies. By including the agency perspective, this thesis tries to fill the gap in the legalization analysis recommended by Hodson (2017). Hodson characterizes the MIP on the basis of the level of obligation, precision and delegation in its design. His analysis shows that the MIP represents a clear-cut but modest advance in legalization. But he admits that the legalization approach cannot sufficiently account for the interaction among actors, or deliberation, and has a strong focus on design as opposed to implementation in practice.

The qualitative format of this thesis allows me to study interaction, political context and implementation. The strategic choices of the actors will be studied both in terms
of content and in procedural terms. With a study of content is meant that each CSR in the case studies will be critically reviewed. Typically by questioning whether the Commission is insisting on a particular reading of the problem and a particular solution to it, or whether it focuses on a shared understanding and ownership of the issue. A critical review of the CSRs also serves to analyse the persuasive power of the arguments, one of the key indicators for analysing effects. Contestability of the CSRs serves as an indicator of hierarchy in this context. By procedural hierarchy is meant the manner of insistence on compliance with the CSRs. In other words what form does pressure from the European institutions take? Compliance through persuasive power of arguments is seen as constituting a non-hierarchical use of the procedure, whereas escalation within the procedure, a rigid and legalistic approach, or threatening to open the corrective arm is seen as hierarchical.

The literature review has argued that analysing the effects of the MIP is surrounded by a lot of methodological difficulties. The MIP does not constitute a clear principal-agent relationship. We cannot assume that Member States are passive receivers of EU norms; they actively try to influence governance outcomes. The MIP is a procedure within a dynamic governance framework where actors interact, act strategically and reflexively and where there is constant downloading and uploading of information and objectives. This interactive nature excludes a clear framework of independent and dependent variables. Rather, it is in the interaction that causality occurs. This research takes an actor-centred perspective on effects, and causality for that matter. Consider the following thought experiment: when would we consider the MIP more effective? If we observe a high overlap between the recommendations and implemented policies, but at the same time we see very little engagement and awareness of domestic actors vis-à-vis the MIP? Or, if the overlap between CSRs and implemented policies is lower, but we see strong engagement and intensive discussions between European and domestic actors? Arguably we would observe more effects in the latter case, whereas the former primarily shows correlation. But studying effects on the basis of behaviour and perceptions of actors is challenging. When studying EU frameworks of policy coordination, researchers draw completely contrary conclusions, sometimes even based on similar material (Zeitlin et al., 2014).

One of the key challenges is how to isolate and attribute effects in a complex web of interaction. How do we distinguish market pressure from domestic political pressure from pressure of the MIP from intrinsic motivation of politicians to introduce a reform? Causality is not always directly observable and establishing a causal narrative is ultimately dependent on the perceptions of actors involved in the process. Similarly, it is
next to impossible to establish an airtight counterfactual. It is most likely that Member
States will still introduce reforms if the MIP did not exist, but this does not mean it
cannot make a valuable contribution to the reform process. Besides, no politician will
admit that s/he implemented a reform only because the EU institutions told him/her
to do so. And yet we can observe that national policies often closely follow European
policy orientations. These methodological difficulties might explain why the effects of
the MIP have so far primarily been discussed in policy papers where less attention has
been devoted to issues such as causality and research strategy.

This thesis will examine the effects of the MIP by studying the economic, intellectual and
political context of each individual CSR in the case studies and its change over time. The
economic context allows us to situate the CSR. Before making judgements about the
persuasive power of a specific CSR and whether this contributes to the national debate,
it has to be analysed against the background of domestic perceptions of the problem.
Here it must be recalled that CSRs rarely touch on completely new issues: pension
sustainability, market liberalisation or flexicurity in the labour market are issues with
a long history, both in the domestic debate and in terms of EU involvement. Intellectual
context here refers to consensus, disagreement and uncertainty over the approach to
dealing with the issue at hand. Many of the CSRs touch upon very contentious issues
that divide both politicians and academics. Finally, the effects of the CSR cannot be seen
as distinct from the domestic political context. If ruling elites perceive the Commission
as an authoritative voice in the debate, the arguments it makes are likely to have a greater
effect. The explanation of the research strategy in the next section will further elaborate
on the methodology that allows for incorporating context.

In order to give some further guidance on the types of effects we might expect to find
and distinguish between different effects, this thesis draws on the conceptual framework
set out in Zeitlin (2009). In analysing the Semester’s predecessor – the Open Method of
Coordination (OMC) – Zeitlin argues that in analysing effects one should look beyond
substantive policy changes at national level. ‘If we consider other types of impact,
including not only procedural changes in governance and policy making processes, but
also cognitive and discursive shifts, along with changes in issue salience and political
agendas, then we may identify deeper and more numerous influences’ (2009: 3). What is
meant here is that effects can occur in the period before reforms take place, the period of
idea formation and societal consensus formation. Politicians need to attach significance
to the issue and come to a shared understanding and problem definition. The previous
chapter has discussed governance as a puzzle in this regard. This is the period where
effects can occur, whereas domestic political factors can be expected to be decisive in
whether these effects also translates into a change of policy.

Zeitlin refers to effects such as changes in issue salience, political agendas, and cognitive and discursive shifts. For example, if multiple Member States introduce reforms where they link the statutory retirement age to life expectancy and these changes are discussed in structured frameworks, experiences are shared and constant analysis is made of sustainability issues around pensions, this can add persuasive pressure on those Member States where progress is lacking in this area. Such effects transcend a perception of effects as mere compliance with the CSR. One of the key added values of coordination frameworks is that national practices are questioned in light of foreign experience. Pro-reform forces in Member States can adopt the language and policy thinking from coordination frameworks and hold governments to account in light of the experiences elsewhere.

In Zeitlin’s conceptual framework, which has been slightly revised on the basis of Barcevicius et al., (2014), this boils down to the following categories:

Substantive effects: changes in national policy thinking (ideational shifts); changes in national policy agendas or issue salience (agenda shifts); and changes in specific national policies (programmatic shifts).

Procedural effects: reinforced horizontal coordination and cross-sectoral integration between interdependent policy fields; improvements in national steering and statistical capacity; enhanced vertical coordination between levels of governance; increased involvement of non-state actors; and development of new horizontal and/or diagonal networks for participation of non-state and subnational actors in EU policy making processes.

Procedural effects can occur through the specific framework that the MIP entails. For example, with the MIP monitoring missions, the Commission asks a series of questions of a national administration on the implementation (or lack thereof) of specific reforms. This means the administration has to come up with a unified response in which various actors of different Ministries have to work together. Similarly, if an administration does not agree with the analysis of the Commission, it will be incentivised to come up with facts and figures that support its argument, which in certain cases can lead to updates in administrative or statistical capacity.
If we move on to causal mechanisms through which these effects can be established, Zeitlin identifies the following channels of influence: external pressure, external support, creative appropriation (strategic use of EU concepts, objectives, indicators and CSRs as a resource in support of the pursuit of actors' own goals) and the interrelated mechanisms of preference transformation: socialization, persuasion, deliberation and learning. These are ways of re-orienting initial policy positions and frames in a passive way through interaction (socialization), in a more explicit way from one actor to the other (persuasion) or by actively searching for solutions together (deliberation and learning). External pressure can take various forms: it can be in the form of reputational damage (naming and shaming) or it can be material, by escalating within the procedure, threatening with sanctions, linking reforms to the SGP targets or to the structural funds (the next chapter will go more into detail on how these channels work). Pressure can also be vertical, between EU institutions and the Member States or horizontal, within the Member State itself. When horizontal pressure is exerted by parliamentarians holding the government to account on the basis of material of the MIP Zeitlin speaks of democratic destabilization effects. External support can be further divided into financial, organizational and technical support.

Table 1: Conceptualisation of effects

<table>
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<tr>
<th>Substantive effects</th>
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<tbody>
<tr>
<td>• Ideational effects</td>
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<td>• Agenda shifts</td>
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<td>• Programmatic shifts</td>
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<tr>
<td>Procedural effects</td>
</tr>
<tr>
<td>• Reinforced horizontal cooperation</td>
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<tr>
<td>• Improvements in steering and statistical capacity</td>
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<tr>
<td>• Enhanced vertical coordination</td>
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<tr>
<td>• Increased involvement of non-state actors</td>
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<tr>
<td>• Development of new networks</td>
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Table 2: Conceptualisation of mechanisms

<table>
<thead>
<tr>
<th>External pressure</th>
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<tbody>
<tr>
<td>• Reputational or Material</td>
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<tr>
<td>• Horizontal of Vertical</td>
</tr>
<tr>
<td>External support</td>
</tr>
<tr>
<td>• Financial, Organisational, Technical</td>
</tr>
<tr>
<td>Creative appropriation / leveraging</td>
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Chapter 2: Analysing the MIP

The second research question focuses not only on channels and mechanisms of influence, but also on contextual determinants of success. This is meant to capture the domestic factors that enhance the effects of the MIP on national policies, including: the perceived legitimacy of the EU, the intellectual basis of the CSR, the procedural fairness of EU recommendations, sensitivity to European criticism, pressure from financial markets, fiscal vulnerability, domestic institutional arrangements (federal, centralised, weak/strong institutions, etc.), media coverage, interaction with other European governance frameworks or institutions (e.g. the Banking Union), etc. These determinants can be explanatory mediating factors, but the list above is not exhaustive. Identifying the determinants that matter is treated as an open question. However, from earlier research we know that the key determinant for enhancing effects is the pro or anti-EU attitude of governing elites, which determines the extent to which they make use of coordination frameworks (Heidenreich and Zeitlin, 2009; Graziano et al., 2011).

Finally, while the two main research questions are phrased as two separate questions, the interaction between hierarchy and effectiveness is of special interest. In other words, do we find that more hierarchical approaches have yielded stronger effects? Or similarly, when the Commission grants Member States more time and flexibility to undertake deep and meaningful reform, does this enhance ownership of reforms by domestic actors, or does it induce moral hazard, as is sometimes claimed?

The conceptual framework set out by Zeitlin is used as a practical tool to draw distinctions between effects and compare cases in a systematic way. It should guide the research process in describing effects. Each case chapter is aimed at telling a country-specific story, establishing a causal narrative and establishing links to the euro area dimension. In the cross-case comparison chapter (chapter 10) I will return more explicitly to the conceptual framework to introduce a more systematic review of the effects that allows for finding patterns across cases and making comparisons.

I do not treat the MIP as a case for larger theoretical questions or for testing established theories, such as neofunctionalism or intergovernmentalism. Rather the MIP is treated
as a new step in European integration that should be studied in its own right. In this sense, the thesis follows the Europeanisation research agenda, which shifts attention away from questions on the European political arena towards the domestic level and analyses how domestic politics and policies changes due to membership of the EU (Börzel and Risse, 2003; Graziano and Vink 2007). The conclusion will delve further into the question of how much significance we should attach to the observed effects, which is a more normative question by nature. This normative analysis revolving around effectiveness also serves as a basis to discuss various proposals to reform the MIP and deepen EMU governance.

2.2 Research strategy

The methodology of this thesis is composed of two parts: a horizontal analysis of the evolution, design, cope and content of the MIP, and contextualised process-tracing in five cases with a cross-case comparison. The later part can be seen as the core of the thesis. The research questions in this thesis exclude a methodology based on clear-cut independent and dependent variables and a large-n study; rather it puts political and economic contexts front and centre and aims to take perceptions and intentions of actors seriously. The central research questions are about capturing a particular institutional dynamic, where both agents and structures matter and which evolves over time.

It is a deliberate choice to focus primarily on qualitative methods in this thesis. The research design is largely built on a criticism of the many quantitative studies that have already been conducted in this area. Chapter one has analysed the literature on the basis of implementation scores, but in recent years scholars have also begun to assess the political role of the Commission on the basis of quantitative modelling. Guidi and Guardiancich argue on the basis of regression models that the Commission takes a dominant position over the Council in the formulation of pension CSRs and acts as a fully technocratic body (2018). A qualitative analysis would have included the many political discussions on pension CSRs in the Council Committees where the Commission also took part and would as such be likely to lead to a different outcome such as in Louvaris (2018). Van der Veer and Haverland assess on the basis of multilevel modelling and a series of indicators the political nature of the Commission in formulating the CSRs (2018). They argue that the Commission in its formulation of CSRs acts as a guardian of the markets more than as a guardian of the people. Whereas I would hold that this political nature should rather be read from analysing the interaction between the Commission and the Member States where intentions behind decisions can be read and analysed.
Chapter 2: Analysing the MIP

The first research part of this thesis consists of three horizontal chapters. These chapters serve as a general analysis of the MIP and can be seen as introductory to the in-depth analysis. These chapters revolve around very basic questions: where does the MIP originate from and how has it evolved over time? How does it work? Which actors are involved? Which Member States and which issues fall under its scope? The approach is based on systematic documentary analysis and interviews with some of the key actors who have been involved in the design of the MIP and are involved in its operation. These chapters have an empirical focus on the functioning of the MIP more broadly. Much of the early literature that has studied the legal design of the MIP treats it as a static governance construct, rather than something dynamic and contextual. The political and economic context has changed over the years and the MIP has been altered accordingly, based on evaluations and learning-by-doing.

This part should provide a detailed description of how the MIP was designed, which choices were made in this design and why, the process by which recommendations are designed and how they are processed in the various forums. If we are to assess the nature of the MIP it is essential to first know precisely who decides, when and how. Studying the changes over time should guide our understanding of institutional adaptation, as part of our analysis of hierarchy. Similarly, the corrective arm of the MIP, as its most hierarchical feature, is studied in detail. The fact that the MIP has a sanction procedure on paper does not inform us about what the function of this sanction procedure is in practice, whether to act as a deterrent, a last resort, etc. Additionally the analysis should guide our understanding of contestability, by describing the forums in which contestation can take place and the process by which this can be done. Finally, it should serve to shed some light on an underlying dynamic that has raised confusion among pundits, namely how the MIP relates to the SGP. All in all, this part should form the descriptive basis to be able to fully understand the subsequent research parts.

Chapter five is a bit of an odd chapter in this thesis, in the sense that it uses a different research methodology. One of the key characteristics of the MIP is the fact that it has a very wide scope; many Member States fall under the MIP and many policy issues are linked to the MIP for these states. This is a crucial characteristic of the MIP that deserves special attention. Its broad scope affects its hierarchical character and effects. Had the MIP been a procedure that only focused on one or two Member States and only touch upon a few policy areas we would likely judge it differently than we do now. Chapter five will dive deeper into this argument. In order to show the scope of the MIP the CSRs have been labelled and counted. In doing so this chapter deviates from the qualitative research focus. However, in the chapter the drawbacks of this coding exercise will also be
discussed as well as those of others who have attempted to analyse CSRs on the basis of labelling. The methodological choices for this research part are discussed in the chapter itself. In general this chapter merely serves to depict a particular characteristic of the MIP. I would still hold that quantitative labelling exercises leave a lot open to interpretation in determining the characteristics of the MIP, also in determining its content.

The horizontal analysis of the design and content of the MIP give an insight into its functioning, but this is far from conclusive. In order to truly explore the characteristics of the MIP, the second research approach focuses on five case studies that will be studied in detail. The aim is to detect patterns and conditions that may apply across different cases in several policy areas, in order to provide insights into how the MIP is being applied in practice.

The methodology that will be used is a combination of contextualised process tracing and comparative case study design. Process tracing over various cases can be regarded as a suitable methodology for investigating empirically how the MIP responds to changes in a complex governance environment, as it allows for examining the successive stages and choices in the process over various country-specific and issue-specific cases and the mutual interactions between governance arrangements and relevant actors in each case. It should therefore allow for exploring the exact structure versus agency relationship in the MIP. ‘Process tracing starts from the assumption of a temporal and analytical sequence, in which later stages in the process are dependent on earlier stages’ (Schimmelfennig, 2015:9). The focus on sequencing makes the methodology especially suitable for this research, as it should unravel the path-dependent relation between policy position of the Member State and the MIP. As Davis argues: ‘The process that is uncovered does not have to be only causal, it can be constitutive as well – that is, accounting for the property of the phenomenon by reference to its structures and allowing the researcher to explain its conditions of possibility’ (2005; 175-176). Process tracing allows to study the factors that impact the process of decision making, such as: what stimuli actors attend to, the behaviour that occurs towards stimuli, the effect of various institutional arrangements on attention, processing and behaviour, and the effect of other variables of interest (George and McKeown, 1985). The goal of process tracing is ultimately to provide a narrative explanation of a causal path that leads to a specific outcome, which should furthermore be done by rendering alternative explanations less plausible (Vennesson, 2008). Finally, process tracing over a variety of cases has been central to other studies on measuring the impact and relation between the national and European coordination processes and can thus be seen as an accepted approach (Barcevicius et al., 2014, Heidenreich and Zeitlin, 2009).
Process tracing also provides an opportunity to combine positivist and interpretivist approaches in the making of a case study, ‘allowing the researcher to explore both the causal ‘what’ and the causal ‘how’’ (Vennesson, 2008: 232; Lin, 1998). The interpretivist part is especially relevant in this research, given that the outcome (a change in policy position in the Member State) is less relevant as the object of study than the mechanisms through which this change occurred. In this thesis, I begin with the positivist part, examining the successive stages of each case over the years in the MIP through documentary analysis, focusing on what changes have been observed in the Member State and what policy advice has followed from this at the European level. This documentary analysis consists primarily of the relevant Commission reports and the National Reform Programs of the Member States to keep the data flow of five cases within manageable limits. Given the level of detail of these reports and the fact that any contested issues are discussed in the interviews, the primary focus on these documents should be sufficient.

The interpretivist part focuses on the context in which these decisions were taken and the mechanisms which produced them. This means that each step that has been identified as relevant in the documentary analysis will be contextualised from the perspective of the actors involved. It moves beyond the observable changes to analysing the context in which this change happened and how it happened. The interpretivist part of process tracing allows me to examine the reasons that actors give for their actions and behaviour (Vennesson, 2008). The preferences and perceptions of the most relevant actors will be key in establishing a credible causal narrative. For this part of the research, 76 in-depth interviews have been conducted with actors that have been identified as most directly involved with the process. The aim of the interviews has been to find out about strategic choices, intentions, perceptions of effects and issues of contestation.

This actor-centred approach is perhaps the most distinctive part of the research strategy. It adheres to the logic that effects from Europeanisation should be understood from how domestic actors use the European frameworks, concepts, etc. (Jacquot and Woll, 2003).7 Jacquot (2008) has argued that to detect the role of Europe in national policy processes, researchers should study national political games and preferences and the ways in which European ideas, norms and concepts are used by national actors to enhance their own purposes. This is referred to as the ‘usage of Europe’; a particular theoretical angle to studying Europeanization effects that examines how European norms are filtered through domestic usage and in how it interacts with domestic politics.

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7 Jacquot and Woll distinguish between ‘cognitive usage’, ‘strategic usage’ and ‘legitimating usage’, which is an alternative way of describing the abovementioned mechanisms of change.
The interpretivist part of this research relies strongly on actor perceptions. In order to overcome the methodological difficulties that are inherent in this approach Zeitlin proposes to combine contextualised process tracing with cross-case comparison on the basis of a clear conceptual framework and careful triangulation of sources of evidence (2009). Triangulation is a research strategy in which you multiply the points of access to information, by relying on a wide set of actors from different backgrounds for the interviews and reviewing actor perceptions on the basis of available documentary evidence. The variety of interviewees allows cross-checking of claims, strengthens validity of the arguments and offsets potential sources of bias. The topic under study involves two main types of actors, the EU institutions on the one hand and domestic policy actors on the other. Both sides produce a clear position in the NRPs and Commission reports and Council CSRs. In each of the cases, multiple actors from either side have been interviewed as well as outside stakeholders, such as financial supervisors, social partners or independent experts. Actors in general have been very responsive to interview requests, sometimes with the help of academics in the various Member States.

The 76 interviews that have been conducted consist primarily of senior officials and policymakers. These include chief economists of ministries, representatives and presidents of the various Council advisory committees, Commission officials (both desk experts and Semester officers), politicians and advisors to Ministers and Prime Ministers, representatives of social partners and the various Central Banks. Interviews have been conducted in Amsterdam, The Hague, Brussels, Antwerp, Paris, Berlin, Milan, Turin, Rome and London. The 76 interviews typically lasted one hour, sometimes included multiple actors (counted as one interview) and were sometimes followed up by phone calls (not counted as an additional interview). Since it was not possible to establish ex ante whether actors would be willing to share the most relevant information the interviews have been conducted in an open and flexible manner. Given the politically sensitive nature of the topic and to allow actors to be forthcoming with information most interviews have been conducted anonymously. A number of actors have agreed to be quoted by name. The guarantee of anonymity has allowed actors to speak more openly, which strengthens the internal validity of the arguments. The vast majority of interviews have been recorded and transcribed. A number of interviewees have requested full anonymity, which means they are not quoted, but their comments have been used in the analysis in a general way.

In each of the cases, actors have been identified who have a more critical position towards the CSR (e.g. trade unions in the case on wages and labour market) and who have a more positive position (e.g. left-wing politicians in the Netherlands). This is an important
element of triangulation, especially if you examine effects: it could be argued that when you ask Commission officials about the effects of a CSR they will have a bias in arguing that their work has added value. And the same can be said for Ministry officials that work with the MIP on a daily basis. Stronger claims have been cross-checked with the other side of the discussion (usually between the EU level and the national administration) as much as possible, to get a full picture of the situation and offset potential bias. The number of respondents varies between the cases, typically because in certain cases it was also necessary to involve more actors in order to establish a clear narrative. It is relatively balanced between the various types of actors.

Table 3: breakdown of interviews across cases

<table>
<thead>
<tr>
<th>Case Type</th>
<th>Interviews</th>
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<tbody>
<tr>
<td>European officials</td>
<td>22</td>
</tr>
<tr>
<td>National officials and politicians</td>
<td>32</td>
</tr>
<tr>
<td>External stakeholders and experts</td>
<td>22</td>
</tr>
<tr>
<td>Total</td>
<td>76</td>
</tr>
</tbody>
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As regards reliability, this thesis shares the view that in qualitative research the essence of reliability lies in consistency (Leung, 2015). The design of this research allows for telling case-specific stories. But in order to enhance consistency, each case chapter has a clear structure: first the topic is introduced and reference is made to the euro area-wide dimension, then the economic context and potential intellectual ambiguity of the issue is discussed. Next comes an analysis of the political context of the issue, then the process is traced within a specific time period, followed by an analysis of the effects of the MIP and its hierarchical character. The timeframe that is traced in detail starts with the publication of the first CSR in 2011 and continues until the end of 2016; documents that were published in 2017 and refer to the 2016 period are also taken on board. In practice, this means that the document trail runs until the Country Reports of Spring 2017. This period is the maximum length that has been deemed manageable for this research. It is long enough to expect change in policy stance and usually a change of government in between, to study a variety of actors in power and strengthen claims about intermediating variables.
2.3 Case selection

The MIP has a wide scope, both in terms of the Member States that have been subject to MIP surveillance and the number of policy issues and types of imbalances covered under it. The types of effects we might find can differ tremendously across policy fields or across countries and the intermediating factors can be numerous in every case. This makes case selection particularly challenging. The comparative method focuses on between-case variation and controlled comparisons. In selecting countries and issues I have tried to find a balance between various relevant factors of variation so that the cases represent a fairly representative account of the types of issues that the MIP typically deals with. The goal is to track patterns of change in different national and institutional settings and to track the process of idea formation and the strategic interactions among actors in the cases. Given the variety of relevant political and economic factors one can identify across cases, finding a perfect representative sample is bound to remain problematic. Researchers therefore have to be careful in making overly strong generalizations on the basis of the cases. This section will argue why the cases that have been selected represent perhaps not a perfect, but arguably a fair balance.

For this study five cases have been selected:

- the Belgian practice of automatic wage indexation;
- professional services liberalisation in Italy;
- labour market segmentation in France;
- the Dutch housing market;
- the German current account surplus.

The choice of these specific cases has been made on the basis of a number of considerations. First, I assumed that a significant number of case studies would contribute to the validity of the arguments and allow for better comparison, given the highly country-specific and issue-specific nature of the CSR implementation process. I considered that five case studies would be the maximum number that would allow me to study the cases in a sufficient level of detail whilst remaining manageable. I considered that I needed cases where Member States have been subject to the MIP over multiple years to study the time dimension. I excluded Member States that are not part of the euro area, since there is an EMU dimension to my research questions and since the sanction procedure, as the most hierarchical element of the MIP, only applies to euro area states. I furthermore excluded the countries that have received financial assistance during the crisis years (Greece, Cyprus, Ireland, Portugal and Spain), since the MIP is the object of study and not the financial assistance packages, which are arguably more hierarchical. Spain has
been a difficult choice in this context, as it has received financial support for its banking sector, yet it has also been subject to the MIP for the entire period, in quite an extensive manner. Spain has been excluded ex ante on the assumption that it is not a pure MIP case, but in hindsight I believe Spain offers valuable lessons for future research on the MIP. As a way of compensation, the case of Spain is discussed in the horizontal chapters.

Germany, France, Italy, the Netherlands and Belgium are the largest economies of the euro area excluding Spain. These five states have all been subject to the MIP for most of the years under study, but for various types of imbalances. The issues in these states can be seen as significant given the size of their economies. The assumption here is that the German economy is more likely to destabilize the EMU due to imbalances than Malta. These five cases represent a good balance between Member States that can be seen as traditionally more susceptible to European influence on national politics such as Belgium and those that can be considered more sceptical, such as France. It includes Member States for which excessive imbalances have been identified, such as Italy and France, but also Member States where the significance of imbalances and its associated position in the MIP has changed over time, such as Belgium and Italy, and Member States were the position has remained constant, such as Germany and the Netherlands. It also represents a balance of Member States in and out of the Excessive Deficit Procedure: Germany and the Netherlands have been mostly out of the EDP; France and Italy mostly in and Belgium half in and half out. All five Member States have seen a change of government in the period under study, often changing colours in terms of ideological stance.

The drawback of this selection is that no Member State from Central and Eastern Europe is included (for future study of the MIP I recommend to especially look at Slovenia, which will be discussed in the horizontal chapter). At the same time, the EMU has been most problematic in the original Member States, much less so in the new ones. The new ones have their problems, but all in all they have converged economically, whereas divergences and rising scepticism has primarily occurred in the old Member States.

In terms of policy issues, the five cases represent a balance between the types of issues one can typically find in the MIP (see also chapter five in this thesis). There is an issue of finance and private debt (mortgages in the Netherlands); a social issue (dualization on the French labour market); two competitiveness issues, one that touches on the demand side (wages in Belgium) and one typical supply-side reform (market liberalisation in Italy); and an issue of current account balance and investment (the surplus of Germany).
These issues can each be seen as significant, as the MIP has as its purpose to overcome past weaknesses in addressing housing bubbles, sensitive issues of wage coordination, assessing current account positions, or overcoming resistance of organised vested interest in welfare arrangements (such as in the labour market) or in product and services markets. These issues also include topics where the criticism of a type of neoliberal bias in the CSRs (as discussed in the literature review) has been most prominent, such as wages, employment contracts, market liberalisation and the question of whether the EU is equally tough on states with a current account surplus as on deficit states.

The cases differ significantly from one another; at a first glance it may seem almost as if it is comparing apples and oranges. However, they are analogous on other dimensions that matter for drawing analytical comparisons. They have each been subject to the MIP for a longer period of time where for multiple years progress has been low or lacking. As such they can be defined as contentious cases. This contestation may manifest itself in different ways, for example in the form of uncertainty and intellectual contestation, of political obstacles or vested interests. It is precisely the dynamic between the ‘cold’ indicator-based logic of MIP recommendations on the one hand and the messiness and constantly evolving nature of domestic politics and potential hurdles to reform that is important to study in order to draw conclusions. This is where the MIP could potentially have an impact through its mechanisms of peer pressure, persuasion and so on and where its hierarchical elements and potential coercive leverage may appear. The MIP was designed precisely to overcome the weaknesses of previous coordination mechanisms in this regard, which were criticized for being too soft. Studying whether the MIP has anything new to offer in this context should not be based on those willing Member States that seek help from the European level on relatively small issues, but from the laggard reformers in economies of key importance whose domestic opposition to the proposed reforms represent particularly difficult situations for a stable governance of the euro area.

The approach that is taken here towards case selection is largely in accordance with what della Porta calls a case-oriented research strategy on the basis of paradigmatic cases (2008). She argues that ‘theorization and generalization in this tradition of research are provided not by statistical regularities but by ideal types’ (2008: 206). A case-based logic tends to explore diversity through thick description of a small number of cases, often contrasted on several dimensions, whereby complexity and the unitary character of the case is given precedence over generality. The case selection in case-oriented research is based on paradigmatic cases, in which the phenomenon of interest is present and which can accordingly be seen as relevant to test the hypothesized mechanisms.
2.4 Summary

The research strategy of this thesis is based on a horizontal and vertical approach to analysing the MIP. The horizontal part focuses on the design, institutional context, evolution and substantive content of the MIP, whereas the vertical approach focuses on the five cases. The methodology mixes positivist and interpretivist approaches for both parts: on the basis of a documentary trail the relevant steps in the process are identified and these steps are contextualised by including interpretations of actors involved. This approach has the advantage that it allows to bring out the politics inherent in this highly technocratic framework, by exposing and analysing choices and contestations. It is based on the belief that context and intentions matter for understanding outcome. At the same time, the intentions and explanations of actors should be judged while taking account of their role in embedded structures. While the focus of this thesis is on the MIP, the approach has the advantage that it allows construction of convincing causal narratives about how the crisis and crisis response evolved within the major economies of the EMU and how domestic problems interact with structures of the EMU.
Part I

Horizontal Analysis

Overview and reading guide

The horizontal analysis serves to answer basic questions that need answering before we can move on to the main research questions. These basic questions are: where does the MIP come from and how has it evolved? (Chapter three) How does the MIP work on paper and which actors are involved? (Chapter four) Which policy issues are covered under the MIP, and how should we judge the scope of policy issues and their ideological direction? (Chapter five)

The horizontal part will show that EU actors have faced dilemmas about how to define and govern macroeconomic imbalances. There have always been various interpretations of the crisis and country-specific elements to the crisis (chapter three). Since imbalances cannot be defined in a strict legal manner, the Commission has been granted wide discretion in the legal framework. In practice, the Commission has sought for accountability through all sorts of procedural safeguards. The ambiguity of the imbalances concept does not always sit well with some legal aspects of the procedure, such as sanctions. But the analysis shows that actors have vastly different interpretations of what the purpose is of these legal aspects (chapter four). The lack of a clear definition has also allowed the Commission to make the MIP into a holistic procedure that encompasses many different policy fields (chapter five).

Key decisions and moments have shaped how the MIP operates in practice and determines the extent to which it can operate in a hierarchical manner. The decision to introduce more interactive and flexible elements in the procedure has made the MIP less rigid in practice (chapter three). The decision not to open the corrective arm for Member States, but to introduce specific monitoring instead has further decreased its potentially hierarchical nature (chapter four). The decision to place so many policy issues under the MIP that its rationale has become almost indistinguishable with that of the Semester at large has further diffused its distinctiveness and political force (chapter five).
All in all, the horizontal part will show how the intentions and practicalities of the MIP might be completely different than what can be derived from the legal text alone. The MIP is responsive to changing economic and political sentiment and its character and effects should therefore be studied within their respective contexts. Researchers should be careful with generic or overly determinist statements about its character, contents or effects. This is what the case studies will further expand upon.
Chapter 3

The origin and evolution of the MIP

3.1 The rise of imbalances in the EMU

One market needs one money. That was the original idea when the EMU was designed in the early 1990s (EC, 1990). The benefits of the integration of the Single Market would be higher if combined with monetary integration. This would lead to better economic performance in Europe due to price stability and exchange rate stability, both of which had been very volatile in the years before. With the euro, transaction costs would be eliminated and capital could flow freely throughout the euro area. This would help both the core economies with an excess of available credit in search of a higher return on investment and growing markets in the periphery where cheaper credit could be used for the process of catching up with the core. Liberalised capital would allow for more efficient capital allocation, more diversification of financial sources and therefore better risk allocation. A more integrated and more liquid financial market would be more resilient. As such, the euro would lead to macroeconomic stability (ibid., p. 9). At least that is what was thought.

The economic theory at the time focused specifically on cyclical convergence of the business cycle. A single monetary policy would only be effective if economies behaved relatively in synch. In line with Optimum Currency Area (OCA) theory, a single monetary policy with unsynchronized business cycles would lead to divergence. If a country fell out of line, it could be faced with an asymmetric shock and would be stripped of its adjustment mechanisms. From the start, the EMU included a set of economically diverse Member States, since the project was as much political as it was economic. Early commentators typically focussed on whether enough cyclical synchronization had been achieved (Eichengreen, 1991) or whether other adjustment mechanisms, such as labour mobility and fiscal transfers would be sufficient to counter shocks (Blanchard and Katz, 1992; Friedman, 1997). The euro also departed from Keynesian logic which holds that, as under the Bretton-Woods system, capital controls are an essential tool to guarantee
Part I: Horizontal Analysis

Macroeconomic stability. Many believed that alternative stabilizers were necessary, such as fiscal risk sharing, to make the currency union stable (Goodhart and Smith, 1993). De Grauwe argued in this context that the EMU was a half-built house (1999).

EU policymakers were conscious of the fact that monetary integration could be disruptive to macroeconomic stability and cause imbalances, since the exchange rate, as an instrument of adjustment, would be eliminated. The Delors Report noted that market sentiment could change abruptly and that market panic could be disruptive. In order to prevent the emergence or aggravation of regional and sectoral imbalances that could exacerbate such market reactions the EMU ‘will require further major steps in all areas of economic policymaking’ (Council, 1989:14). The idea was that the euro area needed some type of cohesion in economic policies of its members to remain stable. At the same time, the Delors report stressed that plurality of the members of the EMU should be preserved and that this required a degree of autonomy in economic decision-making. A balance between these opposing objectives had to be sought (paragraph 17). It is sometimes thought that economically illiterate federalists designed the euro. But Schelkle argues that diversity was clearly on the minds of many of the policymakers at the time, including rather sceptical central bankers who were central to the process of designing the EMU (2017). The EMU has been the product of policymakers with clear ideological differences (Brunnermeier et al., 2016). Finding the right balance between political diversity and unity, responsibility and rules was always going to be a process of trial and error. And much of the debate on EMU today still hinges on the question what the right balance between the two should be. Some have perceived of the EMU as a straitjacket, whereas for others supranationalism has not nearly gone far enough.

The compromise that was struck at the time was that the required cohesion was formulated in convergence criteria to enter the monetary union, such as the requirement to keep inflation low and the exchange rate stable, and in the Broad Economic Policy Guidelines, which offer general orientations to Member States and the Community on macroeconomic and structural issues such as developments in wages, prices and financial market integration. The structural funds of the EU budget were to help economically weaker regions in the catch-up process and applied to all members of the EU. A strong concern in the policy debate at the time was how to prevent fiscal imbalances. In the decade before EMU was established, public debt to GDP ratios had risen sharply. After decades of productivity boom, economies were slowing and governments indebted themselves to continue to fund their welfare states. Close coordination of fiscal policies would ensure compatibility of macroeconomic policies among member states to minimize economic fluctuations and maximize the effectiveness of the common monetary policy (Council,
1989). It should also guard against fears of moral hazard, for when countries would issue too much debt denominated in the common currency, which would weaken its quality. The Stability and Growth Pact (SGP) was to be the anchor of trust in the EMU. The no bailout rule would further strengthen discipline by putting the final responsibility for judging risk in the hands of markets.

EMU 1.0 was largely based on preventing fiscal shocks rather than financial shocks. Looking back at that period, one of the authors of the ‘One Market, One Money’ report argued that the role of finance and the consequences of huge cross-border capital flows were not sufficiently recognised (Gros, 2017). The aim of the euro was to foster financial integration. But if capital is made available more easily, actors will borrow more as a result. Causality should not be interpreted very strictly here, since the pre-crisis years saw capital expansion all around the world. But the creation of the euro and the interest rates of the ECB surely facilitated this process. Credit expansion in the euro area went hand in hand with a vast rise of cross border bank lending dominated by mega banks in core countries. These cross-border flows rose from 1 trillion euro in 1998 to close to 10 trillion at the peak in 2008 (Franks et al., 2018, see also: Hale and Obstfeld, 2015). No other world region saw such a strong rise in cross-border claims as the euro area (Lane, 2013). But this financial integration was not of the type where banks become truly transnational and start lending directly to customers in other states or engage in stable equity financing. Rather it was financial integration on the basis of inter-bank lending and securities in highly liquid financial markets (Hoffmann and Sorensen, 2015).

And so, considerable risk was built up in the financial system and the risk compass of markets faded. The rest of the story is well known: interest rates converged to German levels, Spanish cajas, the Greek state and many others became deeply indebted, banks in the core countries were more than happy to lend, were also massively exposed to the US mortgage market, were undercapitalised and had manipulated risk models. And eventually the mega banks transposed the volatility in the USA to the euro area and inflamed a full-blown euro crisis (Bayoumi, 2017).

Policymakers learned that financial markets do not sufficiently care about macroeconomic imbalances until it is too late and then they overreact. In the euro area these imbalances became visible as high external investment positions and the expansion of bank balance sheets in core countries like Germany or France and a negative lending positions and asset price inflation in Spain, Greece, etc. In the pre-EMU era, periods of high inflation would lead to exchange rate devaluations that would lower the imbalances. And if
imbalances would get too high a country had the possibility to simply crash out, devalue and start over. In the EMU, these imbalances were allowed to reach very high levels and national central banks could not set their own interest rates to offset exuberance. A certain level of divergence in lending and borrowing positions (the current account balance) was in line with theory, since the borrowers were seen as catch-up economies so capital inflow was seen as good (with the assumption that it was mostly invested rather than consumed) (Blanchard and Giavazzi, 2002). But what not many thought possible within a currency union was that in times of financial panic these capital inflows can suddenly reverse in a flight to safety, interbank lending can dry up and peripheral markets collapse as a result (Pisani-Ferry, 2012). This phenomenon is known as a sudden stop. As a result, countries face unsustainable borrowing charges and debt can easily spiral out of control. Ireland was the first one to face a sudden stop in 2008, then followed Greece with multiple sudden stops, then Italy in 2011, and Spain in 2012. This market volatility only stopped with Draghi’s famous words of ‘whatever it takes’. And it turned out that EMU 1.0 might have had a no bail out rule on paper, but no credible framework on how to organise bail-in in case of insolvency. Financial market participants therefore simply assumed the possibility of bail out and largely turned out to be right.

Looking back at it, the euro crisis was in many ways a crisis like any other: a build up of too much leverage in the banks, an expansion of credit, until the music stops (Reinhart and Rogoff, 2009). Some elements of crisis seem highly predictable in hindsight. On the eve of the financial crisis in 2007/8 external assets as a percentage of GDP had increased to over 300% in the euro area, where it had been roughly 50% at the start of EMU. Credit to GDP ratios grew throughout the EMU, but they grew fastest in Cyprus, Ireland, Spain, Portugal and Greece. These were precisely the countries that needed financial assistance in later years (for facts and figures: ASC, 2014). Yet, in real time it remains hard to judge when debt build-up is unsustainable. The peripheral states were also some of the fastest growing economies at the time. Experts can disagree strongly over what is a good or a bad position in external lending or borrowing (Eichengreen, 2012). In a review of the EMU’s capacity for adjustment and convergence the Commission praised the monetary union as a decisive success that disproved many of the concerns that were raised in the

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8 This is sometimes described as a design failure in the euro (e.g. De Grauwe, 2013). The single interest rate of the ECB would be too lax for peripheral states thus fuelling imbalances during the boom phase. Others, such as Sandbu, dispute the importance of this argument. He argues that ‘small counties’ freedom to use central bank rates to smooth financial cycles is greatly exaggerated. The ineffectiveness of monetary independence was, after all, a big reason why countries joined the euro in the first place’ (2015; 34). Besides, there were plenty of other tools available to control the credit bubble.
period leading to EMU (EC, 2006). Since the crisis, it is increasingly recognised that financial cycles can amplify economic fluctuations and lead to high volatility of capital flows (Borio, 2014).

In the most basic explanation of the crisis, the growth of credit to GDP is key. There is also a relatively large consensus on the fact that the euro crisis was a crisis of sudden stops of capital flows, as opposed to a sovereign debt crisis as policymakers have often argued (Baldwin et al., 2015). But when looking in more detail not at what happened, but why it happened, much of the consensus fades. In a systemic crisis like the euro crisis, multiple crisis dynamics occur at the same time. In a systemic crisis, cause and effect are hard to disentangle so that establishing a clear causal pathway proves difficult. There are a host of factors one can focus on: economic, political, institutional, and arguably each played their part, but analysts disagree on their explanatory significance.

To give some non-exhaustive examples: some leading policymakers and experts have focused on the role of policies in the run up to the crisis. Actors in this strand of literature argue that the Member States of the euro area had not used the time of economic growth and readily available capital to pursue stabilizing policies (on fiscal policies: Sinn, 2010; Schäuble, 2011; Schuknecht et al., 2011; Noyer, 2012; on competitiveness: Black, 2010; Bini Smaghi, 2013; Thimann, 2015). Financial markets had lost trust, because the growth models were based on unsound fiscal and macroeconomic foundations. The crisis simply exposed these structural defects. The first years of EMU had worked great in terms of enhancing reforms and stabilizing budgets. Member States needed to meet the criteria for joining the euro and this had led to strong improvements in macroeconomic and fiscal policies. But as soon as the euro was introduced, Member States showed slippage and those who showed the largest slippage were affected stronger. States like Greece, Portugal or France continued to run budget deficits, despite an economic upswing. Others had allowed the rise of high labour costs relative to underlying productivity trends: this had eroded competitiveness and fuelled imbalances. The ECB had continuously warned for divergence in wage trends, but its calls fell on deaf ears among Ministers (e.g. Trichet, 2004; 2010).

A second strand of literature takes a more structuralist approach and focuses on the incompleteness of the euro construct, which allowed imbalances to escalate. Authors

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Exceptions to this assessment include Ahearne and Pisani-Ferry (2006) who argued that divergences in the EMU were underestimated and called for stronger mechanisms for monitoring of competitiveness developments.
in this strand typically argue that the EMU did not have strong enough institutions to reign in financial manias and that countries ought to be protected from the irrational behaviour of markets through common stabilizers (Enderlein et al., 2012; De Grauwe, 2013). Others have used similar structuralist arguments in a more euro sceptical vein, namely to argue that rising imbalances and divergence were bound to happen in the EMU. The EMU was simply a bad idea, because it is not an optimum currency area (Krugman, 2012; Stiglitz, 2016). Another such structuralist argument is that the countries in the EMU have different growth models that cannot live with a single monetary policy (Scharpf, 2011; Hall, 2014).

A third set of authors has taken an agency perspective and has shown how financialisation might have caused the crisis, but political decisions triggered or exacerbated crisis dynamics. Jones argues that the political message from Berlin not to come to aid in Greece accelerated market panic and contagion at the start of the crisis (2010). Eichengreen and Wyplosz argue that had politicians responded proactively, in a way that reflects joint responsibility and with stimulus policies, the crisis would have been much smaller in scale and shorter (2016). Sandbu is perhaps most outspoken in claiming that we should not blame the euro, but bad policies and political decisions for the crisis. He argues that politicians should have been bolder in demanding debt write-downs and allowing for more expansionary fiscal policy, their failure to take the right decisions is what aggravated the crisis (2015).

In line with this last strand of literature, another way of looking at the crisis and how imbalances emerged and escalated is not to distinguish its focus but rather its locus. While there are common elements in the euro crisis, every country also has its own story. Italy is an interesting example in this regard: the Italian sudden stop was very different from the one in Spain. Before the crisis, Italy did not run a large current account deficit, nor did it see a massive credit expansion. The Italian banking sector was even relatively conservative in the run-up to the crisis. Rather they were lenders to local economies. Households were not deeply indebted and the state, while deeply indebted, ran primary surpluses on its budget every year. Unlike Northern EU states, Italy was not severely hit in 2008. But it did see a decline of demand in its export markets, tightening restrictions on credit due to the financial stress and as a result a negative spiral of local businesses and local banks bringing one another down. At the same time, international creditors started to liquidate their Italian assets quite drastically (about 20% of Italian GDP worth of exposure was cut), especially on government bonds. It is possible that they had become worried after discussions on haircuts to investors in Greece. The result was a
sharp drop in locally available liquidity, which strengthened the negative cycles in the local economies and finally resulted in a stark rise of non-performing loans (Jones, 2017). In Spain the problems in banks spilled over to the government debt, in Italy it was largely the other way around. Every country has its own intricate mix of country specific and euro area wide elements that explain how it was affected by crisis.

The variety of narratives of the crisis matters for understanding positions on the relative importance of the MIP and questions about its future. Some see stronger discipline on policies as essential for a stable euro, whereas others focus on centralised fiscal stabilisation and a third would consider granting more leeway on national socioeconomic policies but would focus on ways to build a credible framework for debt restructuring. One thing that authors would agree on is that the EMU has not led to the macroeconomic stability that was hoped for. The existing macroeconomic governance in the EMU got tried and tested in the crisis and was found severely lacking (Buti and Carnot, 2012).

3.2 The perceived need for strengthened economic surveillance

The analysis above shows that dysfunctional financial markets played a key role in the crisis and the unwinding of imbalances. As a result, a wide range of new measures was introduced that deal with banks and other financial actors, not least a new supervisory regime under the Banking Union. The focus on the financial sector helps us to understand shocks in the system, but macroeconomic imbalances also consist of an element of vulnerabilities, which have macroeconomic roots and are often induced by policies. Macroeconomic policies around housing markets, taxes, corporate governance, pension systems or welfare arrangements might not have been the most decisive factor in causing the crisis, but they have certainly interacted with crisis dynamics and are seen as an indispensable part of the focus for emerging from the crisis stronger. As a result, policymakers started looking for a strengthened European grip on socioeconomic policies of Member States at the start of the crisis.

These were the days when politicians had been shocked about the sudden emergence of the huge budget deficit in Greece. Euro area leaders were determined to ensure that such surprises would not occur again. Similarly, policymakers had not put in place monitoring mechanisms of capital flows at the start of the euro and failed to realise

10 Of course, this is not to say that Italy did not see unsustainable dynamics; see also the chapter on Italy in this thesis.
what the huge credit flows were financing. Reinforced economic governance was also an essential part of the compromise to set up common funds for financial assistance. Policymakers looked for more transparency and stronger monitoring of the possible fall-out of national policy mistakes, especially now that the markets had proved to be such unreliable partners in terms of disciplining unwanted behaviour. Policymakers learned that financial markets do not sufficiently care about macroeconomic imbalances; they can even fuel them, until it is too late and then they overreact.

It became clear that there was a gap in the oversight framework of the euro and that rules on public debt and deficits alone are not enough to ensure a stable EMU. Growth, inflation, current account balances or competitiveness differentials had been monitored since the start of EMU under the BEPGs, which have been adopted annually since 1993 and every three years since 2003. But discussions in the Council on recommended policy action were commonly seen as lacking real commitment and ownership by Member States (Kok, 2004; Pisani-Ferry, 2006; Deroose et al., 2008; Wyplosz, 2010; Ioannou and Stracca, 2011). The Commission had not been completely unaware of rising imbalances. For Ireland it noted that the economy was exposed to possible negative shocks, primarily due to developments in the housing market (EC, 2007). And for Spain, the documents do warn of a widening external deficit (EC, 2007a). But these comments had not made much of an impact in these countries, not least because the Commission also repeatedly praised both states for economic progress in these years and for pursuing prudent fiscal policies (Begg, 2013). The windfall gains from the credit boom were in general interpreted as structural improvements in the economy (EC, 2008). It was therefore seen as imperative to update the analytical capacities with a new framework for surveillance and look for ways that would ensure that Member States would take the process more seriously.

The idea of introducing the MIP originated in the Commission at the start of the financial crisis. ECFIN economists were convinced that the focus in the rules on fiscal issues simply did not suffice, as problems could arise elsewhere. One can find earlier traces of calls to broaden and strengthen economic surveillance, such as the Sapir report (Sapir et al., 2004), but it was in 2008 when the idea gained serious traction. In a report on taking stock of ten years of EMU, published on the eve of the financial crisis, DG ECFIN economists warned that the euro area had persistent imbalances, competitive

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11 The BEPGs did include the possibility to reprimand a Member State. But when the Commission used this feature in 2001 for Ireland, the Irish government simply ignored the call, while publicly blaming meddlesome Brussels bureaucrats (Meyer, 2004) and economists criticised the lack of sufficient economic underpinning for the reprimand (e.g. Blanchard, 2001).
divergences and housing booms, and that there was a need to broaden surveillance to address macroeconomic challenges. In hindsight the report reads a bit misplaced, since it also praises the euro area as ‘a pole of stability’, with ‘a sound structure of economic governance’ (EC, 2008). The start of the financial crisis did not immediately expose imbalances. Yet, outside the euro area multiple states got into balance of payments crises giving off strong warning signals about developments in the EMU. Latvia was a clear example: after years of boom it got caught up in the financial turmoil, faced a stop of capital inflow and its excessive current account (peaking at 25% of GDP in 2007) started to reverse and the economy plummeted into deep recession.

A first sign of action was to start regular reviews of competitiveness developments in the Euro Group. Especially the ECB took the stage in these meetings to warn for unsustainable trends, but there was little sense of urgency. As Thomas Wieser (former Eurogroup Working Group President) for example describes:

> There had been presentations from the ECB where he [ECB President Trichet] held up diagrams saying: “Ministers, you are ruining the euro area. These are wage developments in Germany and Austria, and these are the graphs leaving the paper. This is unsustainable, you are killing it”. So it was Trichet and his focus on ULC divergences. But, did anyone listen to him? No. The economists were listening, but not the Finance Ministers. Or, if you look at the current account in Spain, the reversal started in 2003 when they still had a net external negative investment position of 35% of GDP, six years later it was 95%. So it became clear, early on that this was on a trajectory that was unsustainable. But as long as the shit doesn't hit the fan, nothing happens. (Interview 61)

The sense of urgency grew in the years that followed. Senior Commission officials, such as ECFIN’s Marco Buti and Secretary General Catherine Day started pushing for a broader reform process. The key trigger for the Council to start taking reform proposals serious was the Greek deficit saga that started in 2009 with the first rescue loan in May 2010. The SGP had lost its credibility. And with a reform of the SGP at hand, surveillance could be broadened to also include macroeconomic imbalances. The European Council called upon a taskforce to set up a stronger and more credible economic governance framework, including a legal framework to address macroeconomic imbalances, leading to the Van Rompuy Taskforce report (European Council, 2010). The German and French leaders introduced the new economic governance framework as follows: ‘We need more binding and more ambitious rules and commitments for the Euro area Member States. They should reflect that sharing a single currency means sharing responsibility for the
Part I: Horizontal Analysis

Euro area as a whole. They should pave the way for a new quality of cooperation and integration within the Euro area.’ (Merkel and Sarkozy, 2011).

3.3 Designing the MIP

The MIP originated in the Commission, but designing the MIP ended up being a joint effort. In the 2010-11 period, in which the MIP was designed, there were several forums working at the same time. There was a bilateral taskforce between high-level French and German officials, there were discussions in the EPC, Commission notes were discussed in the EFC and discussions on methods and indicators occurred in LIME. At the same time, the Van Rompuy Taskforce tried to get the key political actors aligned. Laffan and Schlosser (2016) describe this period as one of institutional arm-wrestling, with significant frustration on all sides. In a hasty move the European Commission, for example, came out with their comprehensive package of reforms one month before the publication of the Council’s Van Rompuy report.

The major controversy at the time was the strengthening of the fiscal rules. There were deep divisions between creditor and debtor countries on the automaticity of sanctions, room for interpretation, and how to apply sanctions (Degryse, 2012). Most of the details of the final package came from the Commission and the Council committees (including a dominant position of ECB representatives (Beukers, 2013)), but the European Parliament also played a role in forcing a transfer of sovereignty to the European level to enforce discipline with the formula of adopting sanctions via Reversed Qualified Majority Voting (RQMV, see section 4.2.3). This should be seen in light of the Council’s reluctance to be a disciplining force in the past. And by insisting on adopting the various proposals as a package deal, the EP also played a key role in codifying the European Semester in the legal texts, whereas ECFIN officials were still sceptical of whether in the end the Council would accept the Semester (Laffan and Schlosser, 2016). But there were also significant discussions and controversies on designing the MIP.

In addition to sanctions, as discussed elsewhere, one of the key discussion points was the scope of the MIP and which indicators to use in the AMR. In later years, practitioners would argue that the AMR is not the most interesting element in the MIP, but at the time it was the most tangible part. It determines what trends to look at and what a balanced economy looks like. There was a difference of view between experts and between countries on whether the procedure should be focussed or encompassing. The initial idea of some
of the proponents of the MIP was to have a process on the basis of only two or three indicators. A limited number would give clear political visibility to the procedure as a counterweight to the SGP. Others, with a view of designing a more political procedure focused on policy convergence, wanted the focus to be broader. In part these discussions were intellectual, in part political. As various statements of former Commission officials indicate:

_We were not yet very familiar with the concept of imbalances. The only thing we knew was what we saw happening at the time, so the Irish and the Spanish case were not allowed to happen again. But those were also very specific circumstances._ (Interview 8*)

_It took us quite a long time to come to an agreement with the Member States on the criteria. It was a real battlefield. Some wanted a procedure focused on very specific situations that should not be taken lightly. Others wanted a more general procedure and did not like the idea of seeing too much power in the hands of the Commission. And opposed to that you had the financial experts, also encouraged from Washington, who wanted an ambitious proposal and did not accept half-baked outcomes._ (Interview 60*)

Everyone in the Council had their own vulnerabilities and their pet ideas on what causes imbalances. France and Italy opposed the inclusion of public debt as an indicator since it was already covered under the SGP. A French official admitted that his instructions were to support the MIP, but also to make sure his country would not end up with another problem in the coming years (Interview 49). Germany at the start of the process tried to downplay the role of the MIP, so as to have all the focus on strengthening the fiscal rules. But, once they had accepted the MIP, they were quite outspoken on which indicators should be in it. And indeed there can be discussions on this issue. It is not directly obvious why the current headline indicators are in, but others, such as the ratio of non-performing loans, inflation or the investment gap, were left out. At the same time, Pierluigi and Sondermann show that if you apply the indicators retrospectively the scoreboard would point out as early as 2005 that Greece, Cyprus, Ireland, Portugal and Spain were in grave risk, which indicate that they make sense (2018).

Despite resistance by Member States the Commission managed to mostly get its way in the discussion. The scoreboard of today looks much the same as the one that was presented in some of the first discussion notes by the Commission. The most difficult
debate at the time was to convince Germany also to include a reference to current account surpluses in the procedure. Germany was vehemently opposed to treating current account deficits and surpluses in a symmetrical manner and demanded legal safeguards (see the chapter on Germany for more details). Here the Commission had to give in a bit and reassure Germany that a surplus would not easily lead to sanctions and allow the reference values to be set unevenly (-4% of GDP and +6%). This asymmetry is often criticized by economists, who argue that too much focus is being put on internal devaluation in deficit countries, without appropriate revaluation in surplus countries (De Grauwe, 2013).

Once the debates on the indicators and design of the sanction procedure had been settled the legislative process went relatively smooth. There was broad support in the European Parliament for the MIP. The Six-Pack was adopted in autumn 2011, at the height of crisis between the EU institutions and the Berlusconi government. The first Semester cycle started immediately in December 2011.

3.4 From a rigid to an interactive approach

After Regulation 1176/2011 establishing the MIP was adopted, it was decided not to allow for a transition phase for the Member States to meet some of the criteria, but apply the MIP immediately. This was the period that 23 out of 27 Member States were in the EDP. Debt levels were rising fast and EU leaders were in a head to head with financial markets to regain confidence. They had lost credibility in half-hearted attempts to manage the situation in Greece and Italy and thus wanted to show they were serious in building a new framework for economic governance. The Six-Pack was presented as ‘a significant strengthening of our rules and mechanisms’ (Van Rompuy, 2011), with Commissioner Rehn promising to ‘fully use this powerful set of new tools from day one’ (FT, 2012). These were the days that Commission President Barroso claimed with great bravery that the Commission was the ‘economic government of the Union’, which would propose and assess the actions that the Member States should take. ‘Governments, let’s be frank, cannot do this by themselves’ (Barroso, 2011).

But practically operating such a complex and all-encompassing framework such as the Semester from day one is no easy task. The first batch of In-Depth Reviews followed eight months after adoption of the MIP. Under the BEPG, ECFIN assessed the general direction of a Member State economy, but the Semester required deeper political
and technical understanding of economic policies in the Member States. It required institutional and intellectual craftsmanship and learning-by-doing to change from a largely descriptive role to a prescriptive analytical one. This did not fit well with a call for rigorous interpretation of the new legislation from the start. The first cycle was difficult to coordinate between Commission services and was described by one interviewee as a purely paper-based exercise (Interview 16). ECFIN officials would simply read reports and interpret statistics. The Commission decided not to place any Member State under the excessive category in its first year, because it did not yet have the analytical capacities for such a strong approach. In hindsight, the Commission could have made a strong case for labelling Cyprus as having excessive imbalances, given the fact that a banking crisis erupted only a few months later.

The rigour of the framework primarily translated into Commission officials not having a mandate to commit to modifications of Commission text in Council meetings. Officials of Council advisory committees were used to a more informal culture, where it was more common to try and look for compromise on the text. At the start of the Semester, there was in general discussion on how this framework should be interpreted and what the de facto status of the CSRs would be. The fact that the ‘paper-based’ exercise was felt to not always correspond with the facts-on-the-ground in combination with the procedural inability of the Commission to commit to changes of text led to annoyance in the Council:

*I remember that there were some serious questions on the recommendations and the Commission came into the committee and said: “we are not allowed to discuss this”. So I thought “come on, what are we doing here if we are not allowed to discuss?”* (Interview 47 – Italian official)

Others had the feeling that there were clear political views behind the first batch of CSRs, which were not sufficiently backed up by analysis. As a Dutch official describes how he remembers the first debates in the Council:

*... there was a feeling that the recommendations were projected on the analysis. The analysis was there, but the same recommendation would have also followed had the analysis been different.* (Interview 76° – Dutch official)

The Commission publically warned against a possible watering down of the ambitions in Council discussions and regarded dialogue over the content of CSRs as an undermining
of the independence and credibility of the process (EUObserver, 2011). And indeed, some officials admit that ‘the instructions I had were to downplay the Commission's recommendation, this was frustrating’ (Interview 49 – French official). But another official explained that this is precisely the dynamic that could be expected:

This polarisation, so the Commission who felt that the Member States were all bad pupils focussed on doing as little as possible, that was the feeling they gave us at least and consequently the counter-response of the Member States was a sense of ‘we need to find ways around these recommendations by any means necessary’. This created a very unproductive dynamic. (Interview 25* – Belgian official)

Soon enough the Council started pushing back against an overly prescriptive and restrictive approach of the Commission. In order to come to a more interactive approach with consensus on priorities, the Council stressed the need for more leeway for the Member States to choose their implementation path. Similarly, the Council called for more frequent and deeper dialogue at a higher level between the Commission and Member State officials to ensure CSR quality and ownership. Finally, it called for an increase of multilateral thematic discussions in Council committees to come to a shared understanding around common themes (Cypriot Presidency, 2012).

Over the next Semester cycles, new elements were added to ensure that the Commission and the Member States would be more on the same line. The number of bilateral meetings between the Commission experts and high-level civil servants of Member States was increased. Member States received the opportunity to comment on the Country Reports and discuss these comments in the Council advisory committees. Specific MIP fact-finding missions were introduced, which can also include experts from central banks, academics, social partners and economic institutes, and can be preceded by extensive questionnaires to be filled out by the Member State. The Commission also set up offices with European Semester Officers in each Member State as a communication liaison. These officers are an important part of the eyes and ears of the Commission in making sure that the analysis in the MIP corresponds to the facts on the ground. And to help build consensus on the issues that the MIP touches upon by meeting with social partners, central banks, academia or other stakeholders. And finally, it is also worth noting that within the Commission and between the Council committees, a more interactive balance has been reached over the years, with the better inclusion of the actors on the social and employment side (see also Zeitlin and Vanhercke, 2014; 2015; 2018).
The more interactive approach underlined that the Semester relies heavily on the political will of Member States to comply with shared objectives rather than on legal obligation. This objective was made explicit with the change of the Commission in 2014. Juncker from the start believed in a more political approach, based more on encouragement and dialogue than threats and sanctions: ‘You cannot run a single currency on the basis of rules and statistics alone. It needs constant political assessment, as the basis of new economic, fiscal and social policy choices’ (Juncker, 2015a). At the same time, Juncker reduced the number of CSRs in the previously described process of streamlining and introduced procedural changes in the release of documents, so as to allow for more political discussion around key priorities. In this way, the Commission responded to criticisms of an overly prescriptive approach (Lithuanian Council Presidency, 2013). It slimmed down the Semester CSRs to key priority issues that are actionable and monitorable within a twelve to eighteen-month timescale (EC, 2015b). However, Member States for which more severe imbalances have been identified continue to receive more detailed and time-bound CSRs, with more intensified monitoring on implementation (EC, 2016a).

The more targeted and open approach was warmly welcomed by the Council (EFC, 2015) and by many interviewees:

*The former Commission was much more about ‘we have the right analysis and if you are open to common sense, you will come to the same conclusion’. This Commission is more about ‘we have agreed together on the political direction, so let’s now do it’. (Interview 16 – Commission official)*

*The previous Commission was more about threatening, so we have the instruments, we can also give a sanction. There really were conversations between the Commission and the Member States like ‘you have to do more, we are disappointed’. This Juncker Commission is much more about encouraging. (Interview 9* - Commission official)*

*For a long time, they simply pressed a button, “clack”, and a recommendation would come out. You could write up the recommendation yourself before it would even come out, easily. But now something is changing. It is really politics because they understand that procedure is not enough, because it is not effective. Without politics, procedure does not work, the people of the Commission have that in mind. (Interview 24 - Belgian official)*

*... we see now that the Commission can also hear us. This is quite different from the Barroso*
Part I: Horizontal Analysis

**Commission. We couldn't have a real dialogue then.** (Interview 58 - French official)

It would be too much to say that the Semester started off on the wrong foot, with a system that is so encompassing you are bound to have disagreements at the start. But it has certainly taken a bit for actors to find the appropriate interpretation of the mandate. The Commission also sought credibility from the markets in this tumultuous start. At the same time, the Semester has proved adaptable to different circumstances based on learning-by-doing practices. This change has occurred gradually but was affirmed by the change of colour of the Commission.

3.4 A political approach

In Juncker’s first State of the Union (2015), he proclaimed that he wanted to lead ‘a very political Commission.’ The challenges Europe was facing left him no choice, so he claimed, to ‘address them from a very political perspective, in a very political manner and having the political consequences of our decisions very much in mind’. Before analysing what this means for the Commission’s role in the MIP it has to be born in mind that this proclamation of Juncker does not imply that the role of the Barosso Commission was a-political. Interpreting the legal framework with a degree of rigour can be seen as equally political, claiming that the Commission is the economic government of Europe even more so. It concerns different political choices. The problem with the word ‘political’ is that it means different things to different people. It can be interpreted as an affirmation that the issues of the Semester have a deeply political nature, but others would interpret it along the lines of going against evidence-based decision-making. During the years of the Barosso Commission, the political agenda consisted of tightening control on the economic developments in Member States. This agenda was reflected in a number of (successful and unsuccessful) attempts to expand the economic governance framework.

After the Six-Pack, which brought us the MIP, the EU adopted in 2013 the Two-Pack. The Two-Pack introduced an additional layer of control on the budgetary cycle of the Member States whereby the Commission would assess every draft budget and which became fully embedded in the European Semester. In 2012 the Member States adopted the intergovernmental Treaty on Stability, Convergence, and Governance, also known as the Fiscal Compact. The TSCG is aimed to ensure further compliance with the budgetary targets. Signatories agree to introduce a binding balanced budget rule into national law, whereby a deviation from the adjustment path towards a fiscal medium-term objective
could be automatically sanctioned. The status of the treaty is ambiguous, it was ratified by national parliaments in exceptional speed, as the adoption of the Treaty was made a condition for access to the ESM. But, it seems to duplicate and overlap the fiscal framework of the Semester and directly after implementation it already became clear that the Member States did not intend to actually stick to the very rigid criteria (Gros and Alcidi, 2014). For Italy, a strict interpretation of the Treaty would bound the country to severe austerity, but the Italian government feared an adverse market response if it did not sign up to it, as its commitment to the Treaty was not one of conviction (Moschella, 2017).

During these days there was also talk of hardening commitments under the Semester, by making implementation of CSRs a prerequisite for access to the ESM, but this was never implemented (Cypriot Presidency, 2012). Another failed attempt was the introduction of a positive conditionality mechanism to support but also harden commitments to CSR implementation: the Convergence and Competitiveness Instrument, or contractual arrangements (EC, 2013). Another ambiguous, but adopted, expansion of the economic governance framework is the 2011’ Euro Plus Pact. This is an intergovernmental agreement to encourage Member States to take up specific clauses on structural reforms and wage developments in national law. But after a few years, the status of the pact was already unclear: it was described by a Commission official as like the parrot in Monty Python; ‘we don’t know if it’s dead or just sleeping’. Another high-level official in the Council had completely forgotten about its existence.

From 2014 onwards the political mood in Europe started changing and the search for tighter control had run its course. French President Hollande and Italian Prime Minister Renzi raised the issue of increasing flexibility in the European Council in an effort to privilege growth and employment ahead of austerity. In 2015 both countries started openly defying budgetary rules, by demanding exceptions for a housing tax in Italy or because of security threats in France. In the 2015 Spanish elections political parties also openly campaigned against the EU’s budgetary mantra. In this context, Juncker campaigned in the European Parliament elections for a more flexible approach in the Semester. This also helped him in building a supporting coalition between the European People’s Party (EPP) and the Socialists & Democrats (S&D) in the EP. Of course equally important in this short sketch of events is the changing economic context, the euro was no longer under speculative attack of markets, but in a process of recovery. What is argued here is that the move towards a more political Commission did not happen in isolation, it was in response to changing circumstances.
Part I: Horizontal Analysis

The approach of the Juncker Commission also led to a reinterpretation of the general economic approach, from ‘growth-friendly fiscal consolidation’ (EC, 2012), to the so-called ‘virtuous triangle’, consisting of structural reforms, responsible fiscal policies and investment (EC, 2016b). What this change in marketing credos meant in substantive terms was amongst others the introduction of the European Fund for Strategic Investment, the earlier-discussed streamlining of the Semester and the progressive socialization of the CSRs, culminating in the adoption of the European Pillar of Social Rights.

But what does the ‘political’ approach mean, in the application of the MIP?

.. applying the rules with knowledge and feeling for the political context in a Member State. So you are more pragmatic and you look from the perspective of your political aim. So when you take reforms in France, you try to see how you can be most effective in contributing to the national process from Europe. (Interview 8*)

Political means that they recognise that there is no consensus, based on scientific evidence, about there being only one policy option. (...) So the way this appears on the Semester is that when it comes to the politically sensitive stuff it is much more ‘hands off’. (Interview 16)

The reinterpretation and reorientation of the mandate also led to new criticisms on the credibility and predictability of the Semester. The goal of the fiscal and economic governance framework is to act as a credible anchor for policy decisions. In order to be successful, it needs to balance between predictability and simplicity of the rules and recommendations on the one hand and adaptability and smartness on the other (Debrun et al., 2018). But with an increasingly political approach, the balance can be seen as overly tipped towards adaptability. When the Commission adheres to national politicians asking for more time and greater flexibility some would see this as a way to ensure national ownership which is crucial to undertake meaningful reform, but others suspect moral hazard. Some in the Council would like the Commission to be a strict guardian of the Treaty whereby it is the role of the Council to decide on a more appeasing stance towards Member States or not. This role division might have worked when the EU was primarily engaged with the internal market but on economic governance the Commission has been less and less willing to play this role of bad cop. It has started acting more like a (political) mediator, much to the annoyance of hawkish Member
States in the Council.

With Juncker’s political interpretation soon enough Member States started demanding clarification for the decisions and transparency into decision-making. For the MIP, this resulted in the explanatory document: the MIP Compendium. Similarly, the more open formulation of the CSRs is meant to strengthen ownership. But the downside of this approach is that CSRs can be interpreted as too general so that they lose traction in the political debate.

This struggle to find the right balance between contradictory objectives has been most pronounced on the fiscal side of the Semester. As discussed above, Renzi and Hollande had argued for greater leeway in the interpretation of the SGP. But giving the Commission discretion in how it would apply fiscal rules would not bode well with hawkish politicians. Instead, the Juncker Commission tried to introduce more sophistication in the rules based on the existing room for interpretation, in order to find a balance between the opposing views in the Council. This resulted in the Communication on the use of flexibility within the existing rules of the SGP (EC, 2015). This document can be seen as the affirmation of the changing relationship between the SGP and the MIP over the years and is widely interpreted as a significant change of course by the Commission that allowed to move towards fiscal expansion.

The SGP, while being a rules-based framework, also includes discretionary elements, such as the reference to taking “relevant factors” into account when comprehensively assessing compliance with the deficit and debt criteria (Reg. 1467/97, Art. 2). The Commission built on this opening by introducing clauses that would link flexibility to progress on structural reforms (see section 4.2.4 for details). The goal of the communication was to provide guidance and procedural safeguards on how the Commission will apply its margin of interpretation in implementing the SGP. It was meant to provide for sophistication in the rules rather than an increase in discretionary use. But it is questionable whether it achieved this aim. On paper the MIP and SGP are two separate procedures, but with the open way in which structural reforms are defined in the flexibility communication they have become integrated. The case studies will dig deeper into how this works out in practice. The layers of complexity that have been added give the appearance of a discretionary regime, where the framework is tilted so far towards adaptability and smartness that simplicity and predictability have gone lost. According to Eurogroup President Dijsselbloem there is a sense of unease with the Semester again:
I am very worried ... If Member States feel that the Commission’s decisions are very hard to understand and very hard to predict, and are not objective, are perhaps distinguishing between small Member States and large Member States, that is a very big worry. (...) I can sense it during the Euro Group meetings that Ministers are becoming a little concerned about this. (Comments made on 14 June 2016 in the European Parliament)

This unease is primarily directed at the fiscal rules, but elusive linkages to the rest of the Semester are part of the story. Similarly, it is directed to decisions on sanctions, the quote above should be seen in the context of the Commission’s decision not to propose fines for Portugal and Spain under the SGP. For the fiscal rules, a big part of the criticism is focused on the measurement of the structural budget balance. This indicator includes measurement of the cyclical position of an economy, a highly complex and uncertain endeavour (Darvas, 2016). In a power play, as a response to the Commission making the SGP application more ambiguous, the EFC came with its own Code of Conduct on the SGP in which it attempted to re-codify the fiscal rules (Council, 2017). But the attempt to re-codify did not result in more clarity. Symbolic of the complexity of the current framework is the endeavour of the Commission to explain the fiscal rules in a 224-page Vade Mecum (EC, 2017a). Pisani-Ferry aptly describes the document as so ‘hopelessly complex, to such a degree that no finance minister, let alone parliamentarian, fully understands what his or her country must abide by’ (2018). The European Fiscal Board has argued that we must simply accept that applying fiscal rules involves a degree of discretion, which cannot be fully codified. They see discretion as such not as an issue, what matters is whether the discretion is exercised on the basis of economic reflections (2017). A similar argument can be made for the MIP.

From 2016 onwards those who value a clear rules-based framework started pushing for a stricter approach. There is the feeling among some, for example in the German Finance Ministry, that the Commission has a hidden agenda, away from country-specific risks and imbalances towards a euro area economic agenda and increasingly steered from the Secretariat General (Interview 63). German Finance Minister Schäuble has on multiple occasions argued that the political role of the Commission is incompatible with its function in economic surveillance (e.g. Reuters, 2016). Key politicians from the

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13 In the summer of 2016 it became clear that both Spain and Portugal had clearly and repeatedly violated the budgetary rules. It became a test case for the political approach of the Juncker Commission. The Commission decided not to propose sanctions to the Council. There was wide support for this decision, both in the Council and in the European Parliament. But it also led many to question the credibility of the Semester. Portugal had its budget in line with the recommendation the next year, Spain continued to be in the Excessive Deficit Procedure.
Netherlands have equally argued that economic monitoring should be delegated to the ‘independent ESM’ (Rutte, 2018; Dijsselbloem, 2018). Interestingly enough, Wieser argues that in the Council most Member States have become passive with regards to discussions on fiscal issues, largely accepting whatever the Commission proposes. ‘Outside the room, however, they complain bitterly about whatever the Commission proposes’ (2018).

3.5 Conclusion

How can stability be ensured in a Union with a single currency and highly diverse economic and political structures? This question has been on the minds of policymakers from the start of EMU and in many ways still defines current debates over the operation of the MIP. EMU 1.0 allowed for high diversity and was based on a narrow set of simple rules. These proved insufficient, as policymakers learned that financial markets do not discipline imbalances, but deepen them and overreact in times of crisis. As a result, a new tool was designed to monitor and manage imbalances in order to achieve stability. The MIP was also meant to close the gap in oversight, since some of the countries that needed a bail out were deemed to be fine just a few years before. The chapter also shows that actors continue to differ in their explanation of the crisis, depending on the locus and focus of their analysis. The MIP is a tool for addressing imbalances insofar as these arise from national policies. But for stability in the EMU other factors are also at play, such as political trust and financial volatility.

At the start of the crisis, there was a consensus that stricter European control on national socioeconomic policies should be part of the strategy to regain trust from markets and strengthen the EMU. The Commission applied the MIP immediately after its adoption at the height of crisis. It did so in a way that was interpreted as rigorous by (some) Member States. Soon enough, the Member States started pushing back and demanding more

In light of this comment it should be mentioned that the ESM is in a process of building up analytical capacity for monitoring economic developments. Managing Director Klaus Regling has stated that the ESM will regularly monitor the economic situation in Member States, also those without a programme. However, this would not mean a decrease in the competences of the Commission in the MIP rather the ESM and Commission are constructing a framework for cooperation (2018). The Meseberg declaration between Merkel and Macron has declared that the ESM ‘should have the capacity to assess the overall economic situation in the Member States, contributing to crisis prevention. This should be done without duplicating the Commission’s role and in full respect of the treaties’ (Bundesregierung, 2018).
Part I: Horizontal Analysis

input and ownership. The Commission adopted an increasingly political approach in operating the MIP. This approach has given rise in turn to an increasing complexity of governance procedures and renewed criticism on an overly discretionary approach. Few now understand the exact relationship between fiscal flexibility and structural reforms under the MIP. Again, policymakers are faced with the dilemma of balancing between national ownership (diversity) and adherence to common rules and economic guidance (unity).

This chapter has argued that the MIP is responsive to changes in political and economic sentiment. This is an important argument in the overall assessment of the MIP’s hierarchical character. Also, the dilemma of facilitating ownership on the one hand and the need for structural reforms on the other hand that is explained in this chapter will recur in various forms in the case studies. Similarly, it should be noted that there was at the start of the crisis no unitary and clear consensus on what constitutes imbalances; this was a relatively new concept for policymakers. The next two chapters will show how this difficulty in defining imbalances has shaped the MIP’s design and its substantive content.
Chapter 4

The governance of the MIP

4.1 Introduction

This chapter will analyse how the MIP works. The MIP is governed through procedures and interactions between different actors. When the Commission issues a CSR on a particular topic, this entire governance framework is set in motion. The Member State is obliged to explain what it is doing on this issue. The CSR needs to be backed up by an analysis. This analysis is discussed in expert groups in the Council. It is this governance framework that distinguishes a CSR from any other piece of economic advice. It is the procedural safeguards and web of interactions that give credibility to the process. This chapter seeks to explain how this governance framework works.

The first section will describe how the MIP works on paper. The explanation is loosely inspired by the literature on compliance mechanisms as used in Börzel et al. (2003) and as applied in a legal analysis of the Semester by Repasi and Amtenbrink (2016). This section will also dive a bit deeper into the role of sanctions under the corrective arm of the MIP as the most controversial element of the MIP. The chapter will argue that there is a big gap between how the MIP functions on paper and how it is perceived by those who designed and work with the MIP. For example, from the start there were few actors who ever believed in sanctions under the MIP.

The second section gives an overview of the institutional architecture in which the MIP operates and the actors who are involved. This section should be seen against the background of an ongoing debate among integration scholars about how the new economic governance has changed the institutional balance in the EU. Some have argued that the new regime has reinforced intergovernmental decision-making (Fabbrini, 2014; Bickerton, Hodson, and Puettter, 2015). Others have argued that the Commission's supranational powers over national decision-making have been strengthened (Chang, 2013; Bauer and Becker, 2014). Legal scholars have questioned accountability structures
and discretion in this new institutional balance (Dawson, 2015).

This chapter does not seek to take a position in this debate. Rather, it seeks to shed light on what roles various actors have taken and how these have evolved, as well as on how these actors have dealt with dilemmas of discretion and accountability in the design and operation of the MIP.\textsuperscript{15} It takes as a point of departure that both the Commission and Council are indispensable in the operation of the MIP. Rather than making arguments about the dominance of one institution over the other, it is the interaction between the two that is central in this study.

Finally, it should be mentioned that this chapter describes the governance of the MIP on the basis of an analysis of Council documents (published and unpublished) and supporting interviews up to the end of 2017. The governance of the MIP changes constantly: for example, in the Commission proposal for the new Multiannual Financial Framework new elements are introduced that relate to the MIP. Similarly, the Eurogroup is discussing compliance with the MIP as a precondition for access to preventive tools of the ESM. However, these proposals are not included in this analysis, since they have not been fully adopted yet at the time of writing. In this chapter, the same disclaimer applies as in chapter one: given the strong overlap of MIP and Semester issues in terms of governance, the two frameworks are sometimes used interchangeably.

4.2 How does the MIP function on paper?

4.2.1 The purpose of the MIP

The MIP is aimed at the detection, prevention, and correction of trends giving rise to macroeconomic imbalances. It applies to all EU states, but its more coercive enforcement elements only apply to euro area members. The procedure is laid down in Regulations 1174/2011 and 1176/2011, both of which are part of the so-called Six-Pack, the legislative package that collectively strengthens budgetary surveillance and introduces the MIP and the European Semester. The MIP is a procedure within the European Semester, which is a policy process tool whose aim is to integrate and centralise all socioeconomic and fiscal surveillance into a single calendar cycle and also includes the Stability and

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\textsuperscript{15} For a full discussion and elaboration of positions of the debate on intergovernmentalism versus supranationalism in relation to the MIP, see: Kanthak (2018).
Growth Pact. The SGP and MIP are surveillance procedures, which are carried out within the framework of the Broad Economic Policy Guidelines (based on Art. 121 TFEU), the Employment Guidelines (based on Art. 148 TFEU) and the Europe 2020 Strategy targets. All the policy recommendations of the Semester belong to this framework, but only some are linked to either the SGP or the MIP.

The annual Semester cycle starts every autumn with the Annual Growth Survey, which sets out the economic policy priorities for the upcoming year, whereas the strategies mentioned above are multi-year documents. Then follows a country-specific assessment period in which the Commission publishes Country Reports and each Member State publishes a National Reform Programme and a Stability or Convergence Programme (on the fiscal outlook). The cycle ends with Country-Specific Recommendations as its centrepiece <see Annex 1 for a visualisation of the Semester cycle>. The MIP has its legal basis in Article 121, TFEU, which calls upon Member States to regard their economic policies as a matter of common concern and to coordinate them within the Council. The objectives of the MIP can also be traced back to Article 119(3) TFEU, which refers to the guiding principles of stable prices, sound public finances and monetary conditions and a sustainable balance of payments (for further legal analysis, see: Amtenbrink and Repasi, 2017).

Macroeconomic imbalances are defined as ‘any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole’ (Regulation 1176/2011, Art. 2(1)). Imbalances have to be considered excessive if they are severe, which includes ‘imbalances that jeopardise or risks jeopardising the proper functioning of the economic and monetary union’ (Art. 2(2)). Article 4(3) of the Regulation distinguishes between internal and external imbalances. Internal imbalances include public and private indebtedness and can potentially trigger financial and asset market developments. External imbalances include those that can arise from the evolution of the current account position and net investment position, but also competitiveness issues, real effective exchange rates and should take into account the different components of productivity. Finally, Recital 17 states that when assessing imbalances ‘account should be taken of their severity and their potential negative economic and financial spill-over effects which aggravate the vulnerability of the Union economy and are a threat to the smooth functioning of the economic and monetary union.’ The issue of spillover effects is key to the rationale of the MIP since ultimately it tries to mitigate negative externalities of economic developments.
The definition given to imbalances in the Regulation is very broad. After publication of the MIP Regulation, the Commission published multiple in-depth studies on various types of imbalances and their potential riskiness, such as on tax policies (EC, 2012a) or current account surpluses (EC, 2012b). These studies had the explicit purpose of giving some more analytical backing to how the Commission sees macroeconomic imbalances. They should be seen as an answer to the vagueness of the concept in the regulation. It follows from the logic that there is no easy way around discretionary elements in the MIP, but at least these elements are intellectually grounded. The studies have each been discussed in the Council advisory committees to try and come to a shared perspective on imbalances. After continued criticism on the lack of clarity in later Semester cycles, the Commission published a 136-page long MIP Compendium (EC, 2016a).

In the Compendium, the Commission tried to further unpack the concept of macroeconomic imbalances and explain how the MIP addresses them. The Compendium describes the MIP as an instrument to avoid episodes of macroeconomic instability, whereby there are ‘disorderly corrections in financial and asset markets, such as sudden hikes in risk premia, the occurrence of banking crises, current account reversals, asset market crashes, etc’ (2016a: 45). Against this background, it describes imbalances as: ‘the presence of unsustainable trends, for instance, the rapid accumulation of external liabilities or major and protracted competitiveness losses, and situations of vulnerability, such as highly leveraged financial positions or high stocks of external debt’ (2016a: 46). These stock and flow issues (vulnerabilities and trends), should exclude issues that only have local relevance or instances of merely disappointing economic growth. And they should have the potential to be addressed by policy.

Even this more expanded definition cannot evade the fact that governing imbalances includes forward-looking elements, such as the likelihood or risk of a disorderly correction, and includes substantial judgments. The Commission also acknowledges the discretionary nature in various documents. What follows from this is that it is impossible to codify legally the procedure to address imbalances in a high level of detail, and that it would be legally dubious and easily contestable in court to have the compliance be based on detailed and legally enforceable CSRs that look more like Regulations. A closer study of the procedure clearly indicates that this is also not the case.

4.2.2 The annual cycle of the MIP

The MIP’s annual cycle starts with the Alert Mechanism Report (AMR), an annex to the
Annual Growth Survey. The AMR is a filtering device to single out particularly worrisome trends, which deserve further scrutiny and thus become part of further steps into the MIP. The intention of the AMR is to preserve accountability in the interpretation of economic developments by policymakers and commentators; hence, it is based on a set of indicators with thresholds to signal when a value is worrisome. The scoreboard of indicators provides further clarification of what an imbalance is, but is not meant to be used automatically to expose risks. In fact, the recital of Regulation (EU) No. 1176/2011, cautions against an ‘automatic reading’ of the AMR and makes clear that the breach ‘of one or more indicative thresholds need not necessarily imply that macroeconomic imbalances are emerging’. It is important to stress this point in particular, given that the AMR is sometimes interpreted as a set of rules, whereby a higher value than the threshold is seen as a breach of European rules. Here it also has to be underlined that values in the scoreboard are backward-looking rather than predictive, as they reflect the economic reality of two years before issuance of the AMR. Many of the indicators are three or even five-year moving averages and thus ill-equipped to expose immediate trends.

Whether a trend is, in fact, worrisome is a more elaborate question to be determined through the In-Depth Review that follows from the AMR scoreboard. The scoreboard of 14 headline indicators (this number has changed over time) is grouped into external imbalances and competitiveness on the one hand and internal imbalances on the other. They address both stocks, such as private debt, and flows, such as a change in export market share. Additionally, the AMR has a set of 28 auxiliary indicators that provide further contextual detail on the headline indicators, for example in which areas export market share is lost or the composition of external liabilities.

On the basis of the indicators, the Commission uses the AMR to select the Member States for which an In-Depth Review is warranted to determine whether there are indeed imbalances. To limit the number of documents, since 2015 the In-Depth Reviews and the Staff Working Documents that assess the policy efforts of a Member State are

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16 For example, in an interview in the Financial Times (23 December, 2015), Italian Prime Minister Renzi stated: “Germany has a trade surplus of 8 per cent, and the rules say it should be 6 per cent at most.” The same argument can be found within Germany itself, where for example Felbermayr, Fuest and Wollmershäuser argue that Germany has accepted the European rule that its current account should not exceed 6% of GDP (Felbermayr et al., 2017). Another example of misinterpretation of the scoreboard can be found in the analysis of Schulten and Müller who argue that with the scoreboard euro area states ‘are allowed’ a maximum 9 per cent increase in unit labour costs over a period of three years’ (2014: 334, emphasis mine).
Part I: Horizontal Analysis

merged into a single document; the Country Reports. The Country Reports are perceived by Commission officials as the core building block of the process. This is where the Commission services argue to what extent imbalances present problems, take stock of what has been done to address these imbalances and discuss what policy directions could be helpful in resolving them. For larger Member States, a sub-section of the Report assesses potential spillover effects for the euro area. What follows is a decision on the level of imbalances; these have varied over the years, but since 2016 comprise four levels: no imbalances, imbalances, excessive imbalances which requires specific monitoring and excessive imbalances requiring the opening of the Excessive Imbalance Procedure (EIP). After the Member States has responded to the Country Report in the National Reform Programme (NRP), the Semester Country-Specific Recommendations (CSRs) – some of which are linked to the MIP - are published.

The unwritten rule for CSRs is that issues that have not been discussed in the Country Report can in principle not be included in the CSRs. The content of the CSRs should in principle not come as a surprise and this should caution against political interference in their content. Furthermore, it is important to stress that while the Commission is in charge of writing the Country Report and proposing the CSRs, it is the Council which adopts the recommendations. In the Council advisory Committees Economic Policy Committee (EPC), Employment Committee (EMCO), Economic and Financial Committee (EFC) and the Social Protection Committee (SPC), Member State representatives discuss the recommendations and get the chance to propose amendments (see section on the institutional setting for details). Also, it is in these committees and Council formations that the Member States put pressure on one another to comply with the recommendation or explain why they have not done so. Council adoption is still key to the process as it preserves a certain degree of accountability.

4.2.3 The Excessive Imbalance Procedure and the likelihood of sanctions

The key mechanism to ensure that Member States implement the CSRs from the MIP is persuasion. On the basis of the analytical strength of the arguments made in the Country Report and encompassing documents and the discussions in the Council and bilateral exchange, the MIP aims to strengthen commitment to reform in the Member States. The MIP provides a framework for structured discussion to come to a shared diagnosis on economic trends and vulnerabilities and establishes key priorities for reform. The
goal is to ensure voluntary compliance\textsuperscript{17} with the MIP CSRs. Where necessary this can be enhanced by peer pressure.

However, the MIP also provides for enforcement mechanisms for non-compliance with the CSRs. The most prominent of these is the Excessive Imbalance Procedure. The EIP is laid down in Regulation 1174/2011 and finds its Treaty basis in Article 136 TFEU in combination with Article 121 TFEU. Excessive imbalances do not differ in nature from macroeconomic imbalances, but rather in their severity. In practice, a special attention is paid to the risk of negative spillover effects, especially with regards to financial stability. If the Commission considers that a Member State is experiencing excessive imbalances for which monitoring is not sufficient as an enforcement tool, it can propose to the ECOFIN to open up the EIP. After discussion in the Economic and Financial Committee (EFC) – the advisory committee of high-level Member State officials to the ECOFIN Council - the ECOFIN adopts by QMV and following the comply-or-explain rule, a decision opening an EIP. It also adopts a recommendation on the policies to be adopted to correct the imbalances. In this case, the Member State submits a Corrective Action Plan (CAP), which should be endorsed by the ECOFIN. If the ECOFIN deems the CAP insufficient, the Member State gets a second chance to propose a CAP. If the second CAP is seen as insufficient (or the Member State refuses to propose a CAP) the Commission can propose an annual fine of up to 0.1% of GDP to the ECOFIN (Art. 3.2 Reg. 1174/2011). For a country like Spain, this could be up to 1.1 to 1.2 billion euros, which is to be paid to the ESM.

If the ECOFIN accepts the CAP of the Member State in EIP, the Commission will monitor progress on the corrective action being taken. If the ECOFIN – on the basis of a Commission report - deems progress on corrective action to be insufficient, it can impose an interest-bearing deposit on the Member State and set deadlines for corrective action. Failure by the Member State to make sufficient progress on the corrective action to meet the deadline will allow the ECOFIN to transpose the interest-bearing deposit into an annual fine (again up to 0.1% of GDP) (Art. 3.2 Reg. 1174/2011). Furthermore, proposals to impose sanctions by the Commission can only be rejected by Reversed Qualified Majority Voting (RQMV). This means that the Council automatically accepts the Commission recommendation, unless a qualified majority acts within 10 days to overturn the Commission recommendation. Any sanction can only be imposed upon a

\textsuperscript{17} Given the legal focus of this section the words “enforcement” and “compliance” are used, in other sections the focus is on “net effect” and I deliberately step away from the legal interpretation of the MIP.
Part I: Horizontal Analysis

euro area Member State and voting on sanctions only involves euro area Member States.

RQMV is more than a bureaucratic formality since it gives the Commission more discretion in the application of sanctions. Before the introduction of RQMV it was easier for the Commission to be a strict guardian of the Treaties and propose sanctions, since the Council could act as the political decision maker on these and vote them down if necessary, as happened with Germany and France under the SGP. With RQMV sanctions are less likely to be voted down and the Commissions' decision to propose sanctions automatically becomes more political.

Given the controversy over the sanction procedure in the MIP, it is worth unpacking its elements a bit further. The first thing that must be noted is the fact that the sanctioning procedure is not based on non-compliance with a particular recommendation as formulated by the Commission. It is based on not providing or sticking to a sufficient Corrective Action Plan as formulated by the Member State itself, even if this plan must be consistent with the guidelines and timeframe as set out by the Council (Art. 8.1 of Reg. 1176/2011). The EIP can be abrogated as soon as there is evidence of the correction of the excessive imbalance, so there is an obligation concerning the outcome, rather than to fully comply with the CSRs (Art. 11 of Reg. 1176/2011). With fiscal rules, a government can intervene directly to correct a deficit, but the variables in the MIP are only indirectly affected by government action and usually require longer-term engagement. In theory, a Member State can be taken out of the EIP without having taken any action, but because economic circumstances have reversed an unsustainable trend. This also works the other way around: a Member State can implement the entire Corrective Action Plan or all the CSRs, but if the excessive imbalance shows no sign of correction, the EIP is only held in abeyance and is not abrogated (Art. 10.5 of Reg. 1176/2011).

This element of the CAP shows a limit to the discretionary nature of the EIP: the Member State is still in charge of formulating the policy response. The CSRs remain recommendations, which are strictly speaking not legally binding since the obligation is on effort and result, but corrective action can be taken in ways that differ from what is recommended in the CSR. This shows a clear difference with the SGP, where the Commission can set clear numerical targets. And, as pointed out by Amtenbrink and Repasi, the CAP also is not required to take the form of a law, which in principle means that national parliaments in their capacity as legislators remain free to adopt laws which are not in line with the CAP (2017).
But despite this legal safeguard, there are clear discretionary elements in the procedure. First of all, the decision on whether to open up the EIP is based on the Commission's interpretation of economic trends. The opening of the EDP follows (almost) automatically if the numerical thresholds are exceeded (or, at least that is how it is supposed to work on paper). The closing of the EIP is also based on interpretation of economic trends instead of thresholds. Given the fact that reforms take time to take effect, we can very well imagine a situation in which the EU judges the effort. One could imagine a situation in which a Member State is told behind closed doors that if it introduces a particular reform, it will be taken out of the MIP, which would de facto alter the nature of the CSRs. Or the other way around: the Commission can propose a sanction based on legally ambiguous concepts such as a ‘sufficient’ CAP or ‘sufficient progress’ in implementing the CAP. The Commission can also propose a sanction quite early in the procedure when the Member State is not seen as making sufficient progress or when a CAP is rejected. Member States can be in the EDP for a number of years without ever receiving a sanction. In 2011 no less than 23 Member States were in the EDP; the sanctions acted as a deterrent but were never used. But on the basis of the legal text, it is not clear whether being in the EIP for a longer period without receiving a sanction is also possible. One senior Commission official described the EIP as simply ill-designed:

*The EIP regulation has excessive freedom for the Commission to prescribe policies in whatever field almost and to propose sanctions in case of lack of compliance, that come very quickly and with RQMV and tight deadlines. This excess discretion of power also shows why the Commission is afraid to use it. And that is why the EIP has never been launched.*

(Interview 74)

Before coming into force, the MIP regulation was reviewed by the legal services of the Commission, the Council and the European Parliament. Interviewees do not recall serious legal concerns at the time over the application of the procedure. A review in 2018 of the European Court of Auditors also finds no fault in the design of the MIP (ECA, 2018). But others question whether sanctions can be activated at all, because of the legal ambiguity (Moschella, 2014), or whether they would hold up in court if challenged by a Member State (see quotes from President of the EU Court of Justice Lennaerts in Zeitlin and Vanhercke, 2014: 57).

When the MIP was being designed, the EIP was not seen as something controversial. As Commission officials recall: ‘This was the time when we in general were looking for more toughness in our rules’ (Interview 8*). ‘Everyone agreed that we also needed some bite in the
procedure’ (Interview 9°). The idea was that a sanction procedure would give more visibility and authority to the procedure so that CSRs would be taken seriously in the capitals. At the same time an official close to the ECOFIN Council, argues that Member States agreed to the sanction procedure because ‘nobody really believed there would ever be sanctions under the MIP’ (Interview 49). For sanctions the Commission would need a very solid case and clearly show the spillover effects. But as an evaluation by the EFC concluded a few years later, defining and identifying spillover effects proves to be very difficult (EFC, 2014).

If we step away from the legal analysis and think through how the procedure would operate in practice (mindful that there is an element of speculation involved), a sanction under the EIP does not seem very likely. Given the steps that would have to be taken to impose a fine, a Member State must be clearly unwilling to take action and a trend must be sufficiently worrisome to convince the Council to escalate a conflict with the Member State to such an extent that sanctions are warranted. The risks would have to be manifest, with the possibility of disrupting the EMU. If public debt were increasing to an unsustainable level, then the SGP would be a more suitable tool to address this issue. If the issue concerned an erosion of competitiveness that was so unsustainable that it convinced the Council to escalate, it would probably be associated with employment losses and it would be most unlikely that a Member State is unwilling to put in an effort to deliver a result. A possibility that is more in line with the definition of imbalances would be if an unsustainable current account deficit were emerging or if private debt were increasing due to a housing boom. In both cases, financial actors play a key role in determining whether the trend is indeed risky and they would have to be bullish about a risk that is manifest in the eyes of the EU institutions. Financial supervisors can intervene in these circumstances as well, for example by imposing a Countercyclical Capital Buffer or higher risk-weights on mortgage portfolios for financial actors. With the coming of the Banking Union (introduced three years after the MIP), the ECB has been granted leverage over national supervisors to impose - subject to procedural requirements - such tools when needed (for further details on the enforcement of macro-prudential policy tools, see EC, 2016c). Strong market reactions seem more likely to exert effective pressure in such situations than a full escalation within the EIP.

What the procedure does is to provide the EU institutions with a framework for discussion that has to be taken seriously, because there is the possibility of escalation. Opening up the EIP and asking for a CAP can already be seen as a severe step, without ever escalating all the way. Before the MIP, in 2011, the European institutions put heavy pressure on the Berlusconi government to come forward with policy proposals to revive
the Italian economy and restore market confidence, much along the lines of the CSRs (see the chapter on Italy). In this case, they did so without a clear legal framework. A situation of political stalemate after a difficult election result during a time of market stress is not unimaginable. In such a situation, escalation with the MIP could be used to put pressure on a Member State in the hope of untying domestic knots. A legal interpretation of the procedure does not fully capture its intent and possibilities for political use. Escalation or de-escalation within the procedure can be used as a political signal to punish or reward the behaviour of Member States towards correcting their imbalances. On some countries such political signals have a greater impact than on others.

It is as of yet impossible to judge the real value of the EIP, since it has never been opened. But, there have been instances when Member States got very close and where the politics of escalation becomes visible. The In-Depth Reviews (IDR) of 2013 found Slovenia and Spain to be experiencing excessive imbalances. Both states were under strong pressure from the markets and faced a troubled banking sector with rising ratios of non-performing loans. Slovenia was on the brink of a debt crisis and a possible financial assistance programme, and there was a serious discussion on whether or not to open up the EIP in both the Commission and the Council. The IDR speaks of policy uncertainty and legal obstacles to reform (EC, 2013a), but Slovenia’s Prime Minister was strongly opposed to opening the EIP (FT, 2013). Spain had received a bailout for its financial sector in 2012 but - unlike with Portugal or Greece - its Memorandum of Understanding was focused only on financial sector reform rather than broader socioeconomic reform. Pressure on worsening imbalances would have to come mainly from the MIP, although the obligations would be monitored in parallel with the MoU process (EC, 2012c). The ECOFIN Council acknowledged the assessment of the Commission that both countries experienced excessive imbalances but invited the Commission to first review both countries NRP before deciding on opening up the EIP (Council, 2013). The Commission kept the possibility of triggering the EIP in case National Reform Programmes did not present sufficient evidence of increased policy commitments (EC, 2016a).

In the end, the Commission decided that both NRPs were sufficient and the EIP should not be opened. This step was taken at the level of the President of the Commission, desk experts were not aware of the precise reasoning, but expected that the Commission feared strong reactions from the market and that the EIP would be too coercive. Another interviewee argued that it was seen as too politically costly, that alternatives had to be explored first and that the discussions took place at the highest level:
... it was a political agreement, compromised at a high level, not even Finance Ministers, but Prime Minister level. (Interview 47 - former EPC Chair)

The alternative that was found was that both states would be subjected to specific monitoring from the Commission. Labelling a country as having excessive imbalances, but not opening up the corrective arm was a new step in the MIP. From 2014 onwards the Commission used six categories of severity of imbalances, which it later brought back to four (no imbalances, imbalances, excessive imbalances that require specific monitoring and excessive imbalances that require the opening of the EIP). The various categories of the MIP have no legal basis, as the regulation speaks only of regular and excessive imbalances. But the Regulation does mention the possibility for enhanced surveillance missions for Member States experiencing excessive imbalances for the purpose of on-site monitoring (Art. 13(2)). Member States under specific monitoring can receive more prescriptive and time-bound CSRs and a higher frequency of monitoring missions, whose reports are discussed in the EPC. The idea behind specific monitoring was, as a Commission official explains ‘to make the government feel that we are really insisting. We come and check in once every few months’ (Interview 28). Although another Commission official puts it in more friendly terms, stating: ‘it is stronger monitoring, but it is helpful, it is about getting a better picture of the situation. There is no punitive element, absolutely not.’ (Interview 30)

The CSR documents of 2013 for Slovenia and Spain are indeed among the longest and most detailed of the MIP, covering a wide variety of policy domains. Conflicting domestic interests had long been an impediment to serious reform of the banking sector in Spain, but with the bailout package in place, Spain started making serious progress on reform (Otero-Iglesias and Steinberg, 2017). The 2013 In-Depth Review saw Spain as experiencing excessive and worsening imbalances but also argued that the Spanish government showed commitment to reform (EC, 2013b). For Slovenia, the detailed MIP CSRs with specific monitoring missions became a kind of surrogate for a financial assistance programme. Commission officials see Slovenia as a case where the MIP created pressure and yielded result, without opening the corrective arm.18 For example:

With Slovenia the interesting lesson is the combination of strong commitments in the NRP with close monitoring of these commitments, by means of this monitoring system, with missions and reports and discussions in the committees. This was probably quite effective in achieving result. It is too much to say that this was sufficient, because what was the

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18 One Commission official argued that the Slovenian case represented the EIP ‘all but in name’ (Interview 71).
enforcing element at the time? This was the market pressure. But it was quite certain that the MIP was the instrument that permitted to coordinate and to provide a framework on the policy actions taken by Slovenia, so it was the equivalent role that a financial assistance programme provides in coordinating and putting a framework for a country with a light conditionality element [the looming possibility of opening the EIP]. So this contributed to triggering action in a consistent way and contributed to calm the markets. (Interview 74)

Both states were the first to leave the category of excessive imbalances (despite the strong opposition of the ECB) and Slovenia was taken out of the MIP altogether in 2018. The category of excessive imbalances without opening the EIP was later used for France, Italy, Bulgaria, Croatia, Portugal and Cyprus. It is meant to signal urgency. In Bulgaria, for example, it was deemed necessary to spur decisive action by the administration to address problems in the banking sector that the existing supervisory bodies had failed to recognize and which could potentially lead to a liquidity crisis (ECA, 2018). But, in the cases of France and Italy, the label is perhaps less strongly related to the need for immediate action, as the next chapter will discuss. The method of specific monitoring has been introduced more broadly. It was seen as successful in the case of Slovenia and Spain and thus applied throughout the MIP also for Member States that are not labelled as experiencing excessive imbalances. The cases of Spain and Slovenia give an insight into how sanctions are generally seen by the EU institutions. Sanctions should ensure that the Member States and the markets take the MIP seriously, so that escalation within the MIP is seen as a credible step. But the opening of the EIP is seen as a last resort, a deterrent, only to be used in extreme cases. Or as officials put it:

*Like the atomic bomb, there is the idea of never using them. But because they [sanctions] are there they have an effect.* (Interview 74)

*Officially there are sanctions, but no one believes in sanctions.* (Interview 30)

*The politics of this are much more important than the legal aspect of this procedure. The question is not, is it possible to implement the corrective arm, but what is the signal to Member States when we open the corrective procedure?* (Interview 11)

In a way, the design of the MIP and its sanction procedure should also be understood as a sign of the times. These were the days when the creditor countries had a strong leverage in the negotiations in the Council and when parliaments in creditor states had to sign off
Part I: Horizontal Analysis

on the establishment of the EFSF and the ESM and wanted stronger commitments and tighter control in return. The interpretations of how these instruments are to be used can also differ per Member State or over time, depending on which Commission is in office. As Thomas Wieser (former EFC/EWG President) explained:

*It boils down to the question of whether the SGP and the MIP are a mechanistic instrument, a legalistic instrument or a political instrument or an economic instrument. Opinions differ. The Germans want the SGP to be a totally mechanistic free of political interference instrument. If you transcend some kind of threshold you automatically get a fine. The present Commission sees it as a political instrument, which gives a certain framework on what you should be doing. And if you aren't doing it, then we'll find an exception to the rule. Personally, in the MIP, I see it not as a coercive tool, but as an instrument conducive to policy persuasion.* (Interview 61)

In general, there seems to be a consensus against the opening of the corrective arm in European institutions. But the debate on the corrective arm continues. As stated in chapter one, the Five Presidents Report has argued that the MIP should be used to its full extent and the ECB has repeatedly criticized the Commission for not opening the EIP. The ECA found that a number of Member States believe that the non-activation of the EIP has weakened the credibility of the MIP and the deterrent value of the EIP. Other Member States have argued that opening the EIP in circumstances which are not clear-cut would also affect its credibility. In response to the report of the ECA (presented in the annex) the Commission rejects the notion that it has been too soft in the MIP. The Commission also argues that it is opposed to any type of codification of criteria for opening up the EIP, which would also go against the spirit of the Regulation (2018). An important argument for opening up the EIP is that it does not immediately lead to sanctions, but it would allow for stronger monitoring of progress and hardened commitment to reform in a corrective action plan. But, there is disagreement on how much of an effect stronger monitoring by itself would have. To juxtapose some typical views:

... it is as if you feel that you are the kid being disciplined by the parents, you already know that they are checking on you. Then they say ‘now we are going to really really check on you’, you were already checking on me, what’s this? (Anonymous official from Southern Member State)
... it is a point of principle. It is like when you are raising a child and you tell them ‘if you grab one more cookie, then …’, but you never give any sanction, even when the kid grabs a cookie. (...) Some countries continued to grab cookies. (Anonymous official from Northern Member State)

4.2.4 Alternative compliance mechanisms

In addition to voluntary compliance, compliance through specific monitoring, escalation within the procedure, and opening the EIP, there are two further alternative compliance mechanisms. One is compliance by conditionality through the European Structural and Investment Funds. On the basis of Regulation 1303/2013, the Commission can reject applications for funding if they are not sufficiently directed towards the priorities of the CSRs. The Commission can also ask for parts of the funds to be re-directed towards CSR priorities, to maximize the growth and competitiveness impact of the funds. And under the Regulation, there is even the possibility to withhold funds if a Member State is under the corrective arm of the MIP and the EDP (based on Reg. 1086/2006 Art. 23). This gives the EU institutions both an ex-ante and ex-post conditionality policy lever, albeit with clear social safeguards.\footnote{Article 23 of Regulation 1303/2013 includes a provision which states that ‘programmes or priorities which are of critical importance to addressing adverse economic or social conditions’ are exempted from both suspension and reprogramming, including investments related to the youth guarantee scheme or ‘supporting poverty reduction’, while the maximum rate of suspension of funding is reduced for Member States experiencing above average rates of unemployment or poverty.} For example, Italy had to adopt administrative capacity plans and deliver on them by the end of 2016 or the Commission would have suspended interim payment of the ESI funds that were directed to this goal (EC, 2016d). A more prominent use of the conditionality mechanism was the proposal of the Commission to suspend funding for Portugal and Spain, which would have postponed new projects and not hit existing projects, due to non-compliance with the fiscal targets under the EDP in 2016. In the end, this proposal was rejected by the Council.

Opinions differ about the how useful compliance through conditionality is. The Commission argues that the ex-ante conditionality has a reform-enhancing effect (EC, 2017b). But as Gros and Alcidi point out, the examples of the Commission refer to very specific policy areas at the local level, while it has not been applied for any major structural reform and it is questionable whether it would be a useful tool for that purpose (Gros and Alcidi, 2017). Other commentators are more positive about its potential, but also warn that mixing the policy goals of economic governance and that of Cohesion Policy
risks policy overload and dilution and local authorities also criticize the instrument for increasing insecurity among investors (Andor, 2017; Huguenot-Noël, Hunter, and Zuleeg, 2017). Given the fact that this mechanism has not been applied to any major structural reform, it does not play a prominent role in this thesis.

Compliance with MIP CSRs can also be enhanced by the interaction of the MIP with other governance mechanisms. On paper, the MIP is a stand-alone procedure, but in practice, it makes little sense to try and maintain Chinese walls between the fiscal and the macroeconomic realm. Accordingly, the MIP should be seen as embedded in the wider economic governance regime. This form of compliance is contentious; the Commission is sometimes criticized by the Member States for mixing procedures and making use of the opaqueness of the system, as will become clear in the case studies. For the de jure assessment it is worth mentioning that a formal link between structural reforms and the SGP has been established since 2005. After the famous breach of France and Germany of the deficit rules in the early 2000s, the pact was reformed in 2005. This was the period when some of the new Member States in Eastern Europe were engaged in serious pension reforms and the EU wanted to support those. The reform, therefore, introduced clauses that allowed for the net cost of systemic pension reform to be deducted from the deficit for the first five years after the introduction of the reform, since these reforms promise future budgetary savings (Schelkle, 2009).

In 2015 this formal link was expanded when the Commission found itself needing to explain its flexible interpretation of the fiscal rules of the SGP (EC, 2015). The two procedures can give rise to recommendations that create friction with one another, since structural reforms to correct imbalances usually have budgetary implications, so it is important to know which recommendation takes precedent. In its explanation, the Commission refers to a structural reform clause. Under this clause, the costs of structural reforms are to a certain extent excluded from the path towards reaching the country-specific budgetary target. For the reforms to be eligible, they must be major and have verifiable long-term budgetary effects and be fully implemented as monitored by the Semester or by the EIP. The implementation of structural reforms also has a recognized place in various steps of the corrective arm, the EDP. When examining whether an EDP needs to be opened, a lack of implementation of structural reforms can be considered an aggravating relevant factor. And within the corrective arm, the ‘implementation of major structural reforms constitutes a key factor taken into account when considering instead a multiannual path for the correction of the excessive deficit’ (EC, 2015:13). For MIP CSRs – those relating to reforms which have a calculable effect on fiscal sustainability – this means that the deadlines, procedural escalation possibilities, and possible sanctions can be an
additional compliance mechanism for implementing the CSRs.

This section shows that careful analysis of the functioning of the MIP shows the procedure to be less discretionary and coercive than it is sometimes portrayed by its critics. The sanction procedure includes a number of procedural and practical obstacles that will not see it triggered very easily. Macroeconomic imbalances have not been clearly defined in the Regulation, so that in theory any trend could potentially lead to sanctions. But a closer reading of the process shows that accountability mechanisms have been introduced at multiple points, so that the procedure will only address issues after due process and careful assessment. At the same time, the EIP remains a highly discretionary instrument that has the potential to be coercive. Above all this section has shown that a legal reading of the procedure does not capture the context or interpretation of and intentions behind the MIP, especially where it concerns the more complex field around compliance through persuasion and compliance through pressure. The study of the MIP’s operation in practice will shed more light on these mechanisms.

4.3 Institutional setting

4.3.1 Which actors are involved in the MIP?

The MIP involves a great variety of issues and therefore also a great variety of actors who are involved in drafting documents, discussing, processing and evaluating them. This section will introduce the key actors involved in the process. The main driver of the MIP is the Commission, the only organisation in the EU with the administrative capacity, mandate, and background to operate this framework. Within the Commission, there are three key actors: the Directorate General for Economic and Financial Affairs (DG ECFIN), the Directorate General for Employment, Social Affairs and Inclusion (DG EMPL) and the Secretariat General (SecGen). To operate the Semester, the staffs of DG ECFIN and DG EMPL have been significantly upgraded since 2011, as it requires deeper political and technical understanding of Member State economies (Savage and Verdun, 2016). Both DGs work with a combination of issue-specific and country-specific desks. The three DGs form a core group, but they receive issue specific information from other DGs, such as DG GROW on internal market matters or DG TAXUD on tax policies. Also, they rely on the work of Eurostat, for the statistics. DG ECFIN is in charge of drafting the Country Reports; it is the only DG that provides an overall macroeconomic analysis and thus has an important coordinating role in the MIP. In later Semester cycles, DG EMPL has,
however, come more and more on an equal footing, due to the gradual socialisation of
the Semester (Zeitlin and Vanhercke, 2014; 2015; 2018). In the formulation of the CSRs,
it is the SecGen that holds the pen, but the CSRs have to be based on the challenges
identified in the Country Reports. Finally, the CSRs must be approved by the College of
Commissioners before being sent to the Council. This aspect is sometimes criticized in
light of the discussion of politicisation (see chapter three). Sometimes Commissioners
are seen more as guardians of their respective country than technocrats.

At the end of the process, the CSRs are endorsed by the June European Council and
afterward adopted by the ECOFIN Council of Finance Ministers. But before arriving at
the level of government leaders, the CSRs go through a series of advisory committees
of Member State officials. The key driver of the MIP in the Council is the Economic
Policy Committee (EPC). The EPC consists of representatives of either the Economics
or the Finance Ministry of Member States. The EPC discusses the AMR, all the IDR
and Country Reports and all the MIP-related CSRs. The EPC has the responsibility
for MIP-related CSRs, but, depending on the topic, CSRs can also be discussed by the
Employment Committee (EMCO), the Social Protection Committee (SPC), or by the
Economic and Financial Committee-Alternates (EFC-Alternates). The EPC and the EFC-
Alternates are linked to the ECOFIN Council of Finance Ministers and are responsible
for issues falling under the BEPGs, the MIP and the SGP, while the Alternates primarily
discuss the later. EMCO and SPC are linked to the EPSCO Council of Employment and
Social Affairs Ministers and are responsible for issues falling under the framework of the
Employment Guidelines. Since there are crosscutting issues with regards to MIP-CSRs,
there is a joint session each year, between the EPC and EMCO and SPC and with the
EFC-Alternates for fiscal CSRs.

The work of the EPC is furthermore supported by issue-specific configurations, the
most important of which is the Lisbon Methodology Committee (LIME). LIME focuses
on methodological aspects of the AMR and the IDR and discusses the indicators and
data that are used. Furthermore it discusses various models on, for example, the
measurement of spillover effects from reforms. The LIME Committee has also been a
crucial player in designing the MIP in terms of data and indicators. The EPC discusses all
the MIP documents substantively and organises thematic discussions and peer review.
Hence it can be seen as an analytical committee. The EPC and the EFC-Alternates report
to the Economic and Financial Committee (EFC). The EFC consists of senior officials of
Finance Ministries and has a sub-group for the euro area, the Eurogroup Working Group
(EWG). The EFC acts as the gateway to the ECOFIN Council and prepares the ground
for political decision-making by Ministers. EFC members are usually direct advisors to
the role of the EPC, how to design it and how to mobilize Member States to achieve the goals. The EPC is a forum for high-level discussions, where the Commission presents its views, and Member States discuss and agree on the implementation of the policy recommendations. The role of the EPC is particularly important in the context of the crisis, as it serves as a platform for Member States to share their views on the economic situation and discuss the measures to be taken.

While the Commission and Council are the dominant actors in the process, there are a number of external actors involved as well. The ECB is present in all Council discussions on policy coordination. It is allowed to propose amendments to the Commission proposals on the CSRs. The ECB is an interesting actor since it is not directly obvious why a monetary institution should have a say on issues such as tax policy or pension reform. Some would argue that central banks should stick to their mandate and refrain from interfering in the policy process (Buiter, 2015). The ECB believes structural reforms are crucial for the monetary union and therefore plays a quite active role in the debates. It is often allowed to speak first in the debates, since it is considered by some participants to have the best-informed position (Interview 5). The ECB is known to be very outspoken about the need for structural reforms. The ECB is hawkish in the discussion and presents itself as a critic of the Commission’s soft approach towards launching the EIP, for example in 2013 for Spain and Slovenia. But despite its outspoken opinion, the ECB’s role in the EPC should not be exaggerated, as one EPC member argues:

*What is funny with the ECB is that you have the impression that the ECB is put in high consideration in these meetings, because they give the first speech. But if you look at the amendments that the ECB makes to the CSRs, it is now a number of years that I see this process and all the comments of the ECB have never been taken on board. I have never seen a revision made by the ECB accepted in the EPC, never. (Interview 29)*

Furthermore, at the national level there is often, but to varying degrees of intensity, a forum for local and regional governments and civil society actors to comment on Semester documents or meet with Commission officials. Furthermore, national parliaments are encouraged to discuss Semester documents with their executive

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20 For a more extensive discussion of whether Central Bankers should concern themselves with policy coordination, structural reforms and the MIP, see: Pisani-Ferry (2015).
Part I: Horizontal Analysis

to ensure ownership of the process and create additional pressure on governments to implement the recommended reforms. There is a wide variety in the strength and involvement of national parliaments in the process, but across the board, there has been increasing engagement since 2015 (Hallerberg, Marzinotto, and Wolff, 2018).

And finally, there is the European Parliament, on equal footing where it concerns the legislative domain, but clearly at a big distance where it concerns policy coordination. The formal role of the EP is limited: it must be informed of decisions made under the MIP, but cannot offer formally binding guidance on the process. Its role should be read mostly in informal terms. The EP adopts every year a resolution on the Annual Growth Survey, which is a so-called ‘Own Initiative Resolution’ (INI) but is recognised in Council Resolutions on the CSRs. Furthermore, the MIP is included in the Economic Dialogues of the EP. Economic Dialogues can be held with the Commission, with the President of the ECOFIN or Eurogroup or even with representatives of Member States an can concern issues such as the general direction of the MIP or Semester or implementation records. The dialogues are non-binding discussions, but in practice could, potentially, serve as accountability mechanisms for decisions on the opening of an EIP and the assessment of a corrective action plan, both vis-à-vis the Commission and Council as well as the Member State in question. The EP also adopts INI reports on the general direction of the EU’s economic governance and the role of the MIP. The EP has built up resources to be more involved with the Semester, but is struggling to find its appropriate role vis-à-vis the country-specific elements (Schout et al., 2016).

4.3.2 Inside the Council: tools, tasks, and tensions

The internal working of the Council is a lesser-known phenomenon in EU integration literature; it is often seen as a black box (for detailed analysis see: Naurin and Wallace, 2008; Puettter, 2014). But the bureaucratic structure is key to understanding the Semester and the MIP. In the end, the CSRs are Council documents. This is what distinguishes them from other international institutions, such as the recommendations of the IMF’s Article IV consultations. Ultimately it is not the Commission that recommends that Italy should pursue productivity-enhancing reforms or Sweden should reform its housing market, it is the vast majority of Member States who share this assessment because they have endorsed the CSR. When a Member State comes with a counter-analysis to the Commission’s analysis these differences of view are not just discussed in some far-off bilateral meeting, but major differences are discussed in the Council in front of all other Member States. This transparency gives credibility to the analysis of the Commission,
since all get to see where weaknesses might lie. The involvement of the Council is also a crucial element of accountability in the process.

The Council is best understood as a consensus-formation machine. It applies its own formal and informal working methods to ensure engagement of various actors and ultimately to come to shared conclusions between all Member States. Consensus should start at the bottom but disagreement can be escalated to the top. If the EPC cannot agree on an issue, it is passed on to the EFC. The guiding principle is that a higher-level committee in principle does not re-open discussions that have been closed at a lower level. If the EFC cannot agree, the issue is passed on to the level of ambassadors (COREPER), who can pass on issues to ECOFIN or the European Council. Most issues are decided at a lower level, although there have been a few instances where COREPER has altered the text of CSRs that came from EMCO and SPC where there were unresolved disagreements with the EPC. The European Council was strongly engaged with the process during the crisis years, but has now passed most of the work on to the EPSCO Council and especially the ECOFIN Council and the Eurogroup.

The committees are conducive to open and relatively informal discussion on specific policy fields or on the Semester documents. However, for amending the CSRs there is the formal procedure on the basis of the ‘comply or explain’ rule (Art. 2-ab(2) of Reg. 1466/97). This rule states that the Council is expected to follow the recommendations and proposals of the Commission or explain its position publicly. An amendment to the Commission’s text requires the support of a reinforced qualified majority in the Council, of at least 72% of the members of the Council, representing at least 65% of the population of these states (Art. 238(3)(b) TFEU). This is not an easy threshold to meet. Officially, only the Ministers can vote, but in practice, indicative votes are held in the Council committees. What this means is that Member States need to present clear fact-based analysis to alter the text of the CSRs and if the Commission is not convinced it is not easy to assemble a sufficient majority to overturn the Commission’s opinion. Overall more changes get accepted than refused, but many of the changes that pass are factual changes; it is difficult to water down the ambition of a CSR. (Obviously, such examples are to be found, such as in the Dutch case, as discussed in chapter nine. For a discussion and analysis of amendments in the Semester see: Vanhercke and Zeitlin, 2018; Vanheuverzwijn, 2018). Many amendments fail, as one EPC official explains:

*Discussions in the committee are very much evidence-based. For the extent to which a Member State can demonstrate that their analysis is better based than that of the*
Commission: I believe 80% of the discussion is about wording, and of this 50% of Member States would like recognition for what they have already achieved. The Commission thinks that they are not in a school system where they need to give Member States encouragement by praising what they have already accomplished. Member States therefore sometimes feel that CSRs read as if nothing has been done. (Interview 1)

Discussing the text of CSRs in a substantive manner with so many actors present in the advisory committees is not always easy. In practice, it is very difficult for Member State representatives to have full expertise on developments in 27 other economies. Therefore, while the goal is to have multilateral discussions and peer pressure, the Commission often has the upper hand in the discussions, since they are simply the best-informed party. Also, as chapter five will show, there are a lot of CSRs. And in the joint meeting between the EPC and EMCO on adopting the MIP-related CSRs that concern both committees there can be as many as 200 people in the room (this was in 2015). This makes it practically difficult to have a substantive debate and not everyone is happy with this state of affairs.

The EPSCO committees have over the years criticised the number of social issues that fall under the MIP (which implies that the EPC has shared competence). The committees believe that employment issues can have macroeconomic consequences, but are not imbalances as such and should accordingly not be linked to the MIP, but should remain the exclusive competence of the EPSCO Council (EMCO and SPC, 2016). Maricut and Puettter calculated that for the 2016 cycle, only 14 out of 152 CSRs were under exclusive EMCO/SPC competence, while the other 26 social CSRs fell under joint review with the EPC (2018).

Some EMCO and SPC members had the feeling that placing issues under the MIP was sometimes used strategically by the Commission to deliberately include the EPC side. Here it has to be recalled that the social committees and the economic committees come from different historical trajectories and often hold different philosophies (Zeitlin, 2008). At the same time, the joint meetings do push actors from various Ministries to come to a shared position as a unified national delegation. As pointed out by Vanhercke and Zeitlin (2018), this used to be a major source of tension between social and economic policy actors, but has over the years been ironed out.

The process of amending the CSRs allows for strengthening the ownership of the process.
Chapter 4: The governance of the MIP

The Semester should be seen as a joint exercise of the Commission and the Council vis-à-vis each Member State. The Commission might be the dominant actor in the debates, but interviewees argue that Council committee members are not fully passive either; there is an element of peer pressure. As one official explains:

"What you can notice is that the rest of the Council is increasingly part of this debate. First of all, because when the Member State and the Commission do not agree over an amendment we need to vote and this forces the rest to also have an opinion on the state of affairs in this Member State. What you see is that Member States who have already introduced a lot of reform can be quite tough, they criticise others, by saying it is not for nothing that we discuss these issues." (Interview 5*)

Another element in ensuring ownership lies in the process of reviewing and assessment of reforms. The IDRs and AMR are regularly reviewed by the EPC, often helped by its methodological subcommittee LIME. Similarly, discussions are held on how to measure progress on reforms and establish benchmarks or how to interpret economic phenomena such as nominal productivity trends. One way of ensuring that the Member States enact reforms is to issue a CSR, but another way is to simply show what others have done. To enhance this process of ownership, the EPC organises thematic sessions on specific topics. For example, since 2011 some 23 Member States have introduced a pension reform. Drawing lessons and evaluating the reforms of early adaptors can contribute in building consensus in this area. Where it concerns pensions, a subcommittee supports the work of the EPC: the Ageing Working Group (AWG), set up in 1999. The AWG monitors and assesses budgetary and macroeconomic projections of ageing.

Often the discussions in the EPC are based on Commission reports where horizontal analyses and cross-case comparisons of reforms are made and Member States are ranked on the basis of benchmarks. But other times Member States give presentations to share best practices. One example of this is the discussion in 2016 around spending reviews in the EPC (EC, 2016e). For many Member States this was something new and they responded enthusiastically to presentations with peer review about formats on how to do this. Other examples include thematic sessions on the ease of doing business (EC, 2017c) or discussions on regulatory barriers to investment (EC, 2016f). Overall, these sessions help to shape bureaucratic opinion and consensus on MIP-related issues and give valuable feedback for the Commission services, who use the discussions as further input for their analysis.
An important criticism of the pre-crisis coordination framework was its failure to gain traction at the political level (Pisani-Ferry, 2006). With the Semester, there has been a significant effort to also involve the political level in the Council processes. Peer pressure is seen by the EU institutions as a key mechanism to ensure implementation of the CSRs (EC, 2015c), but of course such peer pressure is most effective when it is exercised at the political level. It is not easy to come with a strict definition of when an interaction in the Council is a constructive discussion, when it is a question-and-answer session or when it is peer pressure; this depends largely on the perception of the actors involved. Wyplosz described peer pressure under the Lisbon framework as an exercise of ‘mutual congratulations’ (2010). This changed during the crisis, when discussions in the ECOFIN and Eurogroup got a lot tougher. Reviews of CSR implementation are discussed and Ministers are asked to explain why there has not been more implementation, as the quote above also indicates. Although, some argue that this engagement of Member States has toned down again in later years (Wieser, 2018; speaking in the context of fiscal policy).

Peer pressure can also be enhanced by the use of thematic discussions at the political level. These also take place at the level of the ECOFIN and EPSCO Council and the Eurogroup and are described by EU leaders as a way to exert strong peer pressure on implementation (Juncker et al., 2015a). These exercises are not just about exerting pressure, there is also an element of reflexive learning in them. As one interviewee explains:

We see it can work quite well, as it did in the Competitiveness Council last February [2016]. We discussed the implementation of CSRs in services markets and we asked two Ministers to present the reforms in their country, one of them was Emmanuel Macron of France who had a very good presentation. He not only talked about his reforms, but also what obstacles he ran into when implementing those reforms and it turned out that many Member States faced the same obstacles to reform, there is a lot of vested interest. (Interview 11*)

The CSRs for the euro area as a whole have repeatedly stressed the need to strengthen thematic sessions and benchmarking at the level of Ministers and their number has increased in response (EC, 2016g). For example, the Eurogroup has regularly discussed the issue of the high tax wedge on labour that is found in most Member States and started measuring country performance against a common benchmark (Council, 2015). According to Eurogroup President Dijsselbloem (2015), debates around benchmarks in the Eurogroup have led to increased public awareness, a common view and policy action amongst Member States on a number of issues. These discussions should be seen as the way forward for the role of the Eurogroup in economic governance. In an evaluation of
Chapter 4: The governance of the MIP

the effectiveness of these discussions, Enderlein and Haas conclude that these thematic discussions contribute to building consensus, albeit modestly in their view (2016). But measuring the effects of these types of exercises is no straightforward task as it involves a type of diffusion of ideas that is not always easily traced in precise terms.

4.4 Conclusion

This chapter has done two things. First, it shows how the procedure works on paper and which actors are involved in the process. The carefully designed procedure and full inclusion of various institutional actors is what makes the CSRs distinctive. This chapter has argued that there is awareness of the inherently discretionary nature of the procedure and that it is impossible to codify the latter in precise terms. It has argued that accountability in the MIP has been sought through transparency about how to identify imbalances and by increasing the interaction with different actors. Accountability has also been sought by introducing a scoreboard of indicators that should guide the procedure. This scoreboard should be seen as a filtering device and should not be interpreted in an automatic or rigid fashion; indicators indicate, they do not determine.

Second, this chapter has argued that to truly understand the governance framework one must look beyond how the MIP works on paper. Actors who work with the procedure and were involved in its design often have a completely different interpretation of what the MIP entails in practice than what can be derived from the legal texts alone. This is especially apparent in the discussion of the sanction procedure. While many believed that the inclusion of sanctions was a necessary element to ensure that politicians take the MIP seriously, few believed that these would ever be imposed. The analysis has also shown that this is unlikely to be the case in any but an extreme case.

The second part of the chapter has also argued that while the Commission drives the MIP, it does not operate in a political vacuum. The Council is an indispensable actor in the complex web of interactions that also involves other stakeholders, including the ECB. The Council should not be understood as a unitary actor, as there can be clear differences between social and economic actors about how the MIP should operate. Furthermore, both the Council and the Commission were involved in designing the MIP and both institutions work on the development and analysis of policy ideas that inform the CSRs. The Commission is also fully part of the discussions in the Council and sometimes tests new initiatives in Council committees before introducing them formally. Finally, it
should be remembered that CSRs are Council documents, hence their adoption by the Council is a crucial aspect of the accountability of the MIP.

The arguments about the interactive nature of the MIP and the intentions behind some of its elements such as the sanction procedure should advance our understanding of whether and in what sense the MIP is a hierarchical procedure.
Chapter 5

Scope and content of the MIP

5.1 Introduction

After discussing the historical trajectory and the decision-making procedures in the previous chapters, the final horizontal chapter looks at the question of which issues fall under the MIP. This chapter further expands on the argument of previous chapters that policymakers faced difficulty in defining the concept of macroeconomic imbalances. Regulation 1176/2011 gives wide discretion to the Commission in defining imbalances and policy recommendations. This chapter will discuss how that discretion was used in determining substantive policy content. It will show that the Commission interpreted the mandate of the MIP very widely and turned the MIP into a holistic rather than a narrow procedure. In other words, they decided to place a lot of different policy issues under the MIP. This is a crucial decision for our understanding of the MIP. Had it been a procedure focussed only on a limited number of financial trends the effects and hierarchical nature would have been judged differently. Instead, it is a procedure that focuses on a wide array of social, competitiveness, financial, fiscal and structural issues.

The scope of the MIP is so wide that it has become almost impossible for researchers to say anything substantive about whether there is an ideological stance behind its policy content. Some have also argued that due to this wide scope its distinctive character has been lost. If few understand why issues fall under the MIP, the procedure may loose some of its (hierarchical) force. After presenting an overview of the MIP’s scope this chapter will discuss this criticism of overextension of the MIP and lastly the attempts to measure the ideology behind the policy content of the MIP. This chapter will argue that the issue of scope is crucial in understanding the nature of the MIP. Secondly, it will argue that we should be careful in making overly determinative statements about the ideological stance of the MIP’s policy content. The criticism on generalist assessments of the MIP presented in this chapter also serves to underline the need for a case-specific assessment of the MIP.
5.2 Scope and content: an overview

The MIP became operational in the second round of the Semester in 2012. This was at the height of the crisis when the economic situation in many of the Member States was clearly deteriorating and imbalances were widening rapidly. The MIP’s purpose was to single out trends that are particularly worrisome so that the CSRs linked to the MIP would carry some weight. These were the years when the Commission was criticised for not being sufficiently aware of the widening imbalances before the crisis. Out of fear of missing something important, the Commission made a decision that proved fundamental for the functioning of the MIP in subsequent years: it decided to cast its net very widely, as shown in table 5 below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Member States in MIP</th>
<th>MIP CSRs</th>
<th>non-MIP CSRs</th>
<th>Member States in EAP</th>
<th>Member States without imbalances</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>12</td>
<td>116</td>
<td>90</td>
<td>4</td>
<td>EL, IE, PT, RO</td>
</tr>
<tr>
<td></td>
<td>BE, BG, CY, DK, ES, FI, FR, HU, IT, SI, SE, UK</td>
<td></td>
<td></td>
<td>EL, IE, PT, RO</td>
<td>AT, CZ, EE, DE, LV, LT, LU, MT, NL, PL, SL</td>
</tr>
<tr>
<td>2013</td>
<td>13</td>
<td>253</td>
<td>67</td>
<td>5</td>
<td>CY, EL, IE, PT, RO</td>
</tr>
<tr>
<td></td>
<td>BE, BG, DK, FI, FR, HU, IT, MT, NL, SE, UK, Excessive: ES, SI</td>
<td></td>
<td></td>
<td>CY, EL, IE, PT, RO</td>
<td>AT, CZ, EE, DE, LV, LT, LU, PO, SL</td>
</tr>
<tr>
<td>2014</td>
<td>14</td>
<td>331</td>
<td>76</td>
<td>4</td>
<td>CY, EL, PT, RO</td>
</tr>
<tr>
<td></td>
<td>BE, BG, FI, FR, DE, ES, HU, IE, NL, SE, UK, Excessive: HT, IT, SI</td>
<td></td>
<td></td>
<td>CY, EL, PT, RO</td>
<td>AT, CZ, DK, EE, LV, LT, MT, PO, SL</td>
</tr>
<tr>
<td>2015</td>
<td>16</td>
<td>185</td>
<td>18</td>
<td>2</td>
<td>CY, EL</td>
</tr>
<tr>
<td></td>
<td>BE, FI, DE, ES, HU, IE, NL, RO, SI, SE, UK, Excessive: BG, HT, FR, IT, PT</td>
<td></td>
<td></td>
<td>CY, EL</td>
<td>AT, CZ, DK, EE, LV, LT, MT, PO, SL</td>
</tr>
<tr>
<td>2016</td>
<td>13</td>
<td>164</td>
<td>10</td>
<td>1</td>
<td>EL</td>
</tr>
<tr>
<td></td>
<td>FI, DE, ES, IE, NL, SI, SE, Excessive: BG, HT, CY, FR, IT, PT</td>
<td></td>
<td></td>
<td>EL</td>
<td>AT, BE, CZ, DK, EE, HU, LV, LT, LU, MT, PO, RO, SL, UK</td>
</tr>
<tr>
<td>2017</td>
<td>12</td>
<td>132</td>
<td>10</td>
<td>1</td>
<td>EL</td>
</tr>
<tr>
<td></td>
<td>DE, ES, IE, NL, SI, SE, Excessive: BG, HT, CY, FR, IT, PT</td>
<td></td>
<td></td>
<td>EL</td>
<td>AT, BE, CZ, DK, EE, FI, HU, LV, LT, LU, MT, PO, RO, SL, UK</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>1181</td>
<td>271</td>
<td>(81%)</td>
<td>(19%)</td>
</tr>
</tbody>
</table>
Chapter 5: Scope and content of the MIP

The table shows that the Commission opened up In-Depth Reviews for no less than 12 Member States and found imbalances in all of them. For these 12 Member States, it decided to label more than half of all CSRs as MIP-relevant. This set in motion a path dependency; every new cycle is constrained by past choices. In later Semester cycles, the Commission expanded the MIP’s scope still further. In 2015, it opened up In-Depth Reviews for 16 Member States; it found imbalances in all of them and placed five of them under the excessive category. Additionally, the Commission labelled almost all the CSRs as MIP-relevant. Between 2012 and 2017, a total of 90 In-Depth Reviews were opened. Imbalances were found in 79 of them, and more than 80% of the CSRs were labelled as MIP-relevant.

Before analysing its content, this table requires a number of explanatory comments on how it has been calculated. First of all, only the CSRs for the Member States under MIP surveillance are included, not all the Semester CSRs. Second, what is counted are sub-CSRs; in the documents, a single state receives usually between 2 to 8 full CSRs per year, with around 4 of them linked to the MIP on average. But within a single CSR, one usually finds a call for multiple policy actions. These calls for policy action are counted on the basis of active verbs. For example, the following CSR contains three sub-CSRs: ‘Take measures to reduce high labour taxes and social security contributions, especially for low-wage earners, and address the impact of fiscal drag’ (high labour taxes, social security contributions, and fiscal drag). The reference to ‘low wage earners’ is not counted as a separate policy action, but as a specification. See annex 3 for a more elaborate explanation of the coding.

This method of coding sub-CSRs has the advantage that it better reflects the true scope of the MIP. The European Court of Auditors, which has provided an overview of MIP CSRs on the basis of full CSRs, shows that on average (between 2012 and 2016) 76% of CSRs are labelled as MIP-relevant. This amounts to some 52 CSRs per year (ECA, 2018 table 1). The analysis on the basis of sub-CSRs shows a comparable percentage, but a significantly higher number of policy actions (sub-CSRs). Disaggregation to sub-CSR level also allows me to better code them under different policy categories. Some CSRs clearly have two different issues categorised under one CSR. For example: ‘Take measures to make the second pillar of the pension system more transparent, inter-generationally fairer and more resilient to shocks. Take measures to reduce the remaining distortions in the housing market and the debt bias for households, in particular by decreasing mortgage interest tax deductibility’ (CSR 3 for the Netherlands, 2016). This CSR contains one element on pensions and one on the housing market.
Chapter one and two argued that quantitative approaches to analysing the MIP should be treated with caution, and the analysis above is no exception. The key problem is that if part of the CSR is relevant for the MIP, the Commission labels the full CSR as MIP-relevant. This is indicated by the recitals in the legal documents, which refer to aggregate CSRs only. This makes coding only the MIP-relevant CSRs a bit tricky. There is no way of finding out from the CSR documents (and no easy way from the Country Reports) whether only part of the CSR or the entire CSR is in fact MIP-relevant. In the majority of cases, the entire CSR is directed at one policy challenge, such as competitiveness or the labour market. We can therefore assume that in the majority of cases all elements relate to the same challenge and are as such MIP-relevant. But there are exceptions: the first CSR usually contains multiple elements and in most cases is directed at the fiscal situation of a Member State. Since this CSR is about fiscal policy, it is linked to the SGP, but many are also linked to the MIP. MIP CSRs may include fiscal measures (recital 20, Reg. 1176/2011), but we can imagine that the part on the fiscal balance is SGP-relevant, and the secondary part of the CSR (on issues such as spending reviews or broadening the tax base) is MIP-relevant. In some exceptions, it could be the other way around, such as with the CSR on healthcare and long-term care for Germany in 2014. It is hard to conceive how that links with the current account imbalance. This coding exercise found 52 CSRs relating to the fiscal balance were linked to the MIP. If we were to assume that these are not MIP-relevant, the percentage of MIP-labelled CSRs would drop to 78%. This number should be seen as a rough estimate.

Ultimately, coding exercises are dependent on the wording of the CSRs, which leave a lot open to interpretation. For example, this is the scope of the 2014 CSR on competition policy for Italy:

*Approve the pending legislation or other equivalent measures aimed at simplifying the regulatory environment for businesses and citizens and address implementation gaps in existing legislation. Foster market opening and remove remaining barriers to, and restrictions on, competition in the professional and local public services, insurance, fuel distribution, retail and postal services sectors. Enhance the efficiency of public procurement, especially by streamlining procedures including through the better use of e-procurement, rationalising the central purchasing bodies and securing the proper application of pre- and post-award rules. In local public services, rigorously implement the legislation providing for the rectification of contracts that do not comply with the requirements on in-house awards by 31 December 2014.*
And this is that same CSR in 2017:

*Promptly adopt and implement the pending law on competition and address the remaining restrictions to competition.*

Arguably the first CSR contains more actions and more words.\textsuperscript{21} But in theory, the two CSRs could mean the exact same thing. The ‘remaining restrictions to competition’ could imply that further action is warranted on all of the above. Without diving into the Country Reports, there is no real way of knowing what the Commission had in mind. And this example is no exception. The language of CSRs displays tremendous variation over the years.

With all these caveats about coding and counting in mind, we can still argue that the scope of the MIP has been very wide. Imbalances are complex and manifold economic phenomena, so only a combination of measures on multiple fronts is likely to have an effect on them. When a country sees its competitiveness erode during crisis years, this often goes hand in hand with an increase in debt levels and rising unemployment. In other words, it is the basic resilience of the economy that is at stake. How do you decide in such a situation which policy areas should take precedence and require decisive action and special monitoring over others?

This difficulty of choice explains part of the wide scope of the MIP. But we can also conclude that the Commission has interpreted its mandate within the MIP very widely. The table shows a significant total number of (sub) recommendations: in 2014 alone, there are more than 400 for the 14 states under MIP surveillance. Member States that have been labelled as experiencing excessive imbalances receive on average 22 CSRs per year versus 12 for those that have imbalances that are not excessive. An extreme case is Spain. In 2014, Spain received no less than 55 sub-CSRs, almost all of which were linked to the MIP. But Spain is certainly not an outlier; in the same year, Italy received 48 sub-CSRs. Croatia was put in the excessive category immediately after it joined the EU and received 40 sub-CSRs in its first Semester round. The wide scope of issues puts labels such as “some progress” on the implementation of the CSRs in a different context. Some progress on many actions can still imply that a lot of progress has been achieved.

\textsuperscript{21} Some authors have taken word-count as a way of measuring scope, e.g. van der Veer and Haverland (2018).
The argument concerning the wide interpretation of the mandate can also be extended to the Commission's choice to label a large proportion of Member States as experiencing excessive imbalances (without opening the corrective arm). Escalation within the procedure should signal that trends on the indicators are moving in the wrong direction; imbalances are widening. Such a signalling effect would work best if all Member States started at a similar level, but that is, of course, not the case. During the first years of the crisis, the Commission found imbalances to be widening and scaled up the MIP. But in 2017, the European economy was growing and imbalances were slowly correcting, especially where it concerned flow variables such as the current account or ULC. But still 12 out of 28 Member States were in the MIP, half of which were in the excessive category. Arguably a very focused use of the procedure would increase the signalling effect, whereas if many states are in the advanced categories and all the CSRs are linked to the MIP, this signalling effect becomes much weaker. Member States that are suffering from high values on stock variables for imbalances, such as high levels of public or private debt or a negative NIIP, will take years to correct them. For these Member States the signalling effect of being in the MIP will wear off. The approach of the Commission to use the MIP on a wide scale has, for this reason, been criticised as diluting the rationale of the procedure.

If we switch the focus from the number of CSRs to their content, the 'wide scope' argument continues to hold. Figure 3 below shows the outcome of a coding exercise whereby all the sub-CSRs that fall under the MIP have been labelled under a number of policy categories. What this shows is that a wide range of issues have featured continuously and relatively consistently under the MIP. The MIP is not just about finance or labour costs, but also very much about the organisation of welfare arrangements and the quality of institutions. For Spain, where the imbalance included high private debt and the need for rebalancing the current account deficit, the MIP includes measures against tax evasion, stricter capital ratios for banks, reforms to the judiciary sector, public employment service enhancements, and liberalising professional services, to name but a few.

Overall, the outcome of this coding exercise largely resembles that of a similar exercise that has been conducted for all Semester CSRs (Crespy and Vanheuverzwijn, 2017). Various scholars had already pointed out that the CSRs consist of a large mix of issues (Degryse et al., 2013; Gern et al., 2015). The analysis for the MIP confirms this view. It does not show any category that clearly dominates, nor one that stands out as different from exercises conducted on the entire Semester. Since category B on labour market CSRs is quite broad, it has been further disaggregated in figure 4, which shows absolute
numbers of sub-CSRs.

These two figures are a depiction of the broad categories\(^ {22} \) of policy areas that fall under the MIP. But within each policy area, there is no clear consistency in what is recommended; this is largely case-specific. So when it comes to pensions, some focus on linking the retirement age to life expectancy. But there are also CSRs on the adequacy of the pension system, the contributions of young people, incentives for early retirement or private contributions. Many of the issues that fall under the scope of the MIP are not new but are long-standing issues that have over the years been discussed within various policy forums. One of the largest sub-groups contains CSRs on active labour market policies (ALMP), which include: tackling youth unemployment, the adequacy of employment services, support for vulnerable groups, public work schemes, apprenticeships, etc. These are typically the types of issues that used to be governed only by the European Employment Strategy, but which are now also linked to the MIP.

Figure 3: Policy categories of MIP-related sub-CSRs

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The categorization used is my own. But it resembles (with a few minor changes) what others have done, such as Crespy and Vanheuverzijn (2017) or European Commission (2017). The categories serve to depict the types of issues that fall under the MIP but should be taken with a pinch of salt, since quite often a sub-CSR can be labelled under multiple categories. Similarly, ALMP is a big category because it can be targeted to multiple aspects of the labour market. This will show up as multiple data points. The same goes for services market liberalisations where often various sectors are listed that need to be liberalized, whereas you only have one pension system. The big change between 2014 and 2015 in terms of ALMP CSRs largely lies in issues of formulation: the 2014 CSRs are more specific on the number of actions. Annex 3 has further explanation.
Category C contains CSRs that used to be governed under the Single Market Strategy, such as services market liberalisation (local public services, transport, professions, etc.), public procurement and competition authorities. The issues that fall under category F on the financial sector are also addressed in the framework of the Banking Union, such as asset quality reviews, capital buffers, stress tests, supervisory frameworks, etc. In later years this category has a stronger focus on non-performing loans and supervision of the shadow-banking sector.

A large category concerns CSRs on the adequacy of governance institutions, such as taxation (broadening the tax base and compliance), the judicial sector, corruption, public administration and the quality of public spending. In the category on social policy, one finds CSRs on the inclusion of Roma, the adequacy of minimum income schemes and the effectiveness of social spending.\(^{23}\) Interestingly enough, the MIP contains surprisingly few CSRs that are clearly distinguishable as inflating private debt, such as debt-bias in taxation (which features only 7 times) or related to housing and mortgages (primarily for Sweden and the Netherlands). Finally, the category of CSRs for Member States that fall under the MIP but have not been labelled as MIP-relevant is equally diverse: it ranges from tax issues, pensions, fiscal issues, to all sorts of labour market issues. All in all, it shows that the MIP is almost indistinguishable from the Semester at large. The main differences are in terms of procedure, not so much in terms of content. And

\(^{23}\) Whether or not the MIP is the right instrument for social policies is a continuous debate. The SPC and EMCO (2017) have repeatedly criticized the Commission for placing too many social issues under the MIP. As pointed out in chapter four, labelling social policies as MIP-relevant means that the ECOFIN committees also get a say on the CSRs. On the other hand, French President Macron and Spanish Prime Minister Sanchez (2018) argued that social dimensions must be better embedded in the MIP.
when looking at scope, almost half of the Member States have been subject to the MIP, with 80% of their CSRs linked to the MIP. The MIP is a holistic procedure focussed on a wide array of issues. Some would say that with this wide scope the MIP has become overextended and its distinctive character (versus normal Semester CSRs) has been lost.

5.3 Has the MIP become overextended?

The discussion on overextension - or dilution - is not new. With governance mechanisms like the MIP, there is often a dilemma in deciding how encompassing versus how focused the procedure should be. You can break a complicated picture down to a hundred indicators and lengthy reports that are intellectually rigorous but that nobody will understand; or, you simplify it, so that it is politically more visible, but it also risks lacking in nuance.

The level of detail in the recommendations and the need for streamlining was a key concern under the BEPGs (Deroose et al., 2008). One of the key criticisms of the Lisbon Agenda (to which the BEPGs belonged) was that it is about everything and thus about nothing. This overextension would lead to poor national ownership and weak implementation (Kok, 2004). The IMF also decided in 2002, and further in 2009, to limit the number of policy actions in their conditionality programmes and only focus on those that are macro-critical (Takaji et al., 2014). And when the MIP was being designed, there were discussions on making it a focused procedure so that the limited number of issues would make these more political. After criticism from the Member States that the excessive number and length of CSRs stood in the way of ownership, the Commission reduced the number of CSRs in 2015 (see table 1) and reduced their average length by around 50% (ECA, 2018: Figure 5). Member States have responded positively to this streamlining (Interview 2 – Commission official). But the over-labelling of the MIP as a percentage of total CSRs has remained and even increased.

Efstathiou and Wolff (2018) argue that they were surprised during their coding exercise by the share of CSRs that are labelled MIP-relevant. Issues such as education or childcare in their view have little to do with correcting imbalances, but they can be found in multiple cases. Bénassy-Quéré argues that the labelling of issues under the MIP appears arbitrary. And labelling all sorts of structural issues for which there will always be a need as MIP-relevant - such as active labour market policy - results in the process becoming blurred and overly complex (2017). The ECA concludes that the over-labelling
has weakened effectiveness and credibility of the MIP, and further argues that this was corroborated by many stakeholders. Their survey among EPC members shows that Member State officials do not always find it clear why CSRs are linked to the MIP (ECA, 2018). The criticism of over-labelling also appeared in interviews, where actors described it as a form of competence creep by the Commission:

... everyone is in it and everyone is getting a recommendation. The way it is now, MIP recommendations in the preventive arm have the exact same status as normal recommendations. To me, it does not make a difference. (Interview 8° - Commission official)

The people in the Commission saw this new train arriving, the MIP, so they thought ‘why not step into this train’? So they moved all their stuff into this train. (…) They think that adding everything under the MIP will have an effect, but I don’t think this is the case. (Interview 59 - French economic advisor)

One of the things we are debating with the Commission, together with France, is the fact that the Commission, this is a matter of consistency and transparency, the Commission for some countries like Italy and France always considers the CSRs perfectly matching the MIP. We always ask the Commission to be more clear on this, because it is not possible that you consider all the problems of a country related to the imbalances. There is not a clear view this way. (Interview 29 - Italian official)

We have been warning not to overstretch the MIP. And also the Commission, sometimes, when they got the question why this is under the MIP, I’ve heard very strange explanations. They couldn’t always make a good case. (Interview 22 - Belgian official)

In a more abstract economic sense, Rodrik (2016) argues that if you look at growth accelerations throughout history, they were usually based on the targeted removal of a few key obstacles to growth. One or two fundamental and well-designed reforms in his view are more effective than a broad set of liberalisations and other reforms where scarce political capital is squandered for all sorts of fights at the margins. Rodrik makes the argument in the context of the conditionality package for Greece, but a similar argument could be made for the MIP. Arguably, the 55 sub-CSRs for Spain or the 48 for

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The argument of Rodrik goes a bit further. His key criticism is that small supply-
Italy are a bit much. It feels like the EU is trying to micro-manage their economy. And indeed, it seems legitimate to ask whether recommending a complete policy overhaul in times of depressed demand is the best macroeconomic strategy to reduce imbalances. At the same time, finding the two to three buttons to push that will revitalize an economy like the Spanish or the Italian and so reduce their imbalances is no easy task.

Interviewees have described the selection issue as the key problem in the MIP. It has been an issue that has been heavily debated and criticised internally within the Commission. For example:

The question is, of course, what causes these imbalances? What is the structural element of this? We have had lengthy discussions about this. These were almost fundamentalist. For example, if proper child care is lacking in a country and the participation of women in the labour market is low, can we issue a CSR on this? Child care facilities help to increase the labour market participation. But the question, of course, is whether this is an imbalance. We had many discussions. I am mentioning child care because discussions about that topic were particularly long. But there are other issues where we discussed whether it was a structural issue or not. And then you get all these DG’s that want to come aboard the core group to raise awareness for their own issues. (Interview 60* - Commission official)

The Council committees faced similar struggles as the Commission. One interviewee remembers that in the first Semester cycles there were endless discussions about which issues should be MIP-relevant. These discussions were not very productive, as the official describes:

At committee level, people were measuring the number of recommendations and the number of recommendations linked to the MIP. And people were like: “if I have 4 then that country should have 5”. It was a waste of time. And then you go back to your capital and the Minister is angry: “why did you not get it changed?” So there were big fights over this. And the view that prevailed was that if a country has high debt-to-GDP and these kinds

side reforms do very little in a context of low domestic demand. Whether supply-side reforms during a period of low growth make sense at all is a controversial debate within the political economy discipline. There are also many econometric studies that show growth advantages from smaller supply side reforms that typically fall under the MIP (e.g. Bouis and Duval, 2011 on labour market and product market reforms; Masuch et al., 2017 on institutional reforms). This thesis will not discuss growth advantages of reforms in a general sense, but within specific case settings.
of problems then everything is linked to the MIP. If it’s GDP, it’s everything. (Interview 47 – EPC official)

Some of the critics might accuse the Commission of being arbitrary in linking issues to the MIP. But if it were more selective, linking some issues to the MIP and others not, it would likely face similar criticisms. The debate goes back to the earlier described notion that there is no clear and concise definition of what imbalances are or which actions should correct them. As the quote above indicates, “if it’s GDP, it’s everything”. With imbalances, one may wonder whether there is really any way around the legibility problem. This also explains why the MIP has seen so many changes almost every year; the Commission is still learning how to operate the procedure and find a credible modus operandi concerning inherent political dilemmas. As one official explains his experience:

We sometimes still have these discussions where people ask why this is MIP-relevant because this is all learning-by-doing. We have to make some decisions on being really precise or being able to be more politically relevant by only focusing on a limited number of issues. We have to do some arbitrary interventions there. For France, we decided that all CSRs are MIP-relevant; I mean, also taxation CSRs are not directly relevant to the MIP, to be honest. (Interview 51 – Commission official)

But despite all of this, choices within the MIP sometimes indeed seem illegible. The Netherlands is a good example in this regard. It has had imbalances related to household debt and a current account surplus, and it has mainly received CSRs on the following topics:

Table 6: CSRs for the Netherlands, an overview

<table>
<thead>
<tr>
<th>Year</th>
<th>Linked to MIP</th>
<th>Not linked to MIP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>Housing</td>
<td>Fiscal, Pensions, Labour Market</td>
</tr>
<tr>
<td>2014</td>
<td>Housing, Labour Market, Wages</td>
<td>Fiscal, Pensions</td>
</tr>
<tr>
<td>2015</td>
<td>Housing, Pensions, Fiscal</td>
<td>-</td>
</tr>
<tr>
<td>2016</td>
<td>Housing, Pensions</td>
<td>Fiscal, Labour Market</td>
</tr>
<tr>
<td>2017</td>
<td>Housing, Pensions, Fiscal, Labour Market, Wages</td>
<td>-</td>
</tr>
</tbody>
</table>

The table indicates that the labelling of MIP relevance can fluctuate significantly over the years. It is not obvious why the fiscal CSR, which includes a call for increased
public investment, moves constantly in and out of the MIP, whereas the related issue of the current account surplus is constant. Similarly, the labour market CSR relates to employment protection legislation and the precarious position of the self-employed. This has also been a continuous topic of debate in the Netherlands, yet the CSR fluctuates. Also, it is not directly obvious how employment protection legislation relates to the imbalance of household indebtedness or the surplus. In 2015, the surplus in the Netherlands is still an issue, no wage increase has occurred, and yet the CSR that calls for wage increases disappeared, only to re-emerge in 2017. The point here is not to argue that there are no explanations to be found for these choices if you study the Country Reports up close, but only to show how the labelling of MIP-CSRs indeed seems to suffer from low legibility.

The number of Member States under MIP surveillance and especially the number in the excessive category has also been a topic of discussion within the Commission. The Commission wanted to take away the impression that the MIP is only for the weaker economies. There was the feeling that everyone needed to play its part, including countries like Germany and the Netherlands. For example, Germany was not happy to be receiving CSRs on issues such as the problem of mini-jobs and in-work poverty. The Commission even decided to step up the MIP for the larger states in the 2014-15 period. As one official explains the rationale for this decision:

*There was at that time a sort of systematic consideration that led to a reprioritisation of the focus of the MIP. Initially, it was mostly focused on the vulnerable countries. But by 2015 they were making lots of progress. Instead, there was a growing concern that we could have ended up in a situation of the risks of deflation becoming bigger and bigger and growth not returning. Especially for the bigger euro area countries of the core, there was a growing concern. This could have been the worst situation if you want the euro area growing again while reducing the debt. So there was the decision to step up the procedure for both Italy and France, with this systemic consideration and with much stronger wording on Germany on domestic demand. So there was a logic behind it.* (Interview 74 – Commission official)

Efstathiou and Wolff argue that decisions to place Member States under the excessive category do not reflect worsening trends and are not easy to justify based on economic logic. Rather, choices to place France under the excessive category but leave out Germany are based on political considerations (2018). The quote above indeed indicates that the rationale of stepping up the MIP goes beyond signalling worrying trends on the indicators. France and Italy did not see excessive values on flow indicators, but rather
an overly slow correction of their stock problems. It seems that the MIP is also used as a signalling device that looks at the general macroeconomic trend in the euro area. It is in light of potential spillovers of larger Member States, rather than excessive individual trends, that France, Italy, and Germany have been judged. This decision is not against the legal text of the MIP, which clearly states that account shall be taken of spillover effects and the vulnerability of the entire EMU (paragraph 17, Reg. 1176/2011). However, this decision – as the case studies will show - was not well-understood in these Member States and indeed seen as a political move. Commission officials in interviews admitted that some of these decisions have been seen internally as controversial.

The debate on overextension is important because it shows what kind of procedure the MIP is. This is not a procedure to be used for extreme cases, but one that has been used with a much broader purpose. It covers many issues and its rationale has become indistinguishable from the Semester more generally. This wide scope is understandable from the viewpoint that the European economies still have a lot of issues to deal with. There is also no obvious yardstick by which to say when it is overextended or not. But the wide scope does diffuse its political force. In this sense it also limits the extent to which the MIP can act as a hierarchical mechanism; the issue rather seems to be its discretionary nature and illegibility.

5.4 Does the MIP have an ideological direction?

The wide scope of the MIP also presents researchers with a problem, namely how to systematically assess ‘what’ is recommended under the MIP beyond a mere categorisation as described above. Or to put it differently: is there a substantive or ideological direction underlying the recommendations? Does it steer the Member States towards a particular economic model? Chapter one has provided an introduction to this debate. It showed that there is a group of scholars who have argued that the Semester has undergone a process of socialisation, both in terms of the content of the CSRs and in terms of the actors involved in the process. But a process of socialisation does not necessarily mean that the overall content of the Semester can be judged to be social, at least not in the eyes of a number of critical scholars who continue to hold that social goals have been subordinated in the aggregate policy orientation. This debate should be seen against the background of more general criticisms that there is a neoliberal bias in European economic governance has usually received from critics. The term is heavily contested in the political economy literature, but the purpose here is not to come to a precise definition or testing of the
EU economic governance, as also explained in chapter 1. The contributions to this debate are well-documented in the work of Zeitlin and Vanhercke. This section only analyses some of the latest contributions to this debate. The assumption of some of the critics of the socialisation thesis is that the Semester promotes a coherent set of ideas with a particular neoliberal ideology. But how can one analyse and measure this?

One way to analyse the ideological direction is to look at guiding documents. Each year the Annual Growth Survey (AGS: the document that kicks-off the Semester process) sets out the overall orientation for the Semester. This is a document that is also debated in the European Parliament and endorsed by the Council. It contains general policy goals such as growth-friendly fiscal consolidation, modernising public administration, promoting growth and competitiveness, etc. In later cycles, the fiscal consolidation part has been toned down a bit and investment features more prominently. Under the Juncker Commission, the documents started referring to a so-called ‘virtuous triangle’ of three reinforcing goals: structural reforms, investment, and fiscal responsibility. The documents provide clarity on the direction of policy issues. In 2013, the AGS states that on pension reforms the Member States should align the retirement age with life expectancy, restrict access to early retirement schemes, and enable longer working lives. On taxes, it stated that Member States should introduce reforms that reduce the tax burden on labour, eliminate tax exemptions, reduce the bias towards debt financing and review tax relief for mortgages (EC, 2012). The CSRs are focused on reducing disparities between the Member States in relation to these broader policy goals.

However, the AGS documents over the years also leave a lot open to interpretation, as they generally state broad goals and refer to rather vague notions, such as ‘high-quality services’ and ‘efficient and transparent public administration’. The AGS lists all the policy goals but does not show how these goals are reflected in the CSRs and how often particular issues feature in the latter. As a result, researchers have started labelling the CSRs in ideological categories to try and determine the balance of CSRs. Crespy and Vanheuverzwijn (2017) coded the sub-CSRs into categories and divided them under the headings ‘social investment’ and ‘social retrenchment’. Their analysis shows that the social concept. Rather, the purpose is to show that putting any ideological label on the MIP’s content is hard to substantiate with data, no matter whether it is called neoliberal, or welfare retrenchment or market making, etc.

26 To my knowledge, no ideological analysis exists solely for the MIP, so that this section focuses on the Semester at large.

27 An exception is the 2017 Semester package where the Commission presents an overview of issues, but the overview is for a single year only (EC, 2017).
Part I: Horizontal Analysis

investment category has hovered around 60% of total CSRs and social retrenchment at around 40%. After 2015, the social investment category has risen further.

This would not only confirm the socialisation thesis but also show that the number of socially oriented CSRs was the dominant category almost from the start. Zeitlin and Vanhercke argue that it was primarily the pressure from Member States and civil society that led to the increasing focus on social issues. Crespy and Vanheuverzwijn, on the other hand, hold that the trend in social issues actually confirms the overall neoliberal character of the Semester. They suggest that social retrenchment CSRs have been phased out because more progress has been made, whereas progress has lagged behind on social investment-oriented CSRs.

Another such exercise was conducted by Copeland and Daly (2018), who divided the CSRs into three categories: market-correcting CSRs, market-making CSRs and a mix of the two. They label aggregate CSRs and leave out more CSRs with a less-distinguishable social character than Crespy and Vanheuverzwijn (who only leave out a limited number of categories, such as energy policies). But despite this focus on CSRs with a social character, they still label more than half of CSRs as belonging to the mixed category (7% market correcting, 41% market making, 52% mixed). They note that there is a tendency to combine market-correcting and market-making CSRs. Their qualitative supporting analysis suggests that there is much less agreement on the need to include market-correcting measures at the European level, and that social actors continue to face the dominance of economic actors. They conclude that the orientation of the CSRs is mostly about market-making measures. Their argument echoes the traditional criticism of Scharpf (1996) that the EU is primarily concerned with negative integration (market-making policies) and does not have the ability to undertake positive integration (market-correcting policies).

A third exercise by Haas et al. (2018) looks at whether CSRs contribute to embedding or dis-embedding the market. This analysis only looks at CSRs that clearly indicate an embedding or dis-embedding direction, which in practice means that 75% of CSRs fall outside the scope of analysis. Their conclusion is more cautious about the overall character of the CSRs. They conclude that the EU does not push for one coherent set of either embedding or dis-embedding market reforms. The CSRs show a country-specific focus. What can be observed is a shift over the years towards embedding CSRs and an
overarching flexicurity frame for labour market CSRs.

These exercises represent new attempts by researchers to systematically assess the overall ideological direction of CSRs and are therefore a welcome contribution to the debate. But labelling CSRs under ideological categories remains highly difficult. It remains questionable whether one can define ‘the social’ as opposed to ‘the economic’ in such a binary way. One continues to run into conceptual and methodological issues where interventions are largely at the discretion of the researcher. This chapter has already mentioned how the data is dependent on the formulation of CSRs. But labelling also shows that issues such as stress tests for banks, judicial reform or adequacy of insolvency frameworks do not really belong to any ideological category (the analysts above leave out some of these categories). And what are we to make of references to ‘better coordination of different levels of government’, or ‘a more efficient implementation (or evaluation) of planned reforms’, or ‘increase transparency in minimum wage-setting’? Many CSRs respond to the governance of reforms, not to their substantive content.

Another methodological difficulty is the fact that not all CSRs are equal. In an in-depth analysis of the neoliberal character of employment CSRs for Spain in the period 2005-2014, Garcia Bermejo (2018) shows that the majority of CSRs has been focussed on market-correcting measures (24 out of 40) rather than market-making measures (14 out of 40). Yet, the qualitative content analysis shows the market-making measures to be more far-reaching. It is impossible to speak either of a market-making, or a market-correcting approach according to the author. Rather, there is a balance between the two, with a shift towards market-correction in later years.

Sometimes the character of a CSR also depends on how it is implemented. For example, the CSRs on employment protection legislation can be directed both at the segmentation of marginalised groups and at reducing rigidity in the system. These CSRs can have an open formulation so that the choice of the Member State itself on how to comply with the CSR determines whether they choose a more socially protective route or one that can be deemed social retrenchment or market-making. In this context, one should also include historical trajectory in judging the direction of policy. For example, an analysis by Bertola (2017) shows that the Member States that have deregulated their labour markets since the crisis were also the ones to show the strongest trend in introducing more stringent regulation before the crisis, and those that introduced tighter regulation since the crisis

For an explanation of flexicurity see chapter eight on the French labour market.
were mostly the ones that deregulated in the previous years.

Containing health-care costs can be done in more or less progressive ways. For France, the 2015 CSR asks it to curb excessive pharmaceutical spending, while in Bulgaria, it recommends containing costs by strengthening outpatient care and primary care. Fiscal consolidation strategies can be counterbalanced by measures to broaden the tax base and the effectiveness of tax collection. Increasing the pension age can be counterbalanced by strategies of active ageing. Introducing greater competition in local public services in one Member State can be deemed as unnecessarily market-driven, whereas in another it could be a strategy to enhance transparency and accountability of service providers and a way to tackle cronyism. We can also ask ourselves whether recommending a Member State to reduce the length of legal proceedings in cases of dismissal can be classified as social retrenchment (“tackling rigidities”) if the Member State in question has among the longest legal proceedings of the EU. Other seemingly technical recommendations such as on recurrent property taxes may hide large consequences in terms of redistribution, but whether this is indeed the case depends on how the measures are implemented and may vary per country (Tsoukala, forthcoming). What is argued here is that the terminology used in CSRs does not have a univocal meaning. Some researchers will read a neoliberal strategy into such recommendations, whereas others will consider these progressive ways to tackle issue-specific and country-specific problems.

Issue-specific factors and the balance between and coherence of various CSRs cannot easily be distilled from general coding exercises. They do not point to a coherent or easily detectable overarching policy blueprint. This is not least because it is not just one actor who decides on the content of CSRs; the Member States in the Council have to agree to it too. The content of the Semester/MIP is also a moving target. The EU is still in a process of reaching a larger consensus on concepts and directions. For example, the Eurogroup has started to look for a common definition of the concept of ‘economic resilience’ in thematic sessions (EC, 2017d). The discussion on the European Pillar of Social Rights should also be seen as a step towards reaching consensus on standards, priorities, and definitions.

Trends in topics and substance (as opposed to the aggregate stance) can be analysed. When analysing the 2017 and 2018 CSRs and their guiding documents, it is clear that they have become more social in character. For the 2018 round the CSRs dedicate special attention to social challenges, building on the European Pillar of Social Rights (EC, 2018). The trend is clear, but in order to judge the overall character one would need to analyse
Chapter 5: Scope and content of the MIP

the balance between and hierarchy within the CSRs. Some analysts simply assume that there is an asymmetric character in the Semester CSRs. A recurring criticism is that social goals may (increasingly) feature under the Semester but these are mostly empty shells in light of fiscal discipline. For example, Crespy and Schmidt (2017) wonder how one can expect Member States to introduce social policies such as the activation of their workers in an environment of low demand (for workers) and against the background of fiscal discipline as promoted by the fiscal pillar of the Semester. According to Crespy and Schmidt, the inclusion of activation goals against the risk of an excessive deficit or imbalances procedure is even somewhat naïve.

However, this conclusion (as well as similar conclusions from Crespy and Vanheuverzwijn (2017) and Copeland and Daly (2018)) ultimately rests on assumptions about the CSRs that are not really supported by the empirical evidence that has been presented so far. They also stand in contrast to the rather positive evaluations of the latest Semester cycles of the EMCO and the SPC (2017, 2018), which also include evaluations from social partners. Similarly, the Commission notes that active labour market policies are among the most well-implemented CSRs in Member States (EC, 2018). Where researchers have looked at the implementation of socially oriented CSRs they have mostly found that these are not empty shells (e.g. Jessoula, 2015; Eihmanis, 2017; Jessoula and Madama, 2018).

Of course, criticism on certain social aspects remains. Dawson (2018) finds that spending on innovation and R&D or infrastructure spending are on multiple occasions pointed out as needing an exemption from fiscal consolidation, whereas this is not the case for spending on poverty and social inclusion. Overall, the Commission has recommended more spending cuts than fiscal expansion since the start of the Semester, despite a clear trend towards more balanced budgetary recommendations (Haas et al., 2018). Bongelli (2018) finds a continued focus on decentralisation of wage bargaining and arguments that higher minimum wages would hamper job growth, although he is more positive about the 2018 Semester round.

What can be concluded from analysing these coding exercises is that there are simply too many case-specific and country-specific issues to come to a general conclusion about the overall ideological stance. In this sense I side with the conclusion of Haas et al. (2018). The overall picture seems quite mixed: the Semester (and MIP) is an instrument that promotes social goals, but also competitiveness goals, and goals of institutional quality and sound public finances. The difficulties of determining a coherent picture are also the reason why this thesis does not present a similar ideological categorisation.
exercise specified for the MIP CSRs (beyond what is shown in figure 3). After having carefully studied the CSRs within their categories, I could not come up with a conceptual framework strong enough to analyse the MIP's message in a coherent way beyond what has already been said about the trend of socialisation. For now, studying individual policy areas and the implementation of individual CSRs within their national context gives a more clarifying picture. Hence, this thesis will move on to the case studies.

5.5 Conclusion

This chapter makes two claims: first, it shows that the scope of the MIP is so wide that it has become almost co-extensive with the Semester at large, even to the point of being criticized for over-extension. And second, that due to this variety of issues that fall under the MIP analysts should be careful in making overly determinist statements about the overall ideological stance of the Semester. The first argument helps us to understand the hierarchical nature of the MIP. With such a wide scope there is in practice little difference between whether a CSR has the MIP or only the Semester as a legal basis. Had the Commission used the MIP only for a limited number of issues, its character would have been more distinctive and possibly more hierarchical in terms of political signalling. Casting the net so widely diffuses the political force of the MIP. But as the second section shows, the selection issue is a dilemma for the Commission with no obvious answers.

The second claim helps to answer the research question concerning the existence or not of a neoliberal bias in the recommendations. The data of the coding exercises suggests that the content of CSRs is varied, balanced and mixed. Strong conclusions by authors about their neoliberal character do not seem supported. It is difficult to say anything substantive about the overall ideological character of CSRs beyond showing that there is a trend of social issues becoming more prominent in number. This chapter has not attempted a similar classification of the MIP’s policy content. Rather, what is argued is that there are limits to the extent in which we can measure this with general coding exercises. However, there are still important debates within specific policy fields. These are best studied within the domestic economic and political context. As such, we should study individual CSRs and their implementation. This is what the rest of this thesis will be focused on.
Part II

In–Depth Case Studies

Overview and reading guide

The case studies will show that the MIP primarily works through the force of argument and that procedural steps, such as escalation, have little impact on the net effect. Effects are mostly indirect: they concern keeping issues on the agenda and increasing the political cost of inaction by drawing attention to them. While in no case a government has introduced a measure solely because of pressure from the MIP, the case studies will show that actors find the MIP framework in many cases helpful for the policy process and in certain circumstances actors do really feel pressure. This pressure is dependent on domestic factors and usage of the MIP by domestic actors. Since the pressure primarily concerns reputational damage, this is felt differently by actors, as some remain unimpressed by the MIP’s impact on the policy debate. The Commission often has to adapt its approach in order to remain relevant, depending on domestic political circumstances.

In some of the cases, such as in the Netherlands, there is already a strong technocratic consensus around the arguments of the MIP and the focus is on building political momentum. But in other cases there is serious and genuine disagreement over the arguments behind the CSRs. Member States are not spineless recipients of the CSRs; they actively debate and sometimes oppose the Commission’s view. For this reason, the chapters all (to varying degrees) include a discussion of the arguments and analysis behind the CSRs. These do not aim to provide definitive answers about the economics behind the CSRs, but rather to show that there are legitimate grounds for genuine disagreement. The Belgian and German case will show how the basis for the Commission’s arguments is by no means self-evident.

The cases will show how there is controversy around CSRs: in some of the cases this lies in disagreement at the technocratic level, while in others it is about the role of the EU
in the domestic policy debate. The French and Italian cases will show how the EU has been delegitimized and how domestic actors shy away from any reference to the CSRs. These issues around technocratic or political consensus in the Member State condition the MIP’s ability to be effective and can differ per country, topic and government. The first chapter – on Belgium – identifies quite explicit effects and will show elements of each of the abovementioned arguments. Later cases will show more of the political struggles around reform and the Commission’s search to remain relevant. The last case - on Germany - will show how the MIP can have agenda effects, without these necessarily translating into a change of policy. Chapter 11 will discuss the effects of the MIP comparatively within the conceptual framework of chapter two.
Chapter 6

Wage Indexation in Belgium

6.1 Introduction

Article 153.5 of the TFEU explicitly states that the issue of wages is outside the scope of EU competences. The clause was aimed at protecting the sovereignty of the social partners in the Member States and was introduced at the start of EMU. The timing is no coincidence. An important question in the run-up to EMU was whether a monetary union also needs some European guidance on wages. With a common currency, states cease to have control of the exchange rate mechanism, which puts additional stress on wages as alternative adjustment channel in times of distress (see, e.g. Werner Report, 1970). The exchange rate under normal circumstances can smooth external competitiveness effects caused by diverging wage trends. But with the euro, wages cannot easily move out of line with other euro economies without negative competitiveness consequences. And, according to the classic theory, flexible wage-setting institutions would contribute to an optimal currency area (De Grauwe, 2016). Social partners resisted any watering down of their competences and received protection in the Treaty. As an alternative, the BEPGs repeatedly called for wages to evolve in line with labour productivity to prevent divergence in the euro area. But this has not happened.

At the start of the crisis, the diverging competitiveness dynamics of wages and productivity – as measured in unit labour costs (ULC) - became a focal point of discussion. The prevailing view, propagated primarily by the ECB, was that peripheral states in the euro area had lost their competitiveness (Trichet, 2011). Since the introduction of the euro, ULC in countries with a current account deficit had increased 2.5 times as much as in the surplus countries. And ULC was seen as a defining feature in measuring imbalances (Draghi, 2012). Symbolic of this view was the 2011 Euro Plus Pact, where EU leaders committed themselves to the containment of ULC growth and a reform of their wage setting mechanisms to achieve this. Despite the negative employment effects of

Parts of this chapter have been published as a conference paper: Bokhorst (2017).
Part II: In-Depth Case Studies

this internal devaluation strategy, Juncker, Draghi, Dijssebloem, and Tusk reiterated this prevailing narrative in 2015. They argued that diverging wage developments played a key role in the euro crisis, which they described as a crisis of competitiveness (2015). The chapter on Germany in this thesis argues why this narrative is highly contestable. But, despite controversy about the narrative, many economists do agree that the EMU needs additional monitoring and coordination of wage developments to counter diverging trends (e.g. De Grauwe, 2016; Höpner and Lutter, 2014; Sapir, 2016; Vandenbroucke, 2017).

Social partners too had long been concerned about the role of wages in the EMU. But initiatives in the early 2000s, such as a macroeconomic dialogue between European social partners, the ECB, the Commission, and Council, or the European wage coordination guidelines of the European Trade Union Confederation (ETUC) never gained sufficient traction (Erne, 2015). In the years before the crisis, the ETUC was a proponent of enhanced economic governance for the EMU, which they saw as a means to prevent states from resorting to wage and social dumping as an alternative to devaluation. But in the eventual proposals, especially the MIP, they saw this idea being turned upside down (2010). They successfully lobbied the EP to include legal safeguards to protect wage-setting frameworks. Article 1(3) of the 1176/2011 Regulation states that the MIP ‘shall respect national practices and institutions for wage formation’ and ‘does not affect the right to negotiate, conclude or enforce collective agreements’.

Accordingly, the MIP cannot touch upon the sovereignty of social partners. But it can make recommendations on the legal frameworks in which wage setting takes place, the rules of the game, since these are in the hands of the executive. And it has done so extensively; wage setting has featured prominently in the Semester and MIP (Schulten and Müller, 2015). The Commission is convinced that nominal wages in the EMU should follow real productivity trends and that wage setting should be organised accordingly. It has issued several MIP-related recommendations on this issue to e.g. Belgium, Croatia, and Italy. These CSRs have been controversial from the start. Some Member States in the EMCO are hesitant to even talk about these CSRs since they are not seen as legitimate.

Belgium has received a recommendation on wage developments and its system of wage setting in every Semester cycle. The Belgian case is especially interesting since the CSR has over the years focussed both on bringing wages into line with productivity and on decentralisation of collective bargaining, by reforming the competitiveness law to make sure that corrective measures can be taken and that companies can derogate
from the central wage agreements. Accordingly, this CSR can be seen as one of the most prescriptive recommendations on wages in the MIP. The Commission primarily takes issue with the practice of automatic wage indexation, whereby wage trends automatically follow inflation trends for almost all sectors. Automatic wage indexation has been a widespread practice since the 1920s and is seen as an essential pillar of the Belgian social model. The CSR is thus politically sensitive.

This chapter will show that the Commission’s argument was by no means self-evident to the Belgians. They resisted the CSR on intellectual grounds. However, with both sides toning down their stance over the years and political opportunity arising due to a change of government, the MIP still manages to have a non-negligible influence on Belgium’s reform agenda. In order to understand why the Commission’s argument was by no means self-evident, we first have to unpack the economic logic behind the CSR and the indicators that have been used. The purpose of the economic analysis is not to come to a definitive view on how to assess wage developments in Belgium, but rather to show that there can be genuine intellectual disagreement over the Commission’s argument. The third section will go more into detail about the specifics of the indexation mechanism and will show how it became a sensitive cornerstone of the Belgian social model. The rest of the chapter will trace the political process over the years and assess the influence of the MIP. The case stands out in terms of the pressure exerted on Belgium, but it also shows how this pressure is conditioned by domestic political factors, such as a change of government.

6.2 Belgian wages as a macroeconomic imbalance

Belgium has weathered the crisis relatively well. Like Italy, the Belgian state is deeply indebted. During the crisis years Belgian public debt has steadily crept to over 100% of GDP. But whereas others faced a steep rise in borrowing costs and capital outflows, the Belgian bond market remained remarkably stable. There was an increase in interest rates, but not to alarming levels.\(^3\) Belgium also showed stable and above euro area-average GDP growth since euro introduction. There was a contraction of the economy of 2.8% of GDP in 2009, related to having to bail-out four banks, but this was followed by a swift recovery in 2010. And where many other states faced a second recession in the euro crisis years of 2010-2013, Belgium did not. An important part of the explanation

\(^3\) There was a short instance in 2011 when investors started to cut exposure to Belgian sovereign markets after it had been negotiating a new coalition government for more than a year, this was a major push in the formation of the Di Ruplo government at the end of 2011, after which markets calmed again.
for this lies precisely in the issue under study in this chapter, the automatic indexation mechanism.

In 2007 oil prices rose significantly and consequently inflation also rose in Belgium. Since wages are linked to inflation through indexation, Belgian wages coincidentally got a boost just before the crisis erupted. This rise in wages upheld demand in Belgium, whereas others saw consumer demand plummeting. The system of automatic indexation thus acted as an important economic stabiliser. At the same time, if wage increase continues to outpace that of neighbours and main trading partners, the cost competitiveness of the economy can be affected. At the macro level, purchasing power is preserved, but individual businesses can see their profit squeezed in an economic downturn, while wage costs continue to rise due to indexation. Similarly, sustained trends of wage growth that outpace trends in peers can result in competitiveness loss. Both could result in a loss of employment. The challenge with wage setting is to find a balance between the macroeconomic arguments at the collective level and the need for differentiation and flexibility at the level of individual sectors or businesses. It involves fundamental choices of who bears the burden of shocks. More flexible wage setting systems allow for shocks to be absorbed more easily through wages. But on the aggregate level, this can result in a distortion between the capital share and the labour share in economic growth. Finding this balance is what the debate between the Commission and Belgium has been all about.

We now know that a market attack on Belgian public debt never happened, as the vulnerability never escalated. Belgium also did not see any alarming levels on the indicators of the AMR scoreboard. But this is in hindsight. In 2012 the trend on many of the indicators was negative, so there was no reason for complacency with such a high level of public debt. Overall productivity was high, but productivity growth among the lowest of the EU. Belgium did not face a recession, but growth was stagnant, debt was increasing and unemployment on the rise. The current account was close to balance, but slowly deteriorating. For the Commission, this negative outlook was sufficient to place Belgium under the MIP. It defined the slow but steady erosion of competitiveness as the main imbalance. This erosion was hurting growth and employment and thus required action, especially in a context of having to rebalance the budget under the SGP.

But as the next section will argue, the Commission and the Belgian government were - especially in the early years of the Semester - not in agreement on the relative importance of the various drivers of the competitiveness loss. In other words, the Belgian government agreed with the analysis that Belgium was losing competitiveness,
agreed that wage dynamics are an important factor in competitiveness, but disagreed with the analysis that it was a determinative factor to such an extent that the indexation mechanism required reform. The indexation mechanism is seen in Belgium as performing important social functions, so the negative externalities will have to be well-grounded before a reform of the mechanism can be considered. In order to understand both the position of the Commission and that of Belgium we first have to dig a bit deeper into the measurement and drivers of competitiveness and critically discuss some of its concepts, primarily ULC.

To capture competitiveness dynamics, the Commission takes as a starting point the development of change in export market share, ULC and the Real Effective Exchange Rate (REER). In its various IDRs for Belgium, the Commission argues that Belgium is losing ground with respect to expanding world trade and its export growth is significantly below the euro area-average, while prices of exports are rising faster than the average. The prices relative to trading partners are captured in the REER, whereby a continuous appreciation could lead to businesses pricing themselves out of the market or moving abroad and import becoming cheaper than domestic production. If a country evolves too far out of line with the main trading partners, this can result in employment losses. The REER as measured in consumer prices (HICP deflator) has for Belgium been appreciating over the years been appreciating, especially since the crisis. In response to price increases, Belgium has been recommended to increase competition in the retail sector and network industries such as electricity and gas. But, the REER can also be measured on the basis of ULC, which has shown a stronger appreciation. ULC is central in much of the analysis of the Commission for Belgium and is central to the CSR on wages.

ULC is calculated by dividing the nominal labour costs per employee by the real average value added per worker. Since 1996, Belgium used a weighted average of the nominal hourly labour cost of the three neighbours and main trading partners (Germany, France, and the Netherlands) as a benchmark to compare wage dynamics, but ULC also includes productivity differentials. A rise in an economy’s ULC corresponds to a rise in labour costs that exceeds the increase in labour productivity. A continuous rise of ULC above that of trading partners is generally interpreted as a sign that an economy is losing out on cost-competitiveness, especially if combined with a worsening current account and export market share. ULC is a key indicator in the MIP and usually a reason for the Commission to have a closer look at wage dynamics. As shown in figure 5, the nominal ULC of Belgium has consistently outgrown that of the euro area-average and that of the weighted average of the three main trading partners, which collectively represent 60% of
Belgian trade. It shows that since the crisis the euro area average starts to become flat due to heavy deleveraging in peripheral countries, whereas Belgian nominal ULC continues to grow, mostly due to wages being linked to the indexation mechanism. According to the Commission, a wage gap has emerged which is worrisome for the competitiveness of Belgium.

Figure 5: Evolution of nominal ULC of Belgium, the euro area and the weighted average of the main trading partners (EC, 2012f)

If we take a closer look at the weighted average of the neighbours (Figure 6) it becomes clear that nominal ULC of Belgium is actually relatively in line with France and the Netherlands, but Germany is clearly the outlier. Compared to Germany, everyone’s ULC has evolved out of line in the euro area. An often-heard argument among Belgian experts and policymakers, therefore, is that not Belgium, but Germany is the real problem. In later Semester cycles Germany would also receive CSRs on its lack of wage growth, but
in the 2012 IDR for Belgium, Germany is described as ‘performing much better’ and as achieving ‘remarkable competitive advantage’. Germany gained this advantage because it was the first one to reduce ULC so drastically and precisely because the others did not follow suit. If the latter were the case, the effects would erode and result in a general demand shortage.\footnote{At the same time, the role of ULC in German competitiveness needs much nuancing, see chapter on Germany in this thesis.} Nonetheless, despite the causes of diverging trends perhaps lying with Germany, the consequences for the Belgian economy are still there. Germany is the main trading partner for Belgium. Belgian exports to Germany consist primarily of intermediate (unfinished) low to medium-tech goods, which by nature are more sensitive to cost-competitiveness considerations. Belgian wages increased twice as fast as in Germany since 2000. This has negatively affected export of goods markets where Belgian businesses are losing out on competitors, which is only partly offset by the increase in services markets (EC, 2012f). Since Belgian companies are not able to flexibly adjust wages to productivity due to automatic indexation, they suffer employment losses in the eyes of the Commission. The Commission in the MIP documents argues that the loss of employment does not outweigh the benefits of preserving purchasing power and thus the indexation mechanism should be reformed.

The CSR makes sense on face value. Belgian wage costs are among the highest of the EU,\footnote{An important element here is also the overall high tax wedge on labour, which due to taxes and social security contributions stands out as among the highest in the EU, especially for low-paid work. Accordingly, Belgium is recommended in the CSRs to shift taxes away from labour to less distortive domains such as consumption or capital.} Belgium has one of the most rigid wage setting systems in the world according to the Global Competitiveness Index 2012, and if indeed productivity growth does not justify wage increases employment can suffer and a review of the indexation mechanism is warranted in a time of rising unemployment. But ULC should be treated with much caution. There are strong criticisms about its value as a measure of competitiveness (Wyplosz, 2013). Competitiveness includes many factors, amongst others productivity of labour, diversification of the product portfolio of businesses, diversification of export markets and a focus on growing markets, both geographically and product-wise, sophistication of products, establishing high added value in products, capital intensity, energy prices, the exchange rate and the wage share is just one of them. Krugman has famously argued that competitiveness might be a useful concept for firm-level comparisons, but for countries it amounts to ‘a dangerous obsession’ since countries do not compete with one another in the way that companies do (1994).
Comparing ULC at the country level does not give straightforward answers and could potentially be misleading. To start with, there is no empirical relationship between the growth in ULC and output growth or loss of market share, this relationship is complex and non-linear, the lack of clear linkages is often referred to as the Kaldor’s paradox (Kaldor, 1978). It has to be noted here that ULC is calculated on the basis of aggregate data, which hides what happens at the product level. The labour share in value added differs massively per sector (for example: wage costs represent a small share of total costs in the steel industry, but a much larger share in construction), a wage rise or decrease in certain sectors (e.g. teachers) does not tell us much about external competitiveness. Even for those sectors that are heavily exposed to price competition, it is important to look at how they are integrated into supply chains and who the main competitors are. For example, comparing nominal ULC between Portugal and Germany might not tell us much, because they could compete in different markets and on different products and because German nominal ULC might be low due to low salaries in the public sector, whereas they are high in the sectors in which its businesses compete with Portugal.

Felipe and Kumar (2011) make the argument that there are also conceptual problems in aggregating ULC from the product level to the economy-wide level. At the firm or sector level we can compare the cost in terms of labour for the products we get. But at the country level labour productivity cannot be measured in units per worker, but only as the aggregate economy’s value-added. At the company level it is relatively easy to determine the price element in value-added and the labour-element. At the aggregate level we should view this as the labour share in total output and the capital share in total output. An increase in ULC could imply a decrease of price competitiveness of a country, but it could also mean a change in the allocation of the labour share and the capital share in the value added. In other words, a declining wage share shows an increase in returns on capital relative to labour.

Some would consider real ULC, as a better benchmark for analysing wage developments, which also leads to different outcomes. Real Unit Labour Costs are calculated by dividing nominal ULC by the price developments in a country. As a benchmark, it controls for both productivity and inflation and is identical to the wage share in GDP. It shows the division between labour and capital in the national income. Horn and Watt (2017), for example, argue on the basis of a real ULC analysis that in many Member States in the period before the crisis consumer price increases outstripped the rise in ULC due to higher mark ups. Nominal wages followed price trends, but real wage increases

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33 Country Reports do pay attention to developments in real compensation per employee.
remained more stagnant. In other words, the strong rise in ULC that was visible in many states before the crisis (Portugal, Spain, etc.) does not automatically mean there was an issue of wage drift, real wage growth remained rather stagnant before the crisis. Since the crisis many states have started cutting wage costs and there is a general trend across the western world in which wages represent an increasingly smaller share of total GDP, whereas gains on capital increase (we will return to this issue in the analysis section at the end of this chapter). The relation between price and wage rises is complex in terms of causality. In this puzzle, Horn and Watt question whether a focus on the wage share is not starting at the wrong end of wage-price movements when trying to restore external competitiveness. (For a further analysis of real ULC versus nominal ULC in crisis countries, see: Bourgeot, 2013.)

When examining the different components of ULC growth in Belgium it shows that actually price developments have been a strong explanatory variable in ULC growth, see figure 7. The real compensation per employee that explains the ULC growth does not seem overly strong. The Commission therefore also pays attention to energy prices and the lack of competition in the retail sector. But, it also argues that the wage indexation mechanism is to blame. Not only does it not allow for better aligning wages to productivity, the automatic link between wages and inflation would lead to second round effects whereby wage increases feed price increases which in turn lead to higher wages; a so-called wage-inflation spiral.

Figure 7: A breakdown of Belgian ULC components (EC, 2012f)
Domestic authorities dispute the importance of the wage element and the wage indexation mechanism in the price competitiveness of Belgium. A report by leading Belgian economics institutions shows that market share of Belgian companies has primarily been lost in those sectors where Eastern European Member States have gained significant ground after accession to the single market (NBB, FPB, and CRB, 2011). The wage gap between Belgium and the Eastern EU states is, of course, tremendous. The report therefore gives much greater emphasis on reorientation, upgrading and diversification of export products and markets to restore competitiveness. This is a process for the longer term, while in the meantime wages could continue to rise. But interestingly enough, the report does not call for any reform to wage setting practices, as the reorientation is not necessarily enhanced by slashing wage growth. In other words, some of the leading technocratic organisations in Belgium disagreed quite fundamentally with the analysis of the Commission.

As argued throughout this thesis, the indicators are only a starting point for the analysis in the MIP. But in the Belgian case, the follow-up analysis on the components of competitiveness loss and on the question of how wage growth has affected employment is surprisingly thin and did not convince Belgian actors. It also allowed the Belgians to fight off the recommendation on intellectual grounds. In later Semester cycles, the analysis becomes much finer-grained and substantiated, with more studies cited, more details about the composition of exports and a more nuanced tone about the indexation mechanism. Belgian politicians started introducing more changes to wage setting in parallel. But due to the uncertainty of knowledge around this issue, the political process that follows is not without controversy.

6.3 The practice of wage indexation and domestic debate

Belgium is one of a few countries to use a system in which almost all wages are automatically linked to an index that measures inflation. Many states have some links between inflation and wages, but most allow degrees of variation between sectors, companies or regions and include other factors such as productivity or profits as well. In Belgium, 98.2% of collective labour agreements, covering all public sector jobs and almost all private jobs, include a minimum threshold for the increase in wages: the index (ECB, 2009). The index ensures that wage rises are consistent with cost-of-living developments, thus preserving purchasing power against inflation. The system is often seen as highly centralized, but in reality it involves both a national cross-sector bargaining component as well as sectoral bargaining in the 170 collective committees.
and bargaining at the company level (which is less common and usually only concerns fine-tuning of agreements at sectoral level).

Each collective committee has its own practice, but in principle lower-level agreements can only improve on what has been negotiated at the higher level. The centre of gravity of wage setting is situated at the sectoral level. But the national level sets a bi-annual standard for the maximum real wage increases negotiated at sectoral level: the wage norm. So wage bargaining at sectoral level should fall between the index and the norm. It is up to the collective committee to decide whether indexation is applied monthly, bi-monthly, annually or whenever inflation has hit the 2% threshold (spill index). The latter type is applied with a two-month delay for civil servants. Finally, the great majority of collective agreements at sectoral level are made generally binding by royal decree, which ensures a level playing field within the sector.

The Belgian practice of automatic wage indexation has a long history, starting in the 1920s. It was introduced to safeguard the purchasing power of the population against strong price increases of some essential products. Different automatic indexation practices can be found across Europe in history. However, the practice has in many states come under heavy criticism over the years. In the 1980s, a number of Member States such as the Netherlands, France, and Denmark abolished the automatic indexation practice and decentralised bargaining arrangements to varying degrees. Others, such as Italy, would follow in the 1990s. The periods of high inflation following the oil crises of the 1970s had raised suspicion about indexation due to wage-inflation spirals. These spirals would negatively impact competitiveness and employment.

Nowadays, you find indexation only to a limited extent in many EU states, apart from Belgium, Luxembourg, and Malta. But every time inflation hits a high threshold discussion arises about indexation. The system enjoys wide support in Belgium so that discussions only focus on curbing negative effects. As a matter of fact, a report by the Belgian Central Bank finds that until the crisis no studies can be found in the domestic debate (so excluding OECD and IMF) that argue for radical changes to the system such as abolishing the system as the Dutch or French did before (NBB, 2012/Annex 6). Over the years, Belgian politicians have gone to great lengths to preserve the system, while fighting its externalities during times of high inflation. In the 1980s, thresholds to the index and so-called ‘index jumps’ were introduced, which are one-off corrective measures to temporary suspend indexation until inflation has eroded real wages by 2%. These measures have resulted in heavy protest from unions so that in later years a series
of laws were introduced to establish a system that would act preventively to ensure that wages would not grow excessively out of line with peers.

This debate was also stimulated by the EU institutions, which regarded automatic indexation as incompatible with the newly established EMU. With the euro, the ECB’s policies would be focussed on overall inflation in the euro area and indexation would put Belgium at a structurally higher inflation rate than others, due to the wage-inflation spirals. In 1994 Belgium introduced the Health Index as a response. With the Health Index, price changes of alcohol, tobacco, petrol, and diesel are excluded from indexation, so as to ensure that additional VAT on these products does not impact on wages. At the same time prices for household electricity remained in the index, therefore the system continued to be sensitive to oil price fluctuations albeit less so than before.

The most important innovation of that time, and the centrepiece of this chapter, is the introduction of the Law of 1996 on Employment Promotion and Precautionary Protection of Competitiveness. The Law of 1996 can be seen as the legal framework for the wage-setting mechanism as you still find it today. To be precise, there is no legal obligation to use automatic indexation, but for those labour agreements that do (98.2%), they have to abide by the framework as set out in the Law of 1996. The law introduced a maximum ceiling for wage growth: the wage norm. The wage norm is based on a forecast of rises in nominal hourly labour costs in the three main trading partners of Belgium (France, Germany and the Netherlands, weighted on the basis of trade volume). A technical committee of the Central Economic Council writes a bi-annual report, which indicates where the wage norm should be set, after which a group of key representatives of the social partners decides on the actual wage norm. When the social partners fail to reach an agreement, the government can impose the norm by law. In theory, the wage norm should prevent wages from growing out of line and thus be compatible with requirements of a common currency area. The law was an important concession to the EU institutions, as one interviewee recalls:

*That was seen as suitable in the discussions we had with European institutions to preserve the system of automatic indexation. So we promised at the time that our wages and accordingly our inflation would not lead to an unsustainable competitiveness situation within the currency union.* (Interview 27*)

The law worked relatively well. Until the crisis, no corrective measures had to be
introduced, also because oil prices were relatively contained. The wage norm helped
to moderate wage growth but – as the previous section has shown - did not altogether
prevent an increasing wage gap with neighbouring countries. In understanding why
this is the case, it is important to know that while the Law of 1996 introduces the wage
norm, it also stipulates that indexation is guaranteed, even if this means that the wage
norm will be exceeded (Art. 6.2 in Law of 1996). This means that in times of high inflation,
which Belgium has seen more than its neighbours, the margin for negotiation and
sectoral differentiation (between the index and the wage norm) is very small. Given the
fact that wage bargaining is an important part of the raison d’etre of trade unions –
they need something to show for themselves to their members – sticking to the wage
norm is somewhat of a challenge. But more importantly, wages can continue to outgrow
those of neighbouring countries, because even when social partners want to stick to the
norm, the index in many cases is already higher than the average wage growth in the
neighbouring countries.

Furthermore, the norm adjusts for nominal wage growth in neighbouring countries
rather than ULC. As such, it does not compensate for differences in productivity
growth that should justify differences. The wage norm was conceived at a time of high
productivity growth in Belgium, but this is no longer the case. To give more flexibility
to the system, it also includes the possibility of all-in clauses in which a margin is
determined to compensate for unanticipated inflationary pressure. So, officially there is
an option to limit real wage increase to below the index. But in practice these clauses are
seldom and only partially used; one example is the bi-annual central agreement of 2007-
2008 in which 25% of employees in the private sector were subject to an all-in clause.
Within the framework of the Law of 1996 there are also possibilities for so-called ‘opt
outs’ for individual companies to temporarily deviate from the index when they are in
financial difficulty. The fact that most sectoral agreements are made generally binding by
royal decree is a practice, upon request of the social partners, not a legal necessity. And as
a practice, it does not specifically exclude the possibility of opt-outs. But in real life these
possibilities are seldom used, as wage indexation is a deeply embedded practice, but not
– as often mistakenly assumed by international organisations – strictly enshrined in law
(see also: Serroyen, 2011).

The difference between a practice and a de jure system is subtle but important, as a law
is changed more easily than a practice that occurs in collective bargaining committees.
But from an efficiency point of view, a system based on negotiation is not ideal. Many
employers complain about a lack of flexibility. It is often difficult to come to an agreement
between social partners so that the government has to step in to set the norm. The
Commission agrees with employers and considers the practice too rigid, since de facto it barely allows for wage differentiation linked to productivity, to preserve employment for companies in difficulty. The Commission also notes that the wage norm is repeatedly based on an overestimated assumption of the expected weighted average wage growth in the three neighbours. And implementing ex-post corrections is very difficult and cannot go below the index. This is similarly the case for forecast errors of inflation within Belgium or unexpected inflation hikes.

With the Semester, Belgium is therefore recommended to: ‘reform, in consultation with the social partners and in accordance with national practice, the system of wage bargaining and wage indexation, to ensure that wage growth better reflects developments in labour productivity and competitiveness’ (Council, 2011a). In 2012, Belgium was placed under the MIP and the CSR would be more specific thus including: ensuring ex-post correction mechanisms, promoting all-in clauses and facilitating the use of opt-out clauses in the indexation mechanism (Council, 2012).

In practice, such reform would mean that the system would be made more flexible, more differentiated and with more elements of legal automaticity, rather than negotiation. According to the proponents of indexation, this would diminish the key features of the entire exercise. The fact that in practice indexation is guaranteed and applied to almost everyone is what defines it. The reason why indexation as a practice is so deeply embedded is because it is seen as an essential pillar of the social contract of Belgium. It is a key feature of a social compromise that also involves provisions on temporary unemployment, shortening of working time and lay-off possibilities for economic reasons. The elements of bargaining and compromise on these features have intrinsic value as it seen as strengthening the tissue of Belgian society.

The system of indexation gives the trade unions a nation-wide negotiation baseline, a safeguard; from there, they can negotiate additional top-ups in collective agreements, giving them an advantage over the trade unions in e.g. Germany or the Netherlands, where the outcome of negotiations can be a wage increase as high as inflation. Besides, it is seen as an important element of solidarity, since it also applies to sectors that have less bargaining power and puts the exposed sectors (those that are more sensitive to competition from other countries) on the same base line of wage growth as the sheltered sector (for example the public sector). But the arguments are not just social, as mentioned before; indexation also provides for income stabilization during times of shock. One study put Belgium as the best performer of the EU in terms of income
stabilization during economic shocks after Denmark, and in the top when it comes to unemployment stabilization (Dolls et al., 2012).

For all these reasons, the indexation practice has been heavily defended by the trade unions, which stand to lose most in a reform. The Belgian trade unions enjoy wide support and have a strong position in the state structure. They are seen as having played a central role in the socioeconomic fabric that helped build up the Belgian economy after World War II and thus enjoy a lot of respect from political parties. The unions are divided along ideological lines (Christian, Liberal, and Socialist), rather than along regional lines (Flemish and Walloon), which gives them additional legitimacy to counter divisive trends in the fragile Belgian state structure. If the system would facilitate more differentiation, one has to bear in mind that productivity levels of firms in Wallonia are lower than those in Flanders. The issues of employment, productivity, and related wage rigidity have a strong regional dimension. Employer organisations are also more cautious when it comes to sensitive issues like indexation; unlike their German and Dutch counterparts Belgian trade unions often operate as a block and are not afraid to go on strike if they feel they are unfairly treated. Overall, one can conclude that the index also has a high symbolic value, and is seen as a sacred cow. Most of the political parties dare not touch it. Employer organisations would ideally abolish indexation, but focus on how to make the system work better ‘for strategic reasons’ (Interview 20° – employer organisation representative).

The question is whether in times of rising unemployment efficiency and competitiveness arguments should weigh heavier than the intrinsic value the system represents. In the past Belgium has always chosen for the later. Or, in the words of former Minister of Social Affairs Vandenbroucke:

_The fact that Belgium shows this kind of creativity [changes to the parameters of the index or index jumps] to safeguard the index, but still tries to compensate for problems with inflation and wage growth, shows the very high political sensitivity of the issue._ (Interview 18°)

### 6.4 Tracing the process: the Di Rupo government

This first recommendation did not go down well in Belgian political circles and certainly not with the centre-left government that was installed in 2011 and led by Socialist Prime
Minister Di Rupo. The recommendation also did not come as a surprise. For years Belgium has had to defend its indexation practice in international forums. Just before the launch of the Semester, the euro area leaders were discussing the Euro Plus Pact (see also chapter three). The German proposal for the Pact included the plan to force countries to end indexing practices, which resulted in heavy protest from Belgian Prime Minister Leterme (FT, 2011). At first, the Commission supported the German proposal, but DG ECFIN Commissioner Rehn received a long and detailed description of the functioning of the Law of 1996 from former Prime Minister Verhofstadt. The document convinced him that fully abolishing indexation was not necessary. Surprisingly, he stated in a press conference that the Law was sufficiently smart in its design and distinct from older systems that were damaging for competitiveness (Nieuwsblad, 2011). The statement is odd, given the fact that a few months later Belgium received its first CSR, which clearly calls for reform of wage-setting practices.

These were the years when in general the direction of European integration antagonized trade unions. The original draft of the pact included a provision calling on the Member States to decentralise the bargaining process (EUObserver, 2011). In the final version, these provisions were watered down to: ‘review the wage setting arrangements, and, where necessary, the degree of centralisation in the bargaining process, and the indexation mechanisms, while maintaining the autonomy of the social partners in the collective bargaining process’ (European Council, 2011). And in 2010, when the first drafts of the Semester were discussed, Belgian Finance Minister Reynders, who was chairing the ECOFIN Council at the time, received a request from Rehn to give the highest priority to competitiveness issues surrounding wages and reforms of wage institutions (Serroyen, 2011). Some actors were convinced that the Commission and ECB were on a crusade to diminish the power of trade unions. A 2012 DG ECFIN study had for example created a lot of bad blood by suggesting that reforms leading to better employment outcomes would include ensuring that wage bargaining would be organised in a ‘less centralized way’, with reforms possibly resulting in ‘an overall reduction in the wage-setting power of trade unions’ (EC, 2012g; 104).

In Belgium, political actors and trade unionists interpreted the first CSR as a call to completely abolish automatic wage indexation and decentralise wage bargaining, like other countries had done in the 1980s. The EU institutions are taken very serious in Belgium, so the responses were also strong, as these examples show:

Politically the first CSRs were seen as a full frontal attack on the Belgian social system by
the ECB and the European Commission. (Interview 19° - Belgian official)

The first reports were absolutely not well-received, it was very one-sided and based on the fetish of DG ECFIN [considering automatic wage indexation as flawed] (Interview 23° - trade unionist)

So the response was like ‘they are meddling top-down in our social model’. And you saw immediately that these recommendations were used politically by the right-wing parties who framed the recommendation as a binding norm that should be implemented blindly. (Interview 25° - advisor to the Prime Minister)

The Belgian government tried to get the CSR amended so that the part on wage indexation would be taken out and the recommendation would focus on competitiveness more generally. But these were the years of the Trichet doctrine, ULC divergence was taken very seriously and Belgium failed to gain support for its position. One interviewee described discussions in the Council Committees where the ECB would heavily argue against automatic indexation as incompatible with EMU and the Member States speaking afterwards simply adopted the same language. The most important argument for the ECB is the second-round effects of wage-inflation spirals, caused by the automaticity of the system. Prime Minister Di Rupo even brought the issue up to European Council level, which is very rare. Di Rupo argued that the indexation practice was anchored in the Belgian traditions and fully backed by Parliament. And similarly, that spillover effects would be small, due to Belgium’s size. But it did not help his case. Many Member States have in recent years gotten rid of their automatic indexation schemes and follow the line of the ECB in claiming that indexation does not contribute to a well-functioning EMU, because of its inflationary effects.

The Belgian government recognised the problem of cost competitiveness more broadly. But it did not see the indexation practice as the dominant driver behind the loss and was certainly not planning to significantly reform its indexation practices. Belgium argued at the time that the goals were shared: it wanted to close the wage gap by 2018, but wanted to achieve this through different means. The Di Rupo government aimed at tackling what it saw as the real cause of Belgium’s deteriorating cost competitiveness, namely the inflationary pressure that resulted from increases in the prices of energy and commodities, due to a lack of competition and supervision. Additionally, the Di Rupo government focussed on productivity enhancement with a strategy to boost the
Belgian economy, including measures for SME financing and research & development. And while Belgium did not want to reform indexation, it did recognise the existence of a wage gap with its three neighbours. In 2009-2010 the social partners had agreed on a lump sum maximum wage increase, rather than a percentage for compensation. This means that rather than agreeing on 1 or 2% above indexation, the maximum increase would be 250 euros, which of course is considerably higher for low incomes than higher. In the next two bi-annual agreements (2011-2012 and 2013-2014), the social partners could not agree on a wage norm, which gave the government the possibility to intervene with a binding wage norm set by the government. The government set the wage norm at 0% for 2011 and 0.3% for 2012 (and later at 0% again for 2013-2014) to keep real wage growth under control and promised to apply the wage norm scrupulously (Belgian Federal Government, 2011; 2012).

The efforts did not much impress the Commission. The wage norm might have been set low, but this still excluded indexation, projected to stand at 3.9%. In their analysis of the 2011 National Reform Programme, the Commission services note:

*Given the current acceleration of inflation, the estimate of 3.9% for the increase in the health index over the next two years seems to be rather low. As a consequence, the Law of 1996 will probably not prevent wages in Belgium from increasing faster over the next two years than in the three neighbouring countries.* (EC, 2011: 10)

The Belgian government did not just disagree with the Commission for political reasons, but also found the analytical underpinning of the CSR too thin. It knew that it had to come up with a fact-based analysis to convince the Commission that there were better ways to restore competitiveness. The Cabinet of Di Rupo organised several thematic sessions around the issue of cost competitiveness to have a more fundamental debate on the issue. These included the social partners, civil servants and representatives of the regions, which from then onwards would also be fully involved in the annual Semester cycle. The Belgian government also set up an expert group to calculate the exact size of the wage gap, which had always been a controversial issue among experts. In addition, the Central Bank, the Central Economic Council and the Federal Planning Bureau (a technocratic institution on policy assessment) were asked to come with a thorough analysis of Belgian competitiveness (2011). As stressed in the opening part of this chapter, these institutions did not share the Commission’s view and put the emphasis more on a reorientation of export markets and products and other non-cost competitiveness issues, rather than wages. In interviews with representatives of each of these institutions
appears the perception that the Commission was too dogmatic in its assessment. For example, former Central Bank Director De Batselier:

*I do not think that wages should be directly coupled to productivity, but everyone knows in the back of their heads in the negotiations – both at sectoral level and at the company level – that productivity should be one of the factors to take into account. But economic growth should also matter, the growth path of the firm, the evolution of profit, the distribution in export markets, etc. They pretend like none of this is taken into account, what they expect is to see numbers, so productivity is X, which should mean wage growth is also X. But things don't work like that in our social system of wage bargaining. With the tradition that we have in Belgium, this is not done. Even the employers' organisations would not want to disturb this social balance, because the economy would be heavily damaged if there are conflicts.* (Interview 26*)

It is important to refer here to perceptions (among multiple interviewees), given the fact that the Commission at no point has recommended that wages should be linked to productivity in a legally enshrined one-to-one manner. Commission officials in interviews even called such a possibility economically dangerous and explained they wanted wages to better reflect productivity differences, but also believed there should be room for bargaining to take other factors into account as well (Interview 48). But the perception of dogmatism of the Commission around the issue does not seem to come out of the blue. In subsequent MIP documents the Commission sharpened its tone. For example:

*Given the persisting challenge Belgium faces in this area [labour costs], decisive reforms are called for, including not just remedial measures to address past hikes in unit labour costs but a thorough modernisation of the wage-setting system in order to prevent any future decoupling between nominal wage evolutions and productivity developments.* (EC, 2013e: 4, emphasis mine)

The sharp tone did not go unnoticed in Belgium and led to annoyance. The Di Rupo government felt it was already taking significant steps; trade unions were already on the streets protesting. The sharp tone in the CSRs and documents was seen as deepening social unrest, since the opposition used them politically to criticize Di Rupo for a lack of effort. At the same time, the Belgian government asked the Commission to substantiate its position. The 2012 IDR cites an econometric analysis on the loss of employment that
can be linked to the wage gap (Konings et al., 2012). The Belgian government argued that this study alone was too meagre to convince. It was seen as based on a host of ceteris paribus assumptions and the paper was a joint exercise of the University of Leuven and VOKA, an employers’ organisation with a clear interest in the matter.

The discussion also sparked responses from Belgian professors. De Grauwe, for example, had already argued in 2010 that, when taking a historical perspective, the Belgian wage-setting system had not resulted in structurally higher ULC than the EU average, just a lot of cyclical movement around the average, but these were always corrected over time (2010). A year later he proposed a further decoupling of oil prices from the index to smoothen fluctuation (2011). Peersman, who is known to be more sceptical of the index, argued for coupling indexation to the ECB’s inflation target (Peersman and Van Nieuwerburgh, 2011). Interestingly enough, none of the domestic actors called for a more fundamental reform, such as the Commission was proposing.

The Staff Working Documents of 2012, 2013 and 2014 all note no to limited progress on implementing the CSR on wage indexation. The reform programmes of 2012 and 2013 had mentioned the possibility of reforming the Law of 1996, but no actual steps were taken. In 2014 Di Rupo definitively decided not to take any step and pass the issue on to the next government. As an alternative, the Di Rupo government adopted a Competitiveness and Employment Pact at the end of 2013. One of its primary measures includes lowering the VAT rate on household electricity consumption from 21% to 6%. This step contributed to inflation remaining below 2% in 2014, which in turn contributed – together with productivity gains and the low wage norm - to a slowing down of ULC growth. This can be considered a bit of a political trick to manipulate the index, as also seen in the past. The Commission considered this an insufficient and ineffective way to deal with the issue of ULC and continued to call for structural changes. The measures also clearly went against another CSR in which Belgium was asked to lower taxes on labour to less distortive terrains such as environmental taxation.

Interviewees were mostly divided on the efforts of the Di Rupo government on cost competitiveness. Some would describe Di Rupo as ‘not the staunch opponent of reforms as he is sometimes made out to be’ (Interview 16), or ‘cost competitiveness was taken very seriously’ (Interview 19); others saw his efforts as ‘mostly symbolic’ (Interview 24), or ‘he did the exact minimum’ (Interview 22). But overall it was clear that the call to reform indexation as such fell on deaf ears, as one Belgian official describes it:
The internal debate for many years has been ‘no one shall touch indexation’, you can change the name, so what does indexation mean, but indexation as such should stay, this has not really changed because of anything. This is the holy cow, you shall not touch indexation. (Interview 22)

The fact that both sides did not agree with one another does not mean that there was no evolution in the debate. Over time the Commission grew conscious of the sensitivity of the indexation debate and the ineffectiveness of the approach they had taken so far. Consequently, the Commission tried to broaden the debate and tried to remove the perception that it is dogmatically opposed to such a fundamental feature of the Belgian welfare state. The 2014 recommendation, for example, combines in the same recommendation the part on reforming indexation with issues that are more directed at the side of the employers, such as strengthening competition in certain sectors or offering schooling and training policies. Its 2014 In-Depth Review cites multiple studies on employment effects, loss of purchasing power for lower incomes. It further unpacks the concept of ULC and has a slightly more nuanced undertone than the 2013 position, for instance:

The widespread practice of some form of automatic indexation carries a high symbolic value in the eyes of both its supporters and its detractors. Suggestions for reforming this characteristically Belgian feature, including repeated calls in this direction by European institutions, have stirred stiff resistance by some players and are perceived as a dismantlement of the Belgian welfare state. However, the tangible advantage in the short term of swift purchasing power correction is offset by risks of creeping employment erosion over the longer term with insufficient versatility in times of economic distress affecting competitiveness. Certain reforms would carry important advantages and render the system more sustainable in terms of employment. (EC, 2014a; 52)

The change towards a more open tone finally resulted in the word ‘indexation’ being taken out of the CSR in 2015 and 2016, as Di Rupo had advocated at the beginning of the Semester process. Since then, the Council asks Belgium more broadly to bring wages in line with productivity. This might seem like a symbolic step, but was very important in the perception of the discussion on the Semester. It was a clear sign that overall in the discussion the tone was changing. This step can be explained by a number of factors. The first is that in general from 2015 onwards recommendations were slimmed down in the process of streamlining the European Semester. Secondly, there is the argument that the ‘political’ Commission Juncker decided to take a more distant approach towards
politically sensitive topics. With Juncker himself coming from Luxembourg – which is one among the few countries that has automatic wage indexation – and the Social Affairs Commissioner coming from Belgium, it is not unlikely that this ‘politicisation’ has played a strong role. However, what also became quite clear in the interviews is that the interaction between the European institutions and Belgian actors has played a role, for example with the introduction of the European Semester Officer.

Several interviewees have described a more open attitude and wider policy focus in discussions from both sides in later years. In technical meetings the experts would discuss the effects of indexation in two to two-and-half hour sessions and political discussions were held with the Cabinet of the Prime Minister. Some note that there was even some convergence of positions towards the end of the Di Rupo government, with the Belgians becoming more willing to discuss the negative sides of indexation and the Commission becoming more open towards the positives. This is how the change was perceived by some of the interviewees:

*The perception of the problem has changed from two sides, also from our side, especially in the recommendation, it has become more diplomatic, more neutral. There was too much focus on indexation. (…) I think initially five or six years ago, it was ‘wage indexation, it is a no-brainer, it does not make sense’ (…) So also from our side it has evolved, we have more emphasized that it affects employment, the adjustment of your economy.* (Interview 17 - Commission official)

*So it was a bit like we were insisting on what could be the remedy instead of making a diagnosis, this has changed in the last year. We now say indexation is a mechanism, but it is not the end problem. This has helped a lot in getting the message across.’* (ibid - other Commission official)

*Opening up the recommendation in 2015 has made it much more effective, it has opened up the negotiation to find a common solution, politically.* (Interview 24 - Belgian official)

To others it was still obvious:

*The Commission still thinks that wage indexation is a bad idea, I’m convinced of that. They just prefer not to say it, because they know that in Belgium only one word of this
recommendation will be read, which is indexation. (...) But it is still clear what is their concern. (Interview 22 - Belgian official)

6.5 Tracing the process II: the Michel government

What certainly altered the impact of the recommendation on the Belgian debate was the change of government in the fall of 2014. In the new Michel government, the socialist parties were replaced by the Flemish right-wing N-VA party. The N-VA was the most outspoken in opposing the automatic indexation mechanism, precisely along the lines of the CSR. Part of the explanation here is the fact that unlike the other major parties they do not have strong ties to the trade unions. They too believe there should be better possibilities for correction, more differentiation and better linking to productivity. They had criticized the Di Rupo government repeatedly for a lack of progress on this issue and used the CSRs for this purpose. When Michel came to power he made a strong case for a change of course on socioeconomic issues, with reforms to enhance competitiveness as a primary aim.

For the substance of these economic reforms, N-VA leader de Wever in his policy outline document during the formation of the government cites all the 2014 CSRs for Belgium literally and calls upon the new government to implement them (De Wever, 2014). This is an unprecedented step that clearly shows the different role of the Commission in the domestic political arena. In the Dutch or Italian political debate, it is quite common to refer to the Commission as overly meddlesome bureaucrats, whereas in Belgium the Commission is much more seen as an authoritative institution. It is more politically accepted to directly refer to Commission documents.

The subsequent Michel government in its governmental declaration decided not to question the mechanism of automatic indexation as such. However, it enacted another index jump in April 2015 to overcome the wage gap with neighbouring countries that had built up. The index jump is a one-off corrective measure comprising a temporary suspension of all wage indexation agreements until inflation has eroded real wages by 2% like Belgium had done in the 1980s. In terms of cost competitiveness and lowering unit labour cost growth, it did its job. The 2016 Country Report notes a flat ULC growth in 2014-2016, which in combination with more dynamic growth in other countries has

\[\text{In reality, he would focus primarily on the parts of the CSRs that were in relative accord with the view of his party, such as pension reform, wage setting or in part the tax shift away from labour.}\]
resulted in a narrowing of the wage gap (EC, 2016j). This narrowing can of course not be fully attributed to this measure alone but should be seen in conjuncture with the measures by the Di Rupo government and other measures to lower labour costs, such as a tax shift away from labour and reductions in social security contributions. But it has resulted in shifting attention away from the wage gap – which now was no longer a real issue - towards longer-term sustainability of the system, and thus a reform of the Law of 1996. The Commission never recommended an index jump specifically; for them, the preferred solution has always been a reform in the broader context, rather than one-off corrective measures.

Belgium was told that in principle the issue of the existing wage gap (since 1996) was dealt with, but there were no guarantees that a new wage gap would not emerge in the future. But, since the overall trends were on a path of correction, the Commission decided for 2016 that Belgium was no longer experiencing macroeconomic imbalances and should thus be taken out of the MIP. This decision can be seen as a recognition of the efforts of the government to close the wage gap as also shown by the facts and figures and was certainly celebrated as such by the Belgian government. It also shows that despite the fact that the government pursued the goal by other means than the Commission prescribed, the Commission still recognised that the goal was slowly being achieved. The decision to take Belgium out of the MIP was also linked to reform efforts on other issues, most notably in the area of pensions, taxation, and the labour market.

The importance of this step for the Belgian context was mainly in terms of political communication. Here it is important to note that the government programme resulted in heavy protests. Being taken out of the MIP is seen as evidence that the government is on the right path, that their work is bearing fruit; indeed Michel prides himself on being a reform champion. Especially for the N-VA this is an important political signal that there is a difference between this government and the previous government with the socialists. As confirmed by an N-VA official: *That is indeed the message we want to get across* (Interview 27°). It is important to understand that the N-VA came into existence to establish a reform of the state to ensure more independence for the Flanders region. In the Michel government, they did not manage to secure any major concessions on state reform, which makes a clear change of course on socioeconomic issues all the more important to preserve their electoral base. Similarly, it has to be borne in mind that the Michel government (and especially N-VA) was in a difficult position on other right-wing issues: Belgium in 2016 experienced a relatively large influx of asylum seekers which created a lot of tension and the budget deficit increased in 2016, whereas it decreased steadily under Di Rupo. The Commission in this sense was seen as an independent
and authoritative referee on the effectiveness of this government. The ambition in the
governing document was to have the wage gap fully closed in 2019, so achieving this
three years early was seen as a clear victory.

However, the Commission’s real concern on wages was not the wage gap alone, but long-
term sustainability and thus a reform of the Law of 1996. With the Di Rupo government
also promising a reform of this law, but never sufficiently delivering, the Commission’s
decision to take Belgium out of the MIP before a definitive deal is struck was taken badly
by a number of Member States. They voiced opposition in the EPC because they feared
that this would relieve Belgium of the necessary pressure especially on reforming wage
indexation. Interviewees, however, stress that despite the decision to take Belgium out
of the MIP, the pressure was still very much felt. For example:

So they took Belgium out of the MIP now, because it is clear that we will be back in if
nothing happens. The Commission and the EFC gave off this warning… it creates strong
pressure on this government and it is really the first time that I see that, that the pressure
is so strong. (Interview 24)

Interestingly, this decision by the EFC put the Commission in a position of leverage in
which peer pressure is more effective than in other cases. It is clear that it would be
a very bad political sign for the government if they were to be put back into the MIP.
And this put pressure on the negotiations to come to an agreement. In the fall of 2016,
Belgium had to come with its Draft Budgetary Plan for 2017 in order to meet the deadline
for the budgetary scrutiny of the Two-Pack regulation. In May 2016 Belgium had just
managed to escape the opening of an Excessive Deficit Procedure. The so-called Article
126(3) TFEU assessment, the first step in the EDP, had given Belgium leeway due to
structural reforms being implemented that would benefit public finances in the long-
term, primarily the pension reform. But for the following year, it was clear that Belgium
needed to put in an extra fiscal effort (EC, 2016k). Here it has to be remembered that
Belgian public debt rose to 107% of GDP in 2016.

Ahead of these budgetary negotiations, it was clear to the government that they needed
to come up with a broader story than just fiscal cutbacks. A reform of the Law of 1996
would be the most prominent on the agenda. One interviewee who was closely involved
in the negotiations over the Law of 1996 argues that there is a clear link between the
budgetary assessment of the Commission and the planned reform:
So they say to the government on the Law of 1996, if you book that, we will be less problematic with the budget. Which is very important for the government, because if we stay with the same budgetary trajectory we need to make 9 billion in savings, but not if we change the parameters and if the Commission says that the priority is wages and then they will be more lenient with the budget. (...) I am sure that the Commission in another situation with another government would never do that because it would change nothing. But it means that we are now in a situation where the Commission also analyses the political situation in a country. (Interview 24)

This link is all the more curious given the fact that the assessment of the Commission in autumn is a purely fiscal one. Efforts on structural reforms have no de jure place in the autumn assessment. This establishes whether the planned budget is in accordance with the Medium Term Objective and looks back at compliance over the last year. If a Member State’s budget shows significant deviation from the planned adjustment path, it is deemed at risk of non-compliance with the provisions of the SGP and a new assessment follows in spring on whether or not to open up an EDP, the Article 126(3) TFEU assessment. Only in this later assessment are growth-enhancing structural reforms, i.e. those that improve the public finances in the medium term, included in the assessment of whether to escalate or de-escalate within the procedure.

For the reform of the Law of 1996, this in practice would mean that the Commission would have to calculate the medium-term effects of the reform in a quantified way. With pension reform this is possible, but with the Law of 1996 this is a lot more difficult. Formally the MIP and EDP are separate procedures (apart from the indirect link in the Article 126(3) TFEU assessment). A Commission official denied the existence of a de facto political link in the autumn assessment, arguing instead that this is political rhetoric on the Belgian side (Interview 48). But while the autumn assessment is a purely fiscal one made and published by the Commission services, the Commission (this includes the College of Commissioners) also adopts a resolution on the basis of this assessment by the services, which in turn is discussed by the Eurogroup. While this opinion and the Eurogroup discussion is fully based on the independent and numerical assessment of the services, one could imagine political elements being included in practice. The following explanation on the context of the previous quote supports this theory:

\textit{It was said in a bilateral meeting; it was also the first time in a meeting between the government and the Commission that the desk experts were not present. It was only the political level and the Commission, from the EU it was people of the EFC and the SecGen.}
They will perhaps not recognise it, but for the government, it was very clear. (Interview 24)

This perception of a link is widespread among interviewees, as other examples show:

In Belgium pressure is a bit more felt, because each time we have to explain why we have a government deficit which is higher than originally announced, the Commission says that if we do a bit more on structural reforms we can discuss this. And wage setting is, of course, a structural reform. It is a very political thing, the MIP is an instrument the Commission has to put pressure on a country, an instrument that works better if you can blackmail the country a bit, you need some leverage. (Interview 22 - Belgian official)

The new budget will leave us - if we stick to all agreements – with a headline deficit of around 1.7%. That is close to what we promised the EU. I think they will give their approval, but then we have to show that we are serious with our structural reforms, and that, of course, includes the reform of the Law of 1996. (Interview 27* - N-VA official)

In addition to there being a political link between the budget negotiations and structural reforms it is also convenient for national politicians to link the two in practice so that a package deal can be reached in which there are no clear losers within the coalition. But package deals are difficult. The three coalition partners, in the end, managed to come to an agreement, just hours before the deadline. It was a close call and the coalition nearly fell apart. Domestic political factors remain dominant in explaining why the change of policy occurred. For example, the CD&V - which is a more centrist force in the coalition - had become convinced of the need to reform the Law of 1996. Reforming the Law of 1996 had traditionally not featured in their party programmes, but their 2014 party programme included a new position: namely, to close the wage gap and reform the Law of 1996 to prevent the emergence of a new wage gap (CD&V, 2014). But despite this change, it was still very difficult to come to an agreement for reform. The negotiation on the reform of the Law of 1996 was described by insiders as one of the most controversial elements in this package deal. And the role of the EU here was important to give that final push to come to a compromise, as an N-VA official explains:

.. and then it is useful to have an external authority to give a little push in the right direction and support our path of reform, otherwise it will require a recession again to get this reform dynamic going. (Interview27*)
The package that was agreed in October 2016 indeed included a number of new provisions to change the Law of 1996. It was agreed that the practice of automatic indexation in principle stays, this remains the holy cow, also for the years to come. We would have seen months of social unrest if we would have touched that – the N-VA interviewee sighed (Interview 27*). Under the new Law of 1996 it also remains difficult to differentiate and there is no new provision included that asks to better reflect productivity differences. The new provisions allow for better correction to ensure that a new wage gap does not emerge in the future by making the wage norm stricter. This includes a provision on how to calculate the wage norm. The old law stipulates that this is done on the basis of OECD projections of wage dynamics in the three neighbouring countries, but these turned out to be over-optimistic in many cases and the publication of the statistics often did not fit the timing for a new wage norm. It was already standing practice to base the new wage norm on the most cautious of a series of national and international projections, which in the new law would also be legally enshrined. More important is the inclusion of ex-ante corrections, which allows adjustment of the maximum wage increase for the next two years to the difference between the actual wage increases in Belgium and in the three neighbouring countries over the two previous years. Combined with the introduction of a safety margin for the future, it makes the wage norm considerably stricter and corrects for over-optimistic assumptions.

The update of the law also allows correcting for the full wage gap, not the one accumulated since 1996, which allows to further limit wage growth. And it provides for the legal possibility for the government to intervene in sectoral agreements if they surpass the wage norm. The wage norm has no strict legal status, but should rather be seen as a gentlemen’s agreement, while with the updated law the government can issue fines. This was already possible in theory, but in practice was never used; under the new law it is made a bit easier. And finally, if despite all these safety margins a wage gap still emerges that cannot be closed within two years (remember that the index has priority over the norm) the government is obliged to intervene, which makes it easier to introduce an index jump.

The new law preserves indexation but makes the practice considerably stricter. The law shows the great lengths that Belgium goes through to safeguard indexation. With the stricter wage norm, the margin for wage bargaining, in theory, can become very small. But, while the new system still does not reflect productivity differentials or easier possibilities to opt-out and while indexation can still generate second-round inflation effects, the Commission considered the reform sufficient. The 2017 Country Report notes that substantial progress has been achieved and since it is highly unlikely that the
negotiations on the Law of 1996 will be re-opened any time soon the CSR was taken away (2017g). For the Commission, the issue of ex-ante corrections was a crucial issue. Before the negotiations took place this was already clear to those closely involved:

*The influence of the Commission on this issue is strong, it really is peer pressure. The arguments of the Commission are taken seriously in Belgium, we will have to adapt the law.* (Interview 19* - Belgian official)

The assessments from the Two-Pack that followed – written by the Commission services - after the negotiations had taken place did not show any leniency on the fiscal side due to the reforms, like Belgian actors had expected. Belgium was labelled as at risk of non-compliance (EC, 2016l). This was a clear setback for the Michel government. The next day one of the major newspapers opened as follows: ‘The Di Rupo government got Belgium out of the class of fiscally bad students. But with the Michel government we are on our way back in. The image is killing for a government that prides itself on budgetary orthodoxy’ (De Standaard, 2016*). However, this step only called for the opening of the Article 126(3) report. In this report, a more political document, a more ‘comprehensive’ assessment of the fiscal situation is provided for. This report reiterated the strengthened link between the SGP and structural reforms, praised Belgian progress on the latter, underlined the substantial progress achieved on the CSR concerning wage setting and listed it as among the reforms that will have a positive impact on debt sustainability in the medium to long-term. And while Belgium is asked to introduce additional budget cuts in 2017, it does not open up the EDP for the country (EC, 2017h). This document seems to support the claim that the wage-setting reform should be seen as integrated into the fiscal assessment and that the EU institutions used the entire toolbox to put pressure on the Belgian government.

### 6.6 Analysis: the continued controversy over the role of wages in EMU

This chapter started off by describing the legal safeguards in the MIP Regulation to protect the role of social partners and respect the national practices and institutions for wage formation. Any serious talk about wages or wage setting in EU institutions was long considered taboo, before the crisis. But in recent years a whole range of changes has been introduced to wage-setting arrangements in the various EU Member States. In many cases, this has been done by government intervention, more than by consensus of
social partners and the general direction of reforms has been towards decentralisation and flexibility (Marginson and Welz, 2015; Visser, 2016). The most significant changes have been in introduced in countries receiving financial assistance. But also under MIP surveillance states have responded to CSRs on wage-setting arrangements. For example Italy, France, and Slovenia have each introduced increased possibilities for companies to derogate from sectoral or branch-level agreements at some point, thus responding (to varying degrees) to their MIP CSR. The case of Belgium shows that the CSRs can have a direct effect.

Domestic political factors remain dominant. In Belgium there was a right-wing coalition with a favourable view towards the CSRs. It is doubtful how much additional pressure would have done for the Commission’s case under the Di Rupo government. The EU in general is held in high regard by Belgian elites, so that CSRs are taken very seriously. But this case shows that the MIP can in certain circumstance do more than just trigger domestic discussion and keeping issues on the agenda; it exerted real pressure, including through linkages with the SGP. The outcome of the process leaves an uneasy feeling about whether this pressure is in accordance with the legal safeguards on wage setting in the MIP Regulation.

There has been a continuous debate among experts on how to reconcile the need for coordination of wage developments within the EMU with the need to protect the role of social partners. The role of the MIP here is controversial. And the irony of the situation is that the Belgian system has actually been held up as an example in this debate. Sapir and Wolff described the Law of 1996 as an example that should be followed by others to reconcile national wage developments with convergence in the EMU (Sapir and Wolff, 2015). The idea gained traction among EU leaders, the Five Presidents Report suggested the setting up of Competitiveness Councils in each Member State to give advice on productivity trends and mentions Belgium (together with the Netherlands) in this regard (Juncker et al., 2015a). The idea was inspired by the proposal of Sapir and Wolff.

The subsequent discussions in the Council started with the idea that independent institutions would give non-binding advice on the wage norm, much like the Belgian...
Central Economic Council in the Law of 1996. Long discussions have been held on the
proposal, but in the end, a lot of scepticism remained in the EPC and EMCO (see e.g.
EPC, 2016). Member States were hesitant about giving too strong a role to independent
authorities in the wage-setting process. And trade unions interpreted the idea as an
attack on the autonomous position of the social partners (ETUC, 2015). It should be noted
that in Belgium this body is mostly in the hands of social partners themselves. The final
Council proposal for setting up National Productivity Boards does not mention wages
(apart from stressing the Treaty provisions that protect the role of social partners). And
it reiterates the prominence of the Semester and MIP (Council, 2016). It indicates that
while the taboo on talking about wages in the EU setting might have been broken, the
topic is still highly sensitive and the EU struggles to find the right format.

The European debate on wages continues not only in terms of finding the right governance
framework for coordination but also on whether the push for decentralisation of
bargaining has been the right choice. The 2017 Annual Growth Survey clearly strikes a
slightly different tone on wages than documents at the start of the Semester process six
years earlier. The Commission still argues that wages should follow productivity trends
and continues to argue for decentralisation, but also criticises Member States (primarily
the Netherlands and Germany) where wage trends are too modest with respect to
productivity trends (EC, 2016m). The general debate in Europe seems to move slowly
in the opposite direction over the years as compared to the developments in Belgium.
The euro area moved collectively into surplus on the current account and fighting a lack
of inflation and lack of demand has come more to the forefront of policy debates, as
opposed to building up external competitiveness by tempering wage growth, especially
in a context where monetary policy has hit the zero lower bound.

As stated in section 8.2, the growth of disposable household income has been rather
stagnant in many states. The ILO and OECD warn that when falling labour shares are
not offset by investment countries tend to rely more on credit and net exports in order to
maintain demand so that new imbalances could arise (2015). Others have argued, on the
basis of Real ULC trends that contrary to the classic theory that decentralised or flexible
wage setting institutions allow countries to better adapt to shocks, it is actually the other
way around. The EMU in their view requires more centralised bargaining institutions to
achieve aggregate targets and prevent falling wage shares; decentralisation would only

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According to one Belgian official it was primarily the Germans who were opposed to the idea
of including specific references to wages in the proposal. This would imply a shift of thinking, given the
Germans’ insistence on wage coordination at the start of the crisis.
Part II: In-Depth Case Studies

lead to race-to-the-bottom dynamics (Horn and Watt, 2017; similar arguments have been made by Hancké, 2014 and Vandenbroucke, 2017).

Others continue to argue that wage rigidities (read: more centralised bargaining systems) have exacerbated employment losses over the last years (di Mauro and Ronchi, 2015; ECB, 2017a). But interestingly enough, in a paper on wage inertia in the EMU two top officials from DG ECFIN (in a personal capacity) conclude their paper as follows: ‘recent reforms have generally focused on reducing obstacles to the decentralisation and articulation of wage bargaining, but, [...] developments in the direction of strengthened national-level coordination would also help an aligned reaction of wages to cyclical conditions across sectors and firms, which in the current context would also contribute to Eurozone rebalancing’ (Buti and Turrini, 2017).

In light of this continued discussion around the issue, the dogmatism of the Commission in the first years, as perceived by the Belgians, seems a bit misplaced. Belgium fought the CSR on intellectual grounds, but there has been a continuous domestic debate on reforming the system. In the end, only relatively minor changes were introduced to the indexation practice, in comparison to changes in other Member States. The MIP managed to have an influence on the automatic corrections that have been introduced. Automatic corrections might deal with the possible build-up of wage gaps in the future more efficiently. But all the measures that were taken over the years certainly have had negative consequences, especially for the trade unions.

Trade unionists pride themselves on their role in the collective response of social partners and government at the start of the crisis. At a time when banks had to be saved, they managed to help maintain social peace, with a central agreement that included a 250 euro lump sum, which helped preserve purchasing power. In the eyes of trade unionists, this was a moment of unprecedented consensus, built around social dialogue. But in the following years, their position came increasingly under threat due to direct government intervention, as opposed to dialogue and bargaining. This started with the Di Rupo government, which intervened in wage bargaining by altering the index and introducing a two-year wage freeze before negotiations on the bi-annual wage agreement had started. This hollowing out of dialogue and bargaining continued under the Michel government and with the reform of the Law of 1996, as increasing automaticity by definition decreases room for dialogue (Van Gyes, Terlinden and Vanderkerckhove, 2017). Times have changed, as a trade unionist complained: ‘Currently the trust in social dialogue is completely gone’ (Interview 23°). Another interviewee likened the reform of the
Law of 1996 to ‘the perfect standing in the way of the good’ (Interview 18).

Of course, it would be a caricature to say that the EU is solely responsible for the decline of Belgian trade unions, as domestic factors remain dominant. But this chapter has shown that the EU’s influence on the issue has been strong and reforms always have collateral consequences. The EU should be wary of putting itself in a position where it cannot account for the consequences. It is not easy to define a clear-cut point when the EU crosses the line in this respect. On the one hand, the value of the entire exercise of the MIP is to present an external viewpoint. Domestic actors can sometimes have a bias towards preserving domestic institutions that might not make sense to outsiders. And indeed, social dialogue had been difficult and inefficient in the area of cost-competitiveness over the years. At the same time, a well-functioning socio-economic fabric is also important for building consensus in the future around structural reforms. All in all, this case shows that overly strong insistence on one particular view can be problematic when there is high uncertainty.

To end on a more positive note, there seems to have been a realisation on the side of the Commission about the delicacy of the situation over time. Interviewees were unanimous in praising the value of an increased interactive approach, which nuanced positions on both sides. Meetings with the Commission were held at the highest level of staff (Cabinet of the Prime Minister), trade unions were invited to DG ECFIN to explain their position and a parliamentary session was held in which Commission desk experts explained Semester issues to Belgian parliamentarians. The increase in the interactive dimension has led to a more constructive relationship, both employers, and trade union representatives stated in the interviews that they use the Commission’s reports to substantiate their positions in discussions (on different issues). As a trade unionist - who started off as being very sceptical about the Semester – explains:

In these meetings they [Commission officials] are confronted with real life, so not only reports and studies. You can explain them things, we show them that there is different material available, we challenge them, they challenge us, so that is inspiring. They also realised at DG ECFIN that their view was challenged, but then they introduced these European Semester Officers. (...) These ESOs have created a lot of trust. We are on speaking terms. (...) And those Country Reports are getting better every year, we use them here internally. (...) They have a lot more attention for qualitative factors. (Interview 23*)
6.7 Conclusion

The role of wage policy in EMU remains a controversial topic. With the MIP the EU has gained a more prominent position in national wage policies, but debates continue on the rationale of wage policy coordination in EMU, on finding the right governance framework for the coordination of wages and on the substance of CSRs concerning wages. The Belgian case offers valuable insights into all of these dilemmas. It shows the clash between the rationale of international institutions with a fixed idea on how wages relate to external competitiveness and domestic knowledge where a traditional wage indexation mechanism is guarded as a sacred cow. In the end, reforms have been introduced and these have been labelled as substantial progress, with the CSR dropped for Belgium. But in hindsight, it remains an open question whether these have improved Belgium's wage-setting framework to such a significant extent to justify this level of EU involvement. The intervention certainly has not been without collateral consequences.

Hierarchical elements are more pronounced in the Belgian case, where the EU institutions have used all means available to create leverage in the debate. But ultimately their use of power still relies to a large extent on reputational damage. The EU is held in high regard in Belgium and the Commission has acted as an authority in the debate. It also shows that the composition of the coalition is an intervening factor, as the right-wing government had promised to be reform-minded, which put the Commission in a different position. As interviewees confirm, the Commission would not have given out the types of warnings that they have with a left-wing government, because they would not have any effect. The Belgian case also shows that MIP CSRs are contestable, as both parties had to invest in substantiating their position to come to a fact-based analysis. The CSR triggered serious discussion and investigation into Belgian's external competitiveness evolution. All in all, we can conclude that in Belgium, the MIP has become more interactive over time, as well as more political, and it has had an effect on the reform agenda of successive governments.
Chapter 7

The Liberalisation of Professional Services in Italy

7.1 Introduction

Italy is undoubtedly a prominent case when assessing the MIP. It is widely seen as experiencing severe imbalances in the economy, most notably high public debt in combination with persistent low economic growth. The Italian economy has structurally underperformed compared to other large euro area states since it introduced the euro and has been much slower in the recovery since the crisis. The IMF warned that without significant changes Italy is not expected to return to pre-crisis levels of economic performance until the mid-2020s. Other euro area states will have grown 20-25% larger than 2008 by then (IMF, 2016a). The prospect of not one, but two ‘lost decades’ does not only create economical difficulty in terms of servicing the debt or further complicate the rebalancing of the banking sector, but also challenges confidence in the political class to deliver results. Economic commentators have feared that the next crisis will come from Italy (Mody, 2018). Or that Italians will ultimately turn against the euro and try to step out of the EMU (Fuest, 2017a; Münchau, 2016). In Spring 2018 it also looked like the incoming Italian government would indeed do such a thing and risk a full-blown crisis. A crisis was averted but euro exit remains a looming issue that could trigger a new crisis. Some Italian politicians (e.g. Borghi, 2018) or academic commentators (e.g. Stiglitz, 2018) believe that taking such a step would ultimately be best for Italy. Whether Italian politicians will continue to play around with the idea of leaving the euro remains to be seen. In any case, Eurobarometer data shows that Italy has moved from the top to the bottom in terms of euro-favourability in recent years (Roth et al., 2016). The imbalances in Italy are as much political as they are economic.

At the heart of the Italian slowdown lies a lack of productivity growth. Productivity is
one of the most difficult economic variables to affect through policy, as the functioning of the labour market, educational system, efficiency of the public administration, tax incentives and the banking system are all part of the story. In that sense, all the CSRs for Italy are in a way linked to productivity. One segment where productivity has been especially low is the services sector. Accordingly, Italy has been repeatedly recommended to increase competition in services to drive investment towards more productive providers. This chapter will zoom in on one aspect of the CSR on competition in the services market, namely the liberalisation of professional services, with a specific focus on three heavily regulated professions: lawyers, notaries, and pharmacists.

In and of itself an increase in competition in these three sectors is not the biggest hurdle in the Italian economy. It will only impact productivity in an indirect manner, such as lower prices. Rather it should be seen as part of a broader package of CSRs to reduce structural impediments to growth. It aims to reorientate the economy away from traditional (family) structures, cronyism, rent-subsidizing protections and clientelistic distributions. This package also includes stirring up local public services, the public administration and public expenditure, the civil justice system and inefficient tax schemes. They can be seen as classical structural reforms, in the sense that they ask for initial disruption among a group of insiders for potential gain in the longer term and for society as a whole. The professional services CSR is treated as a symbolic case to show the difficulty of implementing these types of reforms in Italy, as the CSR comes back every Semester cycle. Competition in services is in general one of the most common CSRs in the MIP. And all the larger states, Germany, France, Spain, and Italy have received multiple CSRs specifically focussed on their professions.

The EU still has more than 5500 regulated professions, accounting for 22% of all employees. Restrictive regulation of professional services can give rise to high mark-ups and constrain business dynamics and investment. The Commission sees opening up this market as a potential source of growth, given the increasing role of professions in value chains and their contribution to productivity in manufacturing and other sectors (Bienkowska, 2016). For Italy, the IMF projects significant gains of 3,5% to 7% economic growth in the medium to long term in case of full liberalisation of the services sector (Lusinyan and Muir, 2013).

The EU sees structural reforms as essential for recovery of the Italian economy. Italy has experienced a long history of external pressure from the EU to introduce reforms to strengthen the economy. In the run-up to euro introduction, Italian elites used the
requirements to join the euro to circumvent domestic opposition and institutional sclerosis to push through reforms and shore up the public finances. But over the years – as this chapter will show - such external pressure has become suspect in the eyes of the public and the EU’s push for reforms has even worked in counterproductive ways. This has weakened the MIP’s ability to exert a strong voice in the political debate. Unlike the Belgian case, the main challenge to the MIP’s argument does not lie in shaping consensus, but rather in building wider societal support and political momentum. In the case of professional services liberalisation, consecutive Italian governments agreed with the Commission, but considered this reform a second-order priority. The EU’s calls for reform were not strong enough to overcome heavy domestic opposition by organised interests. But before addressing the resistance to reform, this chapter will first give some background to Italy’s macroeconomic imbalance and why liberalising the professions could help tackle it.

7.2 Italy’s high debt/low growth imbalance

The Italian economy has many things going for it. The level of private debt is among the lowest in the euro area, household savings have traditionally been high (but on a downward path) and the public sector holds a large amount of assets. Italy’s current account deficit has been relatively modest and turned to a surplus in 2013 (albeit due to falling demand). Italy has more foreign liabilities than assets (Net International Investment Position), but the difference is relatively modest and stable in comparison to other euro area states. And even though export market shares have fallen significantly and their geographical spread is limited, Italy’s exports are among the most diversified in the world (Abdon et al., 2010). Italy has a broad industrial structure, the second largest manufacturing base in Europe and especially in the larger firms in the Northern regions productivity is high (Banca d'Italia, 2016). Parts of the Italian economy are flourishing; the food sector around Parma or the fashion industry of Milan, to name but a few. But that's about where the good news stops. Economists and EU experts worry deeply about the state of affairs in Italy. The imbalances in Italy have resulted in high unemployment and flat or falling incomes for all households in recent years (Dobbs et al., 2016). Before analysing the role of professions, this section will first set the scene and describe why Italy ended up at the bottom ranks of the MIP.

The first thing of notice is Italy’s large pile of public debt. In absolute terms, Italy has the largest public debt stock in the EMU, roughly 2.2 trillion euro in 2014, or 132% of GDP, second only to Greece in relative terms. High debt stocks can remain stable if economies
are growing, a high government debt is not a problem by definition, many institutional investors rely on government debt. In order to assess vulnerability debt-to-GDP is not the only indicator one should look at. It also matters who owns the debt, in what way it is financed, what the size of future liabilities is (pension costs) and what the trend in debt-to-GDP is since the real vulnerability lies in rollover risk (Cottarelli, 2017). The Italian treasury has to refinance roughly 380 billion euro per year to service the debt. Italian bonds have longer maturities and are largely financed by domestic investors; this makes a Greece-like situation unlikely. But with a high debt stock investor confidence in the Italian economy is still a key concern. During the highlight of the crisis, the interest rates surged to around 7%.

Chapter three on the evolution of imbalances has described the process of foreign investors and banks liquidating their Italian assets at the start of the crisis and the national banks, supported by the ECB, stepping in. This has stabilised Italy’s debt structure a lot, but there is still vulnerability. If the markets were to question the sustainability of Italy things could easily spiral out of control. Whenever there is economic or political turmoil, everyone immediately looks at the spread between Italian and German government bonds. This sensitivity is likely to (slowly) increase when the ECB starts to wind down its asset purchase programme. But perhaps more importantly, the inability to further increase public debt (without risk) limits the possibilities to stimulate growth by public spending, as many Italian politicians would like to do. It is a constant source of conflict with the EU institutions. And experts – especially in Northern Europe – worry that in a future crisis the interdependence of banks and sovereign debt could result in a doom loop, whereby trouble on one side affects the solvency of the other.

Due to its large debt, Italy sometimes has the reputation of a reckless spender but the opposite is true. Italy has run a significant primary surplus since the 1990s (2009 excluded), meaning that on average the state has more revenue than it spends if you exclude the interest payments on its existing debt. To a significant extent the large debt stock is a relic of the unstable governments of the 1970s and especially the 1980s. After the severe recession of the early 1980s, Italy saw a period of consistent growth above 2.5%, but also reckless spending as political parties extracted spending commitments in exchange for parliamentary support. This resulted in deficits of over 10% a year and an increase of the debt stock from 59.8% of GDP in 1981 to 100.6% in 1991 (Bull, 2015). In the 1990s Italy faced borrowing rates at an extraordinary level, but – with the prospect of joining the euro - managed to get its spending in order. With the adoption of the euro interest rates fell substantially, but overall payment on interest still stood high, averaging at 5% of GDP since 2000. Italy might not be a reckless spender, but its promise
at the start of the euro to bring down its level of debt has not been kept.

When the MIP was still being designed, the Italians argued that debt to GDP should not be a part of the MIP scoreboard, since it is already included in fiscal governance and should thus not be duplicated. But a majority of Member States, the Commission and ECB argued that with high debt to GDP you are vulnerable and the scores on every other indicator become more risky. For this reason, every CSR for Italy is linked to the MIP.

Public debt and the linkages to the banking sector are a source of vulnerability, but the most important imbalance of Italy is low growth. The Italian economy saw high growth rates in the years before EMU and productivity levels were above those of Germany and France. Italy’s industrial base depended to a large extent on exchange rate flexibility. Italy repeatedly used devaluation of the currency to compensate for high inflation and wage growth, which provided temporary relief for competitiveness loss. But it was a costly strategy since it also led to inflationary spirals, perverse distributional effects and discouraged much-needed investment and innovation in the private sector (Ferrera, 2016). Similarly, Demertzis et al. argue that the devaluations that occurred with the Lira in the 20 years before euro introduction did not benefit employment; rather the economy has benefited from periods of currency stability (2017). Italy is the only euro area country that has seen a decline in labour productivity since euro introduction. Especially Total Factor Productivity (TFP) - the portion of economic output that is not explained by increases in labour or capital, but rather by adopting new technologies or more efficient business practices - has declined by 0.3% on average each year since Italy adopted the euro in 1999. In Germany and France TFP went up in that same period by about 10% and non-EU countries saw an even stronger increase (Pinelli et al., 2015).37

The exact nature and causes of the productivity slowdown since the 1990s is a topic of debate among economists (for an overview see e.g. Calligaris et al., 2016; for a more critical view on the productivity narrative, see: Jones, 2016). The slowdown coincided with the introduction of the euro, so often causality is assumed. Blaming the euro for Italy’s declining competitiveness has become a powerful narrative in Italian politics.

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37 An important nuance when discussing productivity in Italy is the fact that there is a strong regional dimension to it. Many regions in the North of Italy still have relatively high productivity. There is a difference between small and larger businesses also. Similarly, productivity, especially TFP, is difficult to measure, one has to bear in mind that Italy is a country where businesses do not always give up all the right statistics (for tax reasons). Also with the studies on TFP growth estimates the models are based on a lot of assumptions, it is sometimes seen as more of an art than a science.
Part II: In-Depth Case Studies

But the linkages between the euro and the Italian slowdown are not obvious. There is some reason to assume that the euro was an aggravating factor in existing imbalances. For example, Gopinath et al. (2017) argue that the decrease in costs of capital after euro introduction has driven capital misallocation in Italy, thus hampering productivity growth. The overvalued euro may have contributed to the loss in export market share it has been experiencing since euro introduction (e.g. De Cecco, 2007). And exchange rate appreciations continue to have a stronger effect on Italy than for example Germany, where exports are relatively price insensitive (see chapter ten).

But blaming the euro's hard currency paradigm alone is too simplistic. Italy has traditionally been largely reliant on industrial districts very specialized in narrow sub-sectors of industries, often small family-owned businesses, whereas productivity gains in recent years have come primarily in the larger firms (Draghi, 2016). The wide array of traditional firms have come under increasing competition from low-wage countries and China’s accession to the WTO. With increasing competition on price and a fixed exchange rate, Italian companies had to adapt to higher quality goods and new markets. For some markets this was successful, but in general, the adaptation has been slower than elsewhere. Similarly, Pellegrino and Zingales argue that traditional corporate structures hampered Italy from reaping the benefits of the ICT revolution, which explains an important part of the productivity slowdown (2017; Calligaris et al., 2016 make a similar argument).

What is clear about Italy and the euro is that the hope among policymakers in the 1990s that the stable currency and lower interest rates would be helpful for a transition of the Italian industrial structure – as formulated in the Lisbon agenda of 2000 – has been rather disappointing. Since the crisis, Italy has been trying to catch up with a series of structural reforms to regain momentum. This transition could benefit from increased competition in the services sector. In 2016 Italy ranked 50th in the World Banks’ Ease of Doing Business index (up from 80th before the crisis), the third lowest of the EMU. An increase in competition in these sectors through liberalisation – so the theoretical argument goes - would lead to a crowding out of unproductive providers, a reallocation of resources towards more productive providers, lower prices and fewer barriers to doing business (for the effects on growth see: Lusinyan and Muir, 2013; Canton et al., 2014). High costs for services are a drag on the Italian manufacturing sector and Italian society at large. Italy has a strong dispersion between relatively low average income and high prices in shops. The Commission, for example, argues that prices in the Italian service sector have grown more than the average in the euro area and have remained rigid during the beginning of the crisis (EC, 2010).
It must be noted that Italy has already before the crisis made substantial liberalisation efforts, including in the services sector. Italy’s overall Product Market Regulation score (PMR) – which is meant to capture the degree of open competitive environment in the economy – was above the OECD average when the Semester was first introduced. PMR scores measure legislated reforms, but the real problem with these reforms lies in their implementation. And the three professions under study in this chapter had – before the crisis – managed to escape much liberalisation. The OECD indicator for restrictiveness for six professions (including notaries, lawyers, and pharmacists) stood by far the highest in comparison to other OECD states before the crisis (OECD, 2009; 186). The costs of a reform in this area are concentrated and felt immediately, whereas benefits are much more dispersed and not always easily detectable. As a result, political incentives for reform in this area are low and it is difficult for politicians to find a convincing narrative to organise consensus around reform. The position of the European institutions is clear, as exemplified in the conclusion of a special report for the Eurogroup published days after the resignation of the Berlusconi government in November 2011:

To secure broad and lasting support [for structural reforms], the government needs to clearly and convincingly explain the unbearably high costs of failure, pit the benefits to the society as a whole against the unavoidable resistance from vocal interest groups’ loath to lose their special privileges, and ensure that everybody contributes to the adjustment efforts with fairness principles. (EC, 2011a; 8)

7.3 Professional orders and pre-crisis reform

Like many other European states, Italy distinguishes between regulated and non-regulated professions. The difference with other countries is that the orders that control the regulated professions in Italy have been particularly strong and autonomous. The regulation that governs their self-regulatory power dates back to the fascist era (regulated in Act No. 897/1938). The ideas behind this can be traced back to corporatism or the guilds of the Middle Ages. Membership of these so-called Ordini is often compulsory, the orders can discipline their members and over the years they have built their own rules, norms and hierarchies, translated into codes of conduct. There are good reasons to delegate a degree of autonomy to professional associations to regulate their profession. For instance, monitoring the quality of the incoming professionals is something that is better assessed by peers. However, in certain professions it is questionable whether the extent of barriers to competition is necessary to preserve quality, or should rather be seen as the protection of privileged interests.
Until the first big reform of professional services in 2006 started to erode their autonomy, the orders had a strong grip on the market. They could set qualification standards to control entry, such as education requirements, examinations or apprenticeship requirements. In the case of notaries and pharmacies, there are also quantitative restrictions on entry. The orders of notaries and lawyers could also control the market through regulations that set or recommend tariffs, allowances, and principles for reimbursement and prevent negotiated compensation or outcome-based pricing. Orders could also prevent or restrict advertising or prohibit certain business structures such as the setting up of multidisciplinary firms. The scope of activities is also regulated in certain professions. For instance, the requirement of authentication by a notary is not just limited to real estate transactions, but also covers a range of activities for corporate governance (transactions in ownership shares) or setting up a business. Similarly, drugs can only be sold in pharmacies, whereas the sale of non-prescription drugs (over-the-counter, OTC drugs) has been liberalised in many other states. Finally, lawyers have a special status in Italy; their national body the Consiglio Nazionale Forense (CNF) is seen as particularly powerful. Many lawyers have influential positions in politics and the administration. Notaries and lawyers are seen as an extension of the state apparatus. The CNF is situated in the Ministry of Justice and is officially consulted in juridical matters.

For decades, the orders enjoyed a strongly autonomous position, shielded from competition. Repeated efforts by politicians to open this restrictive environment faced heavy resistance; often proposals were delayed in parliament and discarded when the government changed (Micelotta and Washington, 2013). From the end of the 1990s onwards, the Competition Authority started arguing that regulatory powers of orders should be limited to addressing market failures, but should not be extended to issues such as setting tariffs. A number of draft laws have been discussed following these discussions, but none were approved. Professional orders do not want to be treated as normal firms, “law is an art, not a trade” is an often heard argument in these debates. Notaries have a high social status and are often influential in local communities and civil society. The government depends on them for the fight against tax evasion and the shadow economy. Pharmacists give medical advice with their service and sometimes have to take on financial risks due to long time lags in the reimbursements of medicine from the public budget. This negatively affects the leverage the government has over them. The professions argue that liberalised business models of the Anglo-Saxon type, dominated by multinational law firms and pharmacy chains, reduce quality and are unfit for the Italian society. Liberalisation leads to concentration of the market and would change the culture of a profession drastically, many would stop being self-employed and turned employee.
Preservation of this corporatist model is not wholly unproblematic. Many Italians perceive of the professionals as an elite class that enjoys special privileges, a world which is difficult to penetrate for outsiders. Carboni, for example, argues that young graduates are becoming resentful, as they are not judged on their merits, but on their connections and recommendations when trying to enter the professional world. This would, in turn, fuel their support for populist movements which want to radically change the system, or make them leave the country altogether (2015). There are also more specific issues. With notaries, the exclusive competences (the many deeds for which you need notarial approval) restrict the ease of doing business, especially given the exceptionally low number of notaries (5000 before the crisis). Pharmacies equally have quantitative restrictions. Before the crisis, there were around 18,000 pharmacists. This is not exceptionally low in international comparison but the quota is based on regional dispersion. This ensures availability of medicine in rural areas, but it also significantly drives up the value of licenses in popular areas like Milan. All in all, the restrictions drive up costs and - as proponents of liberalisation often reiterate – many notaries and pharmacists are among the best-paid professionals in Italy.

The situation with lawyers in Italy is quite the opposite. Italy has the highest number of lawyers in Europe (EC, 2017i). The city of Rome alone has more lawyers than all of France. Weak competition is part of the explanation. The tariffs lead to higher mark ups so that a larger number of lawyers can survive. But the overpopulation of lawyers goes hand in hand with excessive and costly litigation and limited specialisation. The Ordini di Avvocati have been particularly resistant to penetration of larger operators in the market and competition on price. They claim for example that when lawyers are no longer self-employed they are no longer free to exercise their profession.

For a long time, Italy was seen as one of the countries with the highest degree of regulation in professions, where not much changed (OECD, 2010). Only in 2006 was the government able to shake-up the market, with the Bersani decree (Law n. 248/06), named after the Minister of Economic Development at the time. It was a joint effort with the Competition Authority which took an increasingly active approach in the debate, by opening bilateral negotiations with orders to open up their codes of conduct. But the reforms were also spurred by the EU’s Directive on recognition of professional qualifications (2005/36/EC) followed later by the Services Directive (2006/123/EC). The requirement to align national

38 The Italian legal system allows a large number of lawyers to plea without filter to all three levels of judgement, thus incentivizing litigation. The system generates 4 million cases per year. At the end of 2012 there were 9.7 million pending cases, of which about 5 million were civil cases. (see also: Lanau et al., 2014)
Part II: In-Depth Case Studies

practices with both directives combined with the broader liberalisation drive of the Prodi government resulted in enough reform momentum. Prodi had just returned as Commission President and his government started widespread liberalisations in sectors such as the gas market, telecom, ICT, railway, financial services, and professions.

The reforms introduced significant changes, such as more freedom in setting prices (without abolishing tariffs altogether) and advertising, opening up entry requirements and allowing for the setting up of multidisciplinary companies. Bersani also opened up some entry requirements, allowed for the setting up of multidisciplinary companies, limited the exclusive competence of notaries on transfer of ownership of vehicles (which now could be done online), relaxed the limitations on ownership of a pharmacy, limited hereditability of existing pharmacies (the passing on from father to son) and most importantly allowed for the sale of OTC drugs in so-called parafarmacia or in supermarket corners, as long as it is a pharmacist who in the end owns the enterprise in question.

But introducing reforms on paper is not the same as actual implementation. In order to push through the reforms, Bersani had barely consulted the orders. The orders were infuriated by the reforms and responded by strikes and a series of parliamentary hearings (Micelotta and Washington, 2013). For the reforms to work, the orders had to adapt their codes of conduct, but given their disagreement, they did so in very limited and restricted fashion. The reforms might formally have allowed free advertising and pricing, but in practice the orders never fully adapted to the intent of the reform and used practices such as moral suasion on their members to restrict competition on these aspects. The Competition Authority followed with screenings of the codes of conduct and a series of fines (Negrinotti, 2014). The Commission also intervened with a set of cases, but did not succeed. The Commission argued in a case against Italy in the European Court of Justice that the system of maximum tariffs for lawyers is still applied as a general rule and as such obstructs free market access by non-Italian firms, but the Court dismissed this argumentation (ECJ C-565/08). With a similar argumentation the Commission challenged the restricted ownership of pharmacies, but the Court dismissed the claim for reasons of public health preservation (ECJ C-531/06).

The reforms were difficult in their implementation but were not fully without effect. The overall liberalisations of the Prodi government made Italy jump significantly in the OECD Product Market Regulation index and stand out as one of the biggest de jure reforms of that period. An OECD report praises Bersani’s reforms as significant steps on
paper but also notes that competition in advertising and prices are resisted in practice by the orders, thus resulting in overall limited effectiveness. This is not the case for pharmacies, where the post-Bersani years saw an increase in retail shops being allowed to sell OTC drugs (parafarmacia) to over 3700, resulting in a 6,6% decrease in prices between 2007-2008 (OECD, 2010). Additionally, Pagliero (2015) finds that the reforms also lead to higher earnings for young pharmacists and their higher overall employment.

Prodi’s government was succeeded by Berlusconi, with his newly founded People of Freedom (PdL) party in coalition with Lega Nord. The PdL has been known to be especially reluctant to go against organized interests, such as the professions. No major new initiatives were taken on liberalisation. What was presented were mostly empty gestures. For example, in 2009 the government obliged itself to present an annual competition law on the basis of the recommendations of the Competition Authority (Art. 47 of Law 99/2009), but no such law has been introduced during Berlusconi’s term in office. European leaders did not see Berlusconi as a serious reformer. Trust in the Italian government eroded in the years that followed, leading to an escalation of events in the fall of 2011.

7.4 Tracing the process I: from Berlusconi to Monti

In the summer of 2011 the ECB’s President Trichet and President-elect Draghi took an unprecedented step of sending a confidential letter to both Italy and Spain with a list of reform suggestions. For Italy, the letter mentions increasing competition in services as a key challenge and calls for the full liberalisation of professional services. The central bankers were worried about the steep rise in interest rates in the bond markets and expected both countries to come up with a legislative response. The letter makes no mention of the ECB’s Securities Market Programme by which the ECB can directly intervene in secondary markets to calm the rise in interest rates. However, to all relevant players it was obvious that the reform list represented the conditionality attached to this programme as the ECB held off on its decision to invoke the programme while waiting for a response from both countries. To be eligible for the programme Italy had to introduce a budgetary correction plan of 45.5 billion euro over three years combined with structural reforms to put the Italian economy on a more sustainable path. What followed was a politically tumultuous period in search for a sufficient answer and a new budget. Sacchi

39 The letter was later leaked and published in the newspaper Corriere della Sera of 29 September 2011. (See also FT, 2011a)
describes the 2011 period as ‘implicit conditionality’ in which ‘EU institutions carried out frequent and pervasive monitoring of Italy’s commitment to agreed structural reforms, from adoption to implementation’ (2015; p. 13).

The Berlusconi government did not come forward with the legislation that was hoped for. The government published Decree Law 138/2011 ‘concerning urgent measures for the financial stabilization and development of Italy’, but this law was widely criticised for relying too heavily on policy principles, rather than clear implementation paths. For example, the law mentions the need for horizontal reform of professions but does not contain concrete measures to substantiate this horizontal reform. Berlusconi had shortly aired the idea of abolishing the orders altogether during the summer, but the idea was dropped after 22 Senators sent a letter to the President of the Parliament arguing against the proposal (Carboni, 2015). Several interviewees doubted Berlusconi’s real intentions, claiming he wanted to only do the bare minimum to satisfy European partners, but never seriously meant to go against organized interests in Italy. European partners were not convinced either. Berlusconi was urged to come up with more credible proposals. In an emergency euro summit on October 26 he presented a 14-page letter of intentions. The European leaders ended up accepting Berlusconi’s intentions and invited the Commission to monitor the implementation. The markets, however, were less lenient; spreads with the German ten-year bond widened sharply in the days directly after the summit. Italy found little demand for its paper in the market and investors also started turning against some of the larger banks. In the words of Jones, Italy had received ‘an economic vote of no confidence’ (Jones, 2012; 86).

The exact details of what happened during this crisis-ridden autumn of 2011 are still a matter of discussion, but in the days directly after the October summit pressure mounted and bond rates peaked, culminating in the resignation of the Berlusconi government. The fact that the subsequent Monti government was installed only four days after Berlusconi handed in his resignation fuels the suspicion that the change of government was prepared well in advance by President Napolitano. There is some evidence that European officials were involved in this scheme as well. The new ‘national effort

40 The Commission immediately sent a letter to the government urging for more specificity on the intentions. The secret letter was published by newspaper La Repubblica and can be downloaded here: http://download.repubblica.it/pdf/2011/economia/CAB10_1104184608_001.pdf (last accessed 3 January 2017).

41 Geithner, who was Treasury Secretary under the Obama administration writes in his memoires that he was approached by unnamed European officials and asked to refuse to support IMF loans until Berlusconi resigned. The USA refused (Geithner, 2014).
Government’ – consisting of non-party affiliated technocrats – enjoyed an exceptional majority in parliament with all major parties apart from Lega Nord supporting it. This created a unique reform momentum where initially *no one would even dare to say no to Monti’s proposals* (Interview 32). Italian politicians realised that they were in a head-to-head with financial markets to preserve liquidity and - in the words of Monti himself – ‘the government was born out of awareness that the future of the euro also depends on what happens to Italy’ (MEF, 2012:1).

Shortly after its instalment the Monti government introduced a significant set of reforms, based on three package-deal decrees: ‘Salva Italia’, containing measures to ensure financial stability and ‘Cresci Italia’ and ‘Simplifica Italia’, both focussed on measures to enhance growth, by removing barriers for business, promoting efficiency in the public sector, encouraging entrepreneurship and private investment, etc. The three packages represented more elaborate and bold plans for reform than seen during the Berlusconi days, but the effectiveness of measures is dependent on the details in the few hundred legislative acts that are needed to implement these decrees. In any event, the decrees did calm the markets significantly as bond yields went down after a peak in November 2011 and the low-point in GDP contraction of early 2012 slowly started to reverse.

The decrees contained a wide set of proposals to enhance competition in the services sector. The measures included the promotion of public tendering, increase of competences for the Competition Authority, the liberalisation of opening hours for retailers, measures to enhance competition in the banking and insurance sector and measures to promote the liberalisation of professional services. Overall the measures were projected to close 40% of the gap with the best-performing countries in Europe when it comes to competition in services (MEF, 2011). For professional services the decrees reaffirmed the freedom to advertise, halved the prerequisite period for traineeships and abolished professional fee schedules for all regulated professions, thus finishing what Bersani had started. The decrees furthermore included specific measures for notaries and pharmacists. For notaries, competition was widened geographically to allow them to plead in the entire district of the Court of Appeal and their number was increased from 5000 to 5500 with plans to increase it even further in the future. Cresci Italia furthermore introduced the possibility to have the start of a Simplified Limited Liability Company (LLC) be approved by a lawyer instead of a notary, thus limiting the latter’s reserved activities. For pharmacies the decrees proposed amongst others an increase in their number to one per 3000 inhabitants and the expansion of medicines that are allowed to be sold outside of pharmacies to Band C drugs, which do require prescriptions, but are not reimbursed via the National Health Service.
In the following National Reform Programme, the first of the new government, Monti called increasing competition in the services market ‘fundamental’. He introduced the measures also with a philosophy of social fairness, which can be understood from the annoyance that many professionals managed to escape the wage freezes of that time:

*Liberalising the economy is not an abstract principle, but a means for removing privileges and income arising from privileged positions. It helps to give more opportunity to do and to grow to whoever may have initiative without having inherited a certain profession or position.* (MEF, 2012: VI)

A preliminary assessment by the OECD showed the measures would contribute to a 31% improvement in the PMR score for professional services. And all the liberalisation measures together would result in a potential increase of TFP of between two and three per cent in the period up to 2020 (Bouis and Duval, 2011). The Commission called Monti’s reform package ‘determined and wide-ranging’. At the same time, they note on professional services that the regulations still have to be passed by parliament and there is scope for further market opening (EC, 2012h). The first MIP-related CSR is however relatively mild, it simply asks Italy to implement and adopt the liberalisation measures.

Implementation indeed proved difficult. Monti’s government might have started with strong support in parliament, but not too long thereafter its weaknesses emerged. Monti was governing a large coalition with very different policy positions and when the risk of default started to wane political division started to play a role again. The centre right – which was in the majority in the parliament - adopted an increasingly oppositional stance towards liberalisation measures. After a year of Monti government less than a quarter of measures from Cresci Italia – the decree with most liberalisation measures – had been implemented (Il Sole 24 Ore, 2012). It took Parliament a year and five months to pass all the legislative acts with regards to professional services. In the meantime, the Parliament managed to significantly adapt the proposals, under heavy influence of lobbying from the orders (Carboni, 2015).

Pharmacists managed to increase the scope of authorizations for new pharmacies and to cancel most of the proposals to sell Band C drugs outside of pharmacies. Much like Bersani, Monti had been reluctant to water down his measures and had also refused prior consultation with the orders. But this strategy turned out to be based on overconfidence. He received a letter from Federfarma (representing almost all pharmacy
owners) and signed by 73 MPs, which described the measure as a very serious sign of unreasonableness. Monti ignored the letter but was taken by surprise when Berlusconi’s PdL managed to push forward an amendment that forced the government to accept a watered-down version of the proposals. Federfarma criticized the bill for containing errors for example on the tendering of new pharmacies. But the main issue was the liberalisation of Band C drugs, as the President of Federfarma herself explains:

"We went against the reform of Monti because it was simply bad. They did a rushed job, too quickly. We went to talk to the people in parliament about this every day. (...) But for us the real problem is not about opening up pharmacies, the problem is the issue of selling medicine outside pharmacies. (...) If the para-pharmacies also manage to sell medicines with a prescription, the others need to close, because why would you stay in the mountains if you can open in Milano and make more money? So then it will no longer be a public service. (Interview 40)"

After this incident the Monti government had to take a more conciliatory approach towards the professions and accept more watering down of the proposals (e.g. minimum social rights for trainees, such as decent payment, was taken out of the proposals) (Mattina, 2013). With notaries, for example, the short-term increase in their number was maintained (this can be done through an administrative act, which requires less involvement of the parliament), but the proposal to give competence to lawyers to approve a Simplified LLC was taken out. Instead, notaries were obliged not to ask for an honorarium for this Simplified LLC. Several interviewees criticized this move, as one ministry official explains:

"It is wrong to ask people to work for free, the point is to liberalise, not to have them do it for free. Secondly, it is unenforceable. We have a lot of evidence that notaries who are required to do this for free, many ask an honorarium through strategic behaviour. They say ‘I’m happy to do this for free for you, please come back in six months.’ (Interview 31)"

The most serious setback from a pro-liberalization point of view came a few days after the fall of the Monti government in 2013. A bill was passed by parliament giving self-regulatory power back to the order of lawyers (Law 247/2012). The bill had long been pending in Parliament, with MPs waiting for the right moment to strike. The bill re-centralized power back to the National Bar Association and away from local orders. It backtracked on the freedom of comparative advertising on prices established under
Part II: In-Depth Case Studies

Bersani and contained new restrictions to enter the Ordini. It also included higher contributions for pensions, which can be criticized as biased against younger and poorer lawyers.\footnote{See e.g. written questions to the Commission by members of the EP Corrao, Ferrara and Tamburrano on Law No 247/2012 on the lawyers’ code: possible violations of Community principles in Italy, 05/03/2015.} The bill also maintains the provision that law firms should be owned by the lawyers themselves, rather than shareholders, to avoid the penetration of larger investor-based law firms into the market. The tariffs were still abolished, but parameters were introduced, if a client and lawyer fail to come to an agreement on price through negotiation they would need to use these parameters. And the lawyer’s fee of the party that loses in court is also subject to these parameters. In practice, this means that both individual customers and smaller firms with less negotiation power would be heavily dependent on the references for prices. The parameters thus \textit{de facto work as minimum tariffs} (Interview 28 – Commission official) and ensure that advantages of lower prices are enjoyed more by larger firms with negotiation power than by the public. Finally, under Bersani the use of contingency fees\footnote{With contingency fees a lawyer receives as compensation a whole or a part of the asset which is the subject-matter of the litigation.} was allowed, but the new bill abolished these again.

Monti had opposed the bill but did not manage to fully get it off the table either. As soon as his government fell there was a window of opportunity to pass the bill, strongly supported by the lawyers in parliament. As long-time Senator and lawyer Pietro Ichino (PD) explains:

\begin{quote}
This is the most important episode of rolling back the Bersani reforms. (...) They [the lawyers] do not recognise this problem of productivity I think, they don't accept this field of discussion. (...) The Bar Association has a particularly strong position in parliament, there are a lot of lawyers in parliament. I was fiercely against this bill and was seen as a traitor because I was against something that all the lawyers were supporting. All the lawyers were in favour, in a bipartisan way, left-wing and right-wing. (Interview 36)
\end{quote}

Or as another lawyer explains:

\begin{quote}
The legal orders are deeply convinced that it is absolutely necessary to come back to the tariffs, it is the only way to halt a declining income to lawyers, granting this sufficient
\end{quote}
income is necessary for the quality of the service. So the position of the legal orders is that this open competition has caused a race to the bottom. (Interview 42)

To be fair, no OECD country made as much progress on professional services as Italy in the 2008-2013 period (this includes the post-Bersani period). The reforms bring Italy in line with the OECD average on regulation in professional services (Koske et al., 2015). Also, overall in the services sector of Italy, the mark ups have declined substantially towards one of the lowest in the EU (Varga and in ‘t Veld, 2013; 21). Nonetheless, the Commission decided to maintain the CSR on services liberalisation, since especially when it comes to professions, implementation remained key to success and it still saw room for improvement. Monti did not tackle the real issues of ownership and reserved activity that would change the business structures rather than the numbers. Even for the numbers, Monti increased the number of pharmacies, but not their regional distribution, meaning that this is still not based on a market process. He furthermore lost the battle to liberalise the Band C medicines and most importantly allowed the backtracking on earlier reform by the new law for lawyers. The Commission assessed in its 2013 Staff Working Document that Italy had made ‘some progress’ with regards to services liberalisation. The following CSR calls upon Italy to properly implement the measures aimed at market opening in the services sector and to remove remaining restrictions in professional services.

So why did Monti, a former EU Competition Commissioner and a strong proponent of liberalisation, not succeed in fully satisfying the requirements of the CSR in a period of such strong reform momentum? One explanation is the fact that Monti faced a parliament with a centre-right majority, which in Italy stands opposed to the liberalisation of professions. In that period 44% of parliamentarians were also member of a professional order (Carboni, 2015). But the main explanation is the fact that the liberalisation of professions did not have the priority at the time. As Filippo Taddei, independent counsellor to Prime Minister Renzi explains:

In the end it’s politics. (...) They did a couple of very controversial reforms, so fiscal and pensions, and given the underestimation of the political process with the pension reform, they had to spend an amazing amount of political capital on this. The political capital delivered for the Monti government was big. But the measures were also drastic, Italy now has a pension system which is one of the toughest in Europe (...) Monti in that month consumed all his political capital, so when two months later he presented his labour market
reform and the Competition Law [with liberalisation measures] he had to backtrack a lot.
(Interview 32)

Monti’s successor Enrico Letta remembers that despite the wide scope of recommendations by the Commission or even the reform list of the ECB, everyone knew at the time that the focus should be on issues of more immediate effect:

We were under big pressure from the markets so we needed immediate effects, even the pension reform gave very slow effects on the markets, on the spreads, even the pension reform, so imagine regulated professions, it is nothing, compared to the storm we were facing. (Interview 46)

Some would challenge the political capital argument as too soft, blaming the government for not having enough courage to face the more specific and well-organised groups for political reasons, whereas more diffusely organised groups (pensioners and workers) had to take a hit. Elsa Fornero – Minister for Social Affairs in the Monti cabinet and responsible for the pension and labour market reform - for example, argues in such a fashion:

This reform should have been in the same basket as the pensions and the labour market. Because if you ask workers to lengthen their working period and if you ask retirees to denounce a generous indexation, why shouldn't you ask the professions to accept more competition? (...) I did the pension reform in 20 days, why were the same 20 days not enough for a different minister to implement a liberalisation of the professions? It was not that we said first Elsa starts and then Elsa gives the torch to Corrado [Corrado Passera, Minister for Economic Development at the time]. No, we all started immediately. (Interview 45)

The professions might have dodged the bullet here and there, but overall the reforms of the Monti government had a dramatic impact on people. Monti had aimed for more efficient government spending through spending reviews and a broadened tax base and fight against tax evasion, but will mostly be remembered for the more direct measures: tax increases, cuts in public expenditure and serious cuts in social welfare. The austerity – whether fully necessary or not - contributed to falling consumer confidence, the contraction of the economy, the rise in unemployment and increase of social hardship, leaving Monti unpopular among the wider public. Many Italians felt Italy had to pay a high price for remaining in the euro area. In response, Monti tried to make clear that the
reforms were in the national interest and not ‘imposed’ by Brussels:

*It is a problem that lies within the Italian system to decide then enact what we Italians know well in order for us to grow. We don’t see European constraints as being imposed on us. There is no ‘us’ and ‘them’. We are Europe.* (The Guardian, 2012)

But the narrative of imposition by Brussels of a set of policies that lead to social hardship has since became powerful in Italian politics. It slowly changed the mentality of what had previously been one of the most Europhile countries in the EU. A few months before the mandate of Monti ran out Berlusconi pulled the plug on the government, whilst stating the following in a radio interview the next day:

*The technocratic government is finishing today and we hope there will no longer be a suspension of democracy. (...) Monti has bowed down in front of EU requests, particularly those of the ‘German European Union’ of Northern Europe, which only lead to recession.* (see e.g. Inquirer, 2012)

### 7.5 Tracing the process II: from Letta to Renzi

Monti might not have fully satisfied the requirements of the CSR on professional services, but the overall reform drive of his cabinet can hardly be denied. When discussing pressure from EU institutions, it has to be taken into account that the government already felt a strong sense of urgency to reform, with pressure coming mostly from the markets. The pension reform was in line with what was recommended to Italy in the CSR.44 Monti – unlike his predecessor Tremonti - had a good reputation in Brussels and could, therefore, count on a supportive stance. As one interviewee strikingly put it: ‘Monti was considered by the European institutions as their guy’ (Interview 29). Despite the pressure at the time being high, the working relationship with the institutions was seen by former EPC chair Lorenzo Codogno as ‘excellent’ (Interview 47). But this was not the case for the government that followed. The elections of February 2013 created a hung

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44 The pension reform was introduced with tremendous speed and helped calm markets, but suffered from major setbacks later on, costing a lot of public money. For example, many workers had agreed a settlement to interrupt employment in exchange for traditional retirement packages, but the new law left them without income. The largest pension fund revealed after the introduction of the law that the number of these so-called ‘esodati’ was actually almost five times higher than initially assumed. The pension reform is deeply unpopular in Italy.
parliament with only a slight majority for the centre-left coalition over the centre-right and the strong rise of the new Five Star Movement. The three months that followed from the elections were a period of deep political crisis. Bersani, the winner of the elections, did not succeed in his rapprochement to the Five Star Movement and finally had to give way for Letta to form a grand coalition with Berlusconi’s centre-right.

The relationship between the Commission and the Letta government slowly turned sour. The Excessive Deficit Procedure was abrogated for Italy that year, but pressure from the Commission on Italy’s budget did not decrease. Letta himself described the approach of the Commission as ‘too rigid, without any flexibility’ (Interview 46). There were multiple clashes fought out in public between DG ECFIN Commissioner Rehn and Italian politicians, for example on the PdL’s plans to repeal an unpopular housing tax, thus going against previous commitments on the CSR on shifting taxation away from production (FT, 2013a). Similarly, there was a fight on the pace of budgetary consolidation and the sale of state assets (Reuters, 2013). The Commission at the time proposed that they would be more flexible on the budget if Italy would pursue structural reforms (note that this is before the official flexibility communication of 2015). The Commission had clearly become worried about the decline in the pace of reforms and sought ways to reinforce it. The Letta government tried to further implement what Monti had started, but struggled politically. The further liberalisation of professions, for example, was put on a to-do list, but no serious effort was devoted to it. The In-Depth Review of 2014 clearly strikes a different tone than under Monti. Italy is criticized for a slow pace of reforms and sluggish implementation and called upon to ‘decisively step up the pace of reforms’ (EC, 2014b:10). The document concludes that Italy is now experiencing excessive macroeconomic imbalances, which require specific monitoring and strong policy action.

The Letta government was still in a process of regaining market trust so the public fights and damning statements coming from Brussels were damaging to its reputation. But funnily enough, the pressure from the EU was also useful to the government; in a delicate political setting the external constraint (known in Italy as vincolo esterno) was used to fend off opposition.45 As Letta explains:

…this was very important. Because it was a political mess, Berlusconi left the government,
so my government was the sequence of political crisis. We tried to do whatever it takes to put the situation under control, so the most important thing was to have the budget under control. To avoid the assault, the attack of lobbies, parties, to get money, because 2013 was the year when we started to say: ‘now the worst is behind us, now after three years of tightening the belt we have to re-give money to people’. But we avoided doing this too much because we needed to keep the budget under control. So the pressure was there, but it was a form of external conditionality attitude by the Commission. (Interview 46)

For a short period, the idea of opening the corrective arm of the MIP for Italy was aired, but there was never much support for such a step, which was seen as too politically sensitive. Given the precedent set for Spain and Slovenia, Italy also was put under specific monitoring. The introduction of this intermediate step with additional missions is perhaps too bureaucratic to make the evening news, but to insiders the message was clear. As Taddei (independent advisor to PM Renzi) explains how the steps were perceived:

*With the government of Letta, the Commission came in and made it very clear that they do not trust the Italian political process to be autonomous and independent in producing change and reform. They believed that Italy can change a lot by external constraint, because of emergency, so they believed in the Monti approach. But they were very worried that once the decision-making went back to politicians, even to pro-euro politicians like Letta, these people would not have the power or the strength to push forward reforms. They anticipated that by changing their tone, we understood this message, but in the public debate it was absent. (Interview 32)*

The additional pressure on Italy was however never tested. Soon after the Commission’s critical assessment, the government changed colour and Renzi became the new Prime Minister. The coalition with Berlusconi’s party had proven to be an unhappy marriage, stifled by internal conflict. After less than a year in office, the leadership of the Democratic Party voted in favour of Renzi as new party leader based on his call for a new phase and a radical programme of badly needed reforms. A new centre-left coalition was formed. The National Reform Programme that followed contained a wide set of new reform proposals and for the first time included a clear schedule and deadlines. In response the Stability Programme asked for a two-year extension for achieving the budgetary medium-term objective. The following Commission assessment remains highly critical of the lack of progress on the 2013 CSRs but concludes that the new NRP presents a comprehensive, ambitious and time-bound plan for action and thus gives Renzi the benefit of the doubt
and considers the budgetary flexibility justified (EC, 2014c).46

With Renzi in office reform momentum picked up again. The Renzi coalition had stronger support in parliament and was thus able to govern more effectively. The Commission retained the label of excessive imbalances for Italy, but the documents strike a positive note. Substantial progress was made in areas such as the labour market, with the Job’s Act, educational reform or the budgetary process. During Renzi’s first two years in office, Parliament passed 159 laws (83% of them coming from the government) in a significant show of activity compared to the Letta government (Turno, 2016). This optimistic picture, however, does not apply to professional services, where the government ran into the same problems as Bersani and Monti before. In February 2015, the Renzi government introduced a Competition Law (DDL C. 3012). In line with what was suggested in the assessments of the Commission, the law focussed on going one step deeper, namely trying to change the business model of the professions. Key elements of the new law include for pharmacies the full liberalisation of opening hours, the abolition of the limit on being allowed to own no more than four pharmacies per pharmacist and allow equity shareholders to own pharmacies. This would allow opening the door for the introduction of chains and the entrance of foreign investors to the market.

Like Monti’s reform, the law had initially included a provision to allow for the sale of Band C drugs, but – given the resistance to this measure - this was already taken out before the bill reached parliament. For lawyers the bill similarly focuses on ownership, by allowing the setting up of multi-professional companies for legal services and the provision that a law firm can be fully owned by non-professional shareholders. Most interesting are the proposals for notaries where the new law would allow for a digital signature to be a valid confirmation of identity for a number of acts that usually require their approval. For example, the digital signature could be used for the setting up of a Simplified LLC (with capital below 10,000 euro and standardised statutes) or the trading in shares of an LLC. Finally, the reform also included a further widening of the geographical area for competition and an increase in the number of notaries. The content of the law came mostly from reports of the Competition Authority, but the drafting was done in close consultation with the Commission, with interviewees describing that they were mostly on the same line.

46 This step can be interpreted as the prelude to the flexibility communication of 2015, which was published in response to criticism of opaqueness of the process, amongst others in the Italian case. But Renzi also lobbied to have flexibility taken up officially in European documents during the Italian presidency of the Council at the time.
The law was adopted by parliament in the summer of 2017, two and a half years later (and outside the scope of analysis of this thesis). But already before adoption, it was heavily amended in parliament, leaving the initial drafters of the bill disillusioned: *If I were the Commission I would be disappointed* (Interview 31). Or, in the words of Senator Ichino:

*The Competition Law is a very sad chapter, the bill was a pretty good bill in the beginning, but it was emptied by amendments, now it should be rewritten, the way it is now it does not make sense.* (Interview 36)

To name but a few of the changes: ownership of law firms by non-professionals was significantly reduced. The initial proposal had included a provision that transactions on non-residential land with a value below 100,000 euro could be made with a lawyer rather than a notary. The hope was to kick off competition between lawyers and notaries, but the notaries did not allow this reduction of their reserved activities and the provision was dropped off early. Similarly, Renzi had vowed to drag Italy into the digital age and the proposal on digital signatures was one of them, but again resistance was strong and the Senate finally dropped the proposals off. As a ministerial official explains his disappointment:

*Whenever something happens you have the real reason and the pretext. The real reason was that notaries lobbied, the pretext was that the chief of the structure fighting the mafia publicly told that if we let people make transactions online instead of vis-à-vis the notary the control over their identity will be weakened and this might resolve in increasing the easiness of money laundering. Which in my opinion is a ton of bullshit.* (Interview 31)

This leaves Italy having achieved only modest progress on liberalisation of professions. All in all, the Commission concludes that doing business in Italy remains significantly more difficult than in other major EU economies, professions remain heavily regulated and barriers to entry remain strong (EC, 2016d). Five years of CSRs on the issue and multiple reform attempts have resulted in a mixed picture. To give a short tour d’horizon of perspectives: a Competition Authority official argued that Italy was witnessing a culture of backsliding, both on tariffs and on entry to the profession (Interview 37). With lawyers, for example, it is still not clear whether even the Bersani reforms have been fully implemented. The new regulations and the behaviour of the orders specifically target young professionals and part-timers. Instead, the Competition Authority would like to see the crowding out among lawyers to happen on the basis of market processes that
select for the best and the brightest. For legal services, the Commission does note some price effects. Between 2012 and 2014 the lawyers fee grew less than the overall CPI, but it is impossible to assess whether this can be attributed to the reforms (EC, 2014d). One interviewee clarified that due to the reference tariffs, these price effects are only enjoyed by larger firms who have indeed seen a significant decrease in prices for trials, whereas for others prices have stayed broadly the same (Interview 42 - lawyer).

In the Ministries, the predominant opinion was that reforms in product and services markets take a lot of time to take effect, especially in a cyclical downturn (Interview 29). Liberalisation, in theory, is about taking away security with the promise of gain and market expansion in the longer term; people need to take on more risk, but this is difficult during a crisis. Former Competition Authority President Grillo, therefore, argued that the reforms were simply bad in design since they did not provide for a balance between risk-taking and a stronger sense of security in return (Interview 41). Of course it can be argued that these particular professions are in general not the most heavily reliant on such security. But the reforms did have a strong negative effect on many of them, hence the heavy lobbying. As this notary explains what the Bersani and Monti reforms meant for him:

So our fee went down, down, down and competition in the market began to be a war for the lowest price and the lowest price can hardly be mixed with quality, this is the problem. (...) We were thought of as this very small and conservative group, linked to these privileges. This is the past, this is a picture of the last century. We are professionals, we are part of the market, but we are barely coping to pay expenses. We are not so rich as the politicians think. (..) I used to have nearly 15 employees, we are five now. (Interview 34)

For the explanation of why the Renzi government was unable to deliver on liberalisation, again many interviewees point to the argument of political capital being invested in bigger priorities. The Renzi government went against vested interests in the reform on corporate governance in the banking sector, and with the judicial reforms. But the liberalisation of professions proved to be particularly difficult to pass. Another explanation is that Renzi had a reason to focus on other reforms, primarily the reform of the Constitution. The reason lies in the fact that under Article 117 of the current Constitution the regulation of professional services is attributed to the regions, so the state is limited in what it can do. Given the history of fascism, the Italian Constitution is characterized by a balanced bicameral system and powerful regional parliaments to prevent the domination of the state or a single party. This makes broad consensus a requirement for reform, but also
significantly increases the number of veto points and makes it hard for any government to govern. The new Constitution would have favoured decisiveness over representation and on professions it would have completely attributed competence to the central state. The Renzi government gambled, believing that if the new Constitution were passed this would allow them to introduce more significant liberalisation reforms. But the Italian population thought otherwise: the Constitution was rejected in a referendum and Renzi, who had tied his fate to the outcome, had to resign.

7.6 Analysing the role of the MIP

Italy sometimes retains the reputation of kicking the can down the road and waiting for better days in terms of structural reforms. Often when structural reforms in the EU are discussed Italy (and France) are among the first to be mentioned. And yet, when looking at how the position of Italy has developed within the MIP, a Commission official argued that they were never in a difficult spot (Interview 28). Reforms have been set in motion in the pension sector, labour market, education system, banking sector, fiscal framework, public administration, judicial sector and the services market. To be clear, there is a difference between reform on paper and in practice. Often implementation proves difficult and slow, CSRs ask for more to be done, the Commission remains critical on many issues and sometimes reforms fail, such as with the Constitution. And Italian growth has not caught up with peers. But what is interesting is that in terms of effort the European documents strike a much more positive tone than one might expect on the basis of Italy’s reputation and position in the MIP.

As this chapter has shown, the effort on professional services has been much lower and the tone in EU documents more critical. It has been difficult for Italian politicians to build a consensus around these reforms, as there is no clear compelling narrative since the effects are diffuse. Consecutive governments have agreed with the Commission that reforms are necessary, but not invested much energy in pushing them through. And indeed, upon closer study it does not seem directly obvious why ownership of law firms or the sale of Band C drugs would do much to counter Italy’s excessive imbalances. Although the Commission has been respectful of Italian governments’ choice to prioritise other reforms, it would beg to differ on this latter statement. Professional services liberalisation has featured prominently in the CSRs. In 2015, in the process of streamlining the Semester to focus only on priorities, this CSR for Italy was maintained. Italy was even recommended to decisively remove barriers to competition in this area (Council, 2015b). Studies also continue to predict positive effects on growth in case of full liberalisation (e.g. Lanau and Topalova, 2016). Similarly, representatives of the Italian
business lobby Confindustria explained that industry leaders tell the organization that they would highly value further liberalisation of professional services to lower the costs of doing business and value the EU’s involvement on this issue (Interview 44).

As a short side note, it is worth mentioning that the barriers that Italian professions impose might be seen as harmful to economic growth, but are not as excessive as elsewhere in the EU. This can be judged by the fact that in 2015 the Commission launched infringement procedures for six EU states, on the grounds of excessive shareholding requirements, minimum tariffs and prohibition of multidisciplinary practices, which they saw as not in accordance with the Services Directive. These are precisely the issues covered in Italy’s CSR, but apparently, for Italy the Commission did not find such unjustified obstacles since it was not among those six for whom an infringement procedure was opened (EC, 2015e).

One reason for the maintenance of the CSR is because European institutions see added value in continuing to be the one to draw attention to this issue, precisely because domestic political incentives for this reform are low. One of the officials who worked on Renzi’s Competition Law even claimed that ‘without the EU there would not even have been discussion in the past ten years on liberalisation in this field, now at least we talk about it’. (Interview 31) The statement is odd, given that all the details of what the Commission includes in their analysis and CSRs does not come from Brussels itself but from the reports of the Italian Competition Authority. The Competition Authority has spelled out every year what it saw as the required reforms. Italian politicians themselves adopted a law already before the crisis in which they obliged themselves to introduce updates to the competition framework every year, on the basis of the reports of the Competition Authority. The EU, by means of the MIP, only tries to keep Italy to its own commitment. The Competition Authority itself has apparently not been authoritative enough. Some interviewees suspected that the Authority was not sufficiently raising its voice in the debate because it feared a political backlash. As a consequence, the voice of the EU in this debate is stronger.

The EU tries to put its authoritative weight behind the issue, to keep the issue on the agenda and to present it in a broader package of removing structural impediments to growth and enhancing productivity. In the MIP missions, the Commission also meets with representatives of the professional orders to try and come to a more shared understanding and it involves them in peer reviews in the framework of the Single Market Strategy (EC, 2015f). But the orders in Italy have a strong grip on Parliament
and this is where the authority of the Commission is lacking. It has in recent years not been the government who had to be convinced of the necessity of these reforms, but Parliament. In the Italian Parliament it is much more difficult to argue that the EU is insisting.

In discussions on the Competition Law some government officials – such as Minister Calenda for Economic Development under Renzi - argue that the reforms are part of the commitments to Europe. He made reference to the Commissions’ growth forecasts linked to liberalisation, or the country rankings of the OECD to substantiate his position. These types of arguments were, for example, used in the Finance Committee. But other Italian politicians who are in favour of these reforms would deliberately not mention the role of Brussels, or use linguistic balancing acts whereby the trick was always to say ‘yes Brussels asks us to do this, but we do it because we need to do it’ (Interview 47, Lorenzo Codogno, former chief economist at the Italian Treasury).

This brings us to a second element in the analysis, namely the waning legitimacy of the EU in pushing for reforms in Italy. As stated in the introduction, Italy has a long history of using the EU as an external constraint in pushing through reforms. This Vincolo Esterno has been extensively discussed in the academic literature (e.g. Dyson and Featherstone, 1996; Featherstone, 2001; Ferrera and Gualmini, 2004). The external constraint was by and large seen as something positive, especially in a context of fragmented politics. But with Monti, the EU’s role entered front stage and slowly became suspect. As Letta explains how he perceived the role of the EU:

_There was a huge pressure. (…) ... during my government, Monti’s government or even Berlusconi’s government. At that time the pressure was there, with sanctions, not formal sanctions, but political sanctions. This means it was a period in which an interview with a Commissioner saying that Italy was not doing its homework was terrible in terms of reputation for the country. Today this is different. Europe is not so popular, so there is no political sanction by a letter like that or an interview like that. But at that time it was important, so the agenda of the government was conditioned by this attitude. And yes this has changed completely now._ (Interview 46)

47 Another striking example of this Vincolo Esterno mentality is the 1988 article by prominent economists Giavazzi and Pagano called ‘The advantage of tying one’s hands: EMS discipline and central bank credibility’. In the article they argue that Italy should join the exchange rate mechanism (prequel to the euro) as a rational strategy to discipline wage bargainers and escape the cycles of inflation and devaluation. This argument was also important in the run up to Italy joining the euro.
Part II: In-Depth Case Studies

With largely non-hierarchical mechanisms like the Semester, legitimacy is key, because direct enforcement is only used as an ultima ratio. The strength of the argument is important, but the perceived authority of the institutions conveying the message equally so. And this has changed in Italy; the leverage role has worn off and the institutions are now seen as alien in the eyes of part of the public. When the Commission was held in high regard their assessments or recommendations could be used as cognitive leverage in persuading the public to pursue reforms. And as confirmed by Letta in the statement above, it creates direct pressure on politicians. Dunlop and Radaelli (2016) note in this context that in 2014 Italian media reported every month on what the Commission or Council thought about Italian affairs and the stock exchange reacted quickly to the publication of the Commission assessment of the NRP.

But with Monti’s reforms not being very popular, opposition parties accusing him of being Merkel’s agent and the economy remaining in poor shape the perception of the EU has changed. To be clear, not many Italians are aware of the specifics of the MIP, but there is a general awareness that Brussels is checking upon the budget and that reforms are part of this. In the days of Monti or even Letta, some Europhiles would argue for reforms in the general public policy debate with slogans like ‘Europe asked for it’, ‘we have their backing’. But this rhetoric had to change to ‘Giovanni asked for it’ (the Italian version of Joe the Plumber) since opposition parties started drawing a distinction between what Europe wanted and what was in the interest of average Italians. Step by step rhetoric kicked in that glorified the years before euro introduction when the Italian economy grew fast. People started looking for a symbol to blame and the European institutions – given their distant position – became a useful idiot in this regard. Where traditionally the external constraint was used to overcome opposition, now it started to be used as a symbol to rally opposition. To give a few examples of leading Five Star Movement politicians:

*What I know are the consequences of the introduction of the euro: the loss of purchasing power, the decline in wages, the reduction in competitiveness, the social degradation, and unemployment.* (Di Batista, translated from German, Die Welt, 2016)

*The Euro, the heist of the century: it is not irrevocable, as Mario Draghi decided. Break the cage; regain the sovereignty sold off to kleptocrats, technocrats, and oligarchs. Rebuild from the rubble the Europe of people.* (Beppe Grillo, translated from Italian, Gazzetta di Parma, 2017)
In public debates ‘Europe asked for it’, became ‘Who is Juncker to tell us what to do?’ It shows that there is a political price to be paid by engaging more prominently as EU in reforms (and budget) that are politically sensitive. Ideally, the Semester is not only about persuading member states to enact the reforms they do not want to do, but also about being helpful in reforms they do want to do. The Italian debate on the reform of the Constitution is an example where the changed perspective on the role of the EU became visible. It would go too far to say that the referendum on the Constitution was also a vote on the EU, but EU involvement, in this case, was clearly counter-productive. Renzi tried to counter the suspicion that this reform was induced by the EU. He argued that a new Constitution would actually strengthen the governments’ hand in Europe, but opposition was strong. For example, Lega Nord’s leader Salvini argued that Italians should not vote for the Constitution precisely because this is what the Commission, Germany, France and the financial industry wanted for Italy while reminding the Italians of all the damage that the EU’s invoked pension reform had done to them. ‘With the new reform we will be more enslaved to the EU’, Salvini stated in an interview (TGcom interview, 2016).

The example of the reform of the Constitution should serve as a warning that adding more pressure does not necessarily increase the effect and can even lead to a backlash. This leads to a dilemma on how to exert pressure effectively on Italy from the MIP. There are no easy options without externalities for either the effectiveness of the mechanism or the legitimacy and support for the EU. Multiple interviewees in northern Member States have argued for a much tougher approach on Italy through the MIP. The fact that the corrective arm of the MIP has not been opened for Italy is seen as either proof of flaws in the instrument or the Commission’s use of the instrument. In the EU institutions, there are also those who argued that opposition parties would always find someone to blame. If it were not the EU, it would be the USA or even the freemasons. (Interview 61) At the same time, however, there is no real intellectual argument to be made that the EU has forced Italy to do anything, either on the Constitution or other reform areas.

For professional services, this latter argument has certainly been true. And also in other reform areas this does not seem to have been the case. Elsa Fornero – the Minister responsible for the pension reform in the Monti government – describes that she met only once with Commissioner Rehn to explain her plans with regard to pensions, but never felt any form of imposition (Interview 45). Stefano Sacchi – advisor to Renzi on the labour market reform – likewise observed that The Commission was quite happy with what we were doing. (…) It was never like “you have to do this”, we wouldn't have accepted this as
There can be a controversy regarding the pace at which you adopt these recommendations, but not on the substance. There was also never imposition. And if I look at other countries I have never seen imposition either. (Interview 29)

But perceptions matter in politics, even when they are not necessarily based on fact. Developments in Italy call into question the use of external constraint since the Eurobarometer clearly shows declining support for the euro. 40% of Italians believe the euro has been bad for Italy; only Lithuania scores lower in this regard (EC, 2017j). This scepticism has become an easy political source to tap for politicians to gain popularity by exploiting the discontent. It leads to calls for referenda or alternative currencies, to preserve sovereignty and freedom, since Italians are tired of being told what to do by others. All of this affects the ability of the MIP to be effective in Italy. Some, such as Ferrera, continue to believe that the external constraint is crucial for Italian reforms. He even specifically cites the liberalisation of professional services in this regard (2016). But others believe that in this new toxic political climate the external constraint no longer provides cover for Italian politicians when facing opposition (Moschella, 2017; Jones, 2017). Jones refers to a poll by Macro Advisory Partners which shows that Italians, in general, do not want to step out of the EU or the euro; rather they have a problem with the constraints imposed on them by European institutions (the lack of support from Europe that Italians have felt in tackling migration flows is also an important factor here) (2017a).

48 The Jobs Act was one of the centerpieces of Renzi’s period in office. Italian officials and Sacchi himself argued they never felt direct imposition from the EU, but pressure helped with the pace in which reforms were introduced. This pressure was a combination of the following elements: not wanting to be subject to the corrective arm of the MIP, the two-year delay to achieve the MTO of the SGP, the argument against moral hazard in the discussions on QE within the ECB (see also: Sacchi and Roh, 2016) and the argument to counter the perception in other European parliaments that Italy only announces reforms but never implements them. As such pressure was felt; Italy needed something to show to the world. A Commission official argued that it was also never denied that the launching of the EIP could be an option for Italy and that this was a serious factor. Renzi wanted to prevent a negative assessment in the MIP. The MIP was important in the last phase of passing the reform in Parliament; according to this (senior) official, it was really in the context of the MIP mission that Renzi decided to put a confidence vote in Parliament on the bill. The confidence vote curtailed debate in Parliament and infuriated opposition. After the labour market reform was adopted, Italy was labeled as compliant with fiscal requirements, receiving leniency on the budgetary path, due to ‘the expected implementation of ambitious growth-enhancing structural reforms’. (EC, 2015g)
It is worthwhile in this regard to look at Renzi’s political tactics. Sensitive about anti-Brussels sentiment, Renzi himself lashed out continuously at the role of the EU in the wake of the referendum. Renzi realised that everyone in Brussels knew that there was no reasonable alternative to his government if they wanted the CSRs to be implemented. But he also did not want to fall into the same trap as Monti, by being seen as Brussels’ puppet. In the words of one of his former advisors: ‘it does not buy you credit vis-à-vis the political community to show that you are compliant with Europe, maybe with the 5% that voted for Monti, but certainly not with the public at large’ (Interview 38). Monti had always tried to argue that reforms were in the Italian interest and not imposed by the EU. But Renzi took a much more aggressive approach: he called the fiscal recommendations ‘diktats’; likened the EU to an old, boring aunt who tells you what to do; argued that he wants to address the needs of Italians rather than Brussels technocracy, and that Italy does not take lessons from Europe; threatened to block future negotiations on the EU’s Multiannual Financial Framework if Italy did not receive leniency for migration costs; and suggested that it was mostly Germany breaking European rules, because of its current account surplus (see e.g. Euractiv, 2016; DW, 2016; Dunlop and Radaelli, 2016).

The EU ended up giving Renzi’s government flexibility on the budgetary side, stretching rules and procedures to their maximum. In the end, this approach did not help Renzi to build sufficient support, but it is unlikely in this context that a stronger constraint by the EU would have helped much in achieving the goal of structural reforms. In the meantime, parties that campaigned on an anti-euro ticket have gained even further support and the relationship has become even more delicate. None of this is to say that the Commission should stop issuing CSRs all together towards Italy, but it helps to explain Juncker’s political approach and why the MIP has not been more forceful in exerting pressure in Italy. (In the conclusions this thesis will address the question of what this means for the future.)

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49 A media study by Bruegel found that Germany and German-influenced programmes play a dominant role in explaining the crisis, whereas financial markets and banks do not play major roles in the crisis discourse (Müller et al., 2018). In this context it is worth quoting former chief economist at the ECB Issing, who argued: ‘In the 1990s high-level Italian officials told me: “we have to adopt the euro, because this will force us to pursue reforms.” I told them: “I hope this will indeed happen, but you will end up cursing at the Germans for their focus on stability and rules.” (Interview NRC Handelsblad, 02/12/16 – translated from Dutch). The negative effect of the German current account surplus on the Italian economy or the benefit to the Italian economy of a possible increase in spending in Germany is highly questionable (see, for example Gros, 2016 or the chapter on Germany in this thesis).

50 The Commission concluded on the 2017 budget that the expansionary measures of Renzi would arguably not contribute to boost potential growth, thus implicitly accusing Renzi of buying popularity with selective tax breaks, yet no serious steps were taken (EC, 2016n).

51 Causality here should be treated with caution, the EU played a role in the campaign, but many domestic factors were also at work.
With so much controversy at the political level around European pressure and constraint, it is worth looking closer at how pressure has actually been exerted in more detail. This brings us to the final observations of this chapter, concerning the interactions at the administrative level. The first point to note is that in general the relationship between the Commission and the Italian authorities is good; the economic language is the same and there is much agreement on substance. With Renzi’s Competition Law there was a discussion on tactics: the Commission insisted that Italy would do more, whereas the Renzi government believed that including too much at once would stir too much opposition in parliament and thus decrease the chance of success. But all in all, the real disagreements boil down to discussions over whether the glass is half full or half empty with regards to the progress made on implementation. In line with the overall findings in other chapters, the interviewees who are directly involved in the Semester support the view that there has been an increase in the interactive dimension. This has grown over time to constant interaction at technical level, whereby the Commission is fully aware of the stage of the legislative process on every reform initiative.

Pressure has primarily been exerted through constant monitoring. In 2014, the monitoring was deliberately increased with the specific missions after Italy was seen as experiencing excessive imbalances and a slowing down of the reform effort with the Letta government. In these monitoring missions, all the reform proposals were discussed with relevant partners, preceded by extensive questionnaires with well over a hundred questions on the details of every reform. The questionnaire from a 2015 MIP mission also shows that many of these questions concerned the budget, which gives further support to the claim that in practice the MIP and SGP are very much linked (EC, 2015h). In general, these missions help the Commission and ECB services (also present on some of the missions) to be fully up to date. They also help to structure the internal bureaucracy of Italy, by ensuring that all relevant departments are on the same page and involved in the reform process.

And indeed ministerial officials see the merit of the missions in ensuring there is sufficient ownership of the reform process by all departments, to get everyone involved. They ensured that all reform efforts were translated into economic language, targets, expected effects, all gathered in a single document. The additional monitoring reports are discussed in the EPC, which also held thematic discussions on for example Italy’s wages. Such sessions can be useful exercises, but in practice should be seen as open discussions and stocktaking on the basis of a Commission presentation with a few questions here and there, rather than the well-organized peer review sessions with other countries as discussants. The National Reform Programme similarly has an important
status in Italy, as officials spend months in preparation for it.

Codogno, who was responsible for the technical drafting of Semester documents in Italy, describes policy coordination in Italy before the Semester (Lisbon process/OMC) as not very compelling and struggling to get the attention of directorates in the administration or Ministers themselves. But this changed radically in 2011:

*It changed completely when it became part of the Semester. The Semester to me is extremely important, it may seem stupid but having the same time schedule, a budgetary schedule in Europe and on reforms and having an organised discussion on this, this was a good change. Let’s face it, this was extremely important. (...) This process to some extent forced the different parts of the administration to be aligned, so basically, it was a way to get everybody involved.* (Interview 47)

The added value should thus primarily be seen in aligning the administration around priorities, keeping issues on the agenda and making sure everyone is up-to-date. But part of the original rationale of the specific monitoring was also to make the Italians feel that the Commission is really insisting. The specific monitoring was introduced as an alternative to opening up the corrective arm of the MIP. Here the added value is much more questionable. In the 2014 period there was a mission almost every month and in the meantime the Commission wanted to be informed on all sorts of other steps. This put strong pressure on the administration, which struggled to find resources to cope with the required information. The number of missions was perceived by the Italian officials as overburdening, as assessment over assessment. If the end goal is to have Parliament approve reforms strong enough to decrease imbalances, overburdening the administration is not necessarily the best approach. This step was too bureaucratic to reach politicians, who are in general not aware of labels such as ‘excessive imbalances’ or ‘specific monitoring’. Italian officials pushed back and the Commission soon gave in. Over time the monitoring process was loosened, delegations in missions became smaller, and the Commission realised its questionnaires were perhaps a bit excessive. 2015 saw two extra evaluation reports, but 2016 saw a form of continuous monitoring without the extra reports. All of this comes to show that there has been a realisation that, with regard to Italy, forms of imposition on the administration perhaps attack the wrong target and constructive engagement seems more fruitful.
7.7 Conclusion

In his first speech after the elections of 2018, President Napolitano, speaking in front of the Senate, stated that to a large part of the voters, Europe has appeared more like a set of constraints than a set of ideals and opportunities (2018). It is the troubling fall-out from a period in which Italy has been under heavy pressure from European institutions and its legitimacy has waned in the eyes of the public. The EU has become a target to rally opposition instead of overcoming it. With the reforms and budget cuts not delivering results in the eyes of a substantial part of the public, an EU-induced economic recipe of ‘more of the same’ will be a tough sell for any future government. But a closer study of how this pressure has translated in the framework of the MIP shows that the increasingly toxic situation at the political level stands at a distance from the constructive relationship and the consensus found at the administrative level in the interaction with the EU institutions.

The Italian case shows that it remains challenging to build consensus around structural reforms. In the case of the liberalisation of professional services this has meant that administrations have agreed with the Commission on the substance, but societal consensus has been lacking, so that organised interest and their political allies have been able to block or delay reform attempts or implement them half-heartedly when they were introduced in a top-down manner. For this reform there is not a strong narrative or direct incentives, whereas opposition is concentrated. In this context, the proponents of reform consider EU pressure on the matter and close (but not excessive) monitoring on implementation of the utmost importance. With the MIP the reform is brought in a broader package to remove structural impediments to growth and help the Italian economy regain momentum, with projections of economic gains and spillover effects to productivity in manufacturing. Consecutive administrations have been able to make progress on various parts of this package. There are clearly success stories. But making substantial progress on the liberalisation of professions has been treated as a second-order priority. Italy is no exception; of all the Semester CSRs, Member States have shown the least progress on competition in the services markets (EC, 2017).

There are signs of structural improvements in the Italian economy, in terms of export market orientation, quality of products and wage and price developments (Bugamelli et al., 2018). But overall, the Italian economy has not yet managed to catch up with developments in neighbouring countries since the euro area started recovering. At the same time, the Italian financial system is seen as showing fragility, if a future crises
were to come. In countries like Germany and the Netherlands, popular opinion holds that the ECB’s expansionary policies have been primarily directed at giving leeway to the Italian economy, but its administrations have not sufficiently capitalised on this by implementing reforms. The EU has to walk a tightrope when it comes to pressure on Italy. As long as the administration is on the same line as the Commission in terms of policy substance, adding pressure through the MIP might not be the most effective way to stimulate reform consensus. With the EU institutions coming into a negative limelight when being prominently involved, the logical response would be for domestic institutions to gain a stronger voice in the reform debate.
Part II: In-Depth Case Studies
Chapter 8

Labour Market Segmentation in France

8.1 Introduction

Europe’s labour markets have seen a continuous stream of reforms in recent years. Within the common framework of the European Employment Strategy, each Member State has over the years build its own web of contractual arrangements, tax incentives, school-to-work programmes or redeployment requirements, each with their own balance between labour market flexibility and worker security. The Italian Rodolfo Debenedetti Foundation counts 200 reforms of employment protection alone in the 15 original Member States in the 25 years preceding the crisis, increasing flexibility in over half of cases (Bentolila, Boeri and Cahuc, 2010). But the crisis years have seen even more activity. With the tremendous loss of output and the rise of unemployment, labour market reforms have featured as among the top priorities for the EU’s economic governance (Turrini et al., 2014). Sixteen out of nineteen countries ever to appear in the MIP have received at least one recommendation on the organisation of their labour market.

The most prominent countries to appear in the category of labour market policies in the CSRs are France, Italy, and Spain. France is a curious case here, as for many years wages have evolved relatively well in line with productivity and productivity per hour is closely in line with that of Germany. The competitiveness problem of France and its link to the labour market is therefore much less obvious than in Italy or Spain, where wage growth and productivity have clearly diverged. But French workers work considerably fewer hours per week than the USA or UK and France overall has lower employment than Germany. While the majority of French workers show high productivity per hour and have stable contracts, another significant part finds itself at the margins of the labour
market, stuck in either unemployment or temporary employment. In other words, the labour market is segmented. When combined with a relatively generous social welfare system, this still means that the cost of labour is relatively high (in 2013 the 3\(^{\text{rd}}\) highest in the euro area). This has an impact on France’s imbalance of declining competitiveness, as seen for example in loss of market share. This chapter will show that this narrative is not without its problems.

When addressing segmentation in the labour market, Member States typically receive CSRs on a number of issues: the cost of labour (such as social security contributions), the need to increase skills in order to make hiring labour more attractive (for example via vocational training or Life Long Learning programmes), labour market transitions (such as various kinds of Active Labour Market Policies – ALMP) and the organisation of labour market institutions (primarily focussed on Employment Protection Legislation – EPL). France has received recommendations on all of these issues. While paying due attention to the first aspects, this chapter will primarily focus on the last issue.

The French case differs from Italian case in the sense that the issue of employment is already firmly on the political agenda and unlike the Belgian case there are no major disagreements between the Commission and French authorities. Rather, this case shows that labour market policies are surrounded by strategic uncertainty and the Commission and French authorities have behaved more as partners in a process of collective puzzling. But the French case does show clear similarities with the Italian case in the sense that a similar process of delegitimization of the EU in the public debate has occurred. The French case will also show similar horizontal coordination effects in the administration. And while the French authorities have been mostly in line with the Commission on substance, they differ on how serious the problem really is, as the next section will show.

8.2 Imbalances in the French economy and the link with EPL

France was quick to recover from the 2008 recession and was one among a few countries to avoid a recession in 2010-11. The French state occupies a very large share of the economy; state spending has consistently been around 57\% of GDP, among the largest state shares in the EU. A large state with a solid social policy framework can act as an economic stabilizer at times of distress as it manages to preserve demand. This is what happened in France, which the Commission praised for performing a lot better than others. A 2010 Commission paper – a sort of prequel to the Semester – even ascribes the
speedy recovery to ‘the absence of major imbalances’ (EC, 2010; 63): no housing bubble nor large current account deficit. But this optimism changed significantly over the years. In 2012, the Commission noted in its Alert Mechanism Report that France was experiencing ‘serious imbalances’, continued by ‘imbalances that need decisive policy action’ in 2013, followed by ‘imbalances that need decisive policy action and specific monitoring’ to ‘excessive imbalances’ the year after. A large presence of the state in the economy might help cushion shocks, but it can also be a drag on recovery and weigh heavily on the public budget in the years after the shock. The steep rise in public debt and the slow, but continuous, deterioration of competitiveness saw France being placed under MIP surveillance and evolve step-by-step towards the category of excessive imbalances.

France entered the Excessive Deficit Procedure in 2008 with similar public debt levels as Germany, around 65% rising to 81% of GDP in 2010 for both. But from that moment on, the two countries started to diverge, with Germany bringing its debt levels significantly down and French debt rising to above 100% of GDP. France has continued to borrow at relatively low rates on financial markets, which have been in need of safe assets. But it is clear that with debt levels close to 100% of GDP France cannot afford too high a spread on government bonds and is thus more vulnerable. The pace of fiscal adjustment is, however, no straightforward case from a euro area perspective. Given the size of the French economy, an overly quick adjustment could negatively impact aggregate demand and add to the deflationary pressure that euro area states were experiencing in the second half of the crisis. Spillover effects on the struggling Southern European economies from fiscal policy, though hard to measure in precise terms, are even seen as stronger from France than from Germany (Belke and Osowski, 2016).

Whether high public debt should be seen as an excessive imbalance is also a matter of which indicators are included in the analysis. For example, France has higher public spending than Germany, but also lower future pension costs due to much more favourable demographics (e.g. EC, 2018a). Hence there is an argument to be made in claiming that France, therefore, can sustain higher public debt than Germany in the medium term. Fiscally hawkish politicians would disagree with such assessments and see France as making a mockery of the SGP, but the Commission has treated the French deficit with relative leniency (pressured by heavy lobbying on the French side). Both in 2013 and in 2015 the Commission (with Council approval) extended the deadline for correcting the French deficit, because of the negative impact a recession in France could have on the
Part II: In-Depth Case Studies

recovery of the euro area economy.52

It is not the high public debt by itself that constitutes the imbalance in the French economy. Similar to the Italian case, it is the public debt in combination with sluggish growth and deteriorating competitiveness that is a cause for concern. France has been losing competitiveness since 2000 with exports increasing much slower than imports. The current account deficit has remained relatively modest, but the share of French multinationals that are very successful outside France and repatriate profits can in part explain this difference. The competitiveness loss is mostly seen in a loss of export market share. French loss of market share has been among the highest, with a near 20% decline between 2005-10. And when the French government tries to boost demand, this is immediately reflected in higher imports but to a lesser extent in higher profit shares for French firms. Profit margins, in general, have been under stress in France; the Commission assessment in 2013 shows that they are the lowest of the euro area (EC, 2013f).

Few would dispute that France is indeed losing competitiveness, but again one can play a game of indicators on how severe or problematic the situation really is. Purchasing power per head was similar to that of the British in 2016 and far more equally dispersed than in the UK. The loss of market share is mainly due to the rise of economies in Asia, because of which almost all Western economies have lost market share. It is German preservation of market share that seems to be the outlier. But if one takes the housing market into account, housing costs already explain a large part of the ULC differential with Germany, which can afford to pay lower wages due to much lower housing costs, whereas the French have considerable more household wealth due to these high housing prices (see e.g. ECB, 2013a for wealth statistics).

The point here is not to question whether there should be some adjustment in France, nor to give in to French national pride over Germany or others. The point is to show that labelling some with ‘excessive imbalances’ over others is not undisputed, certainly not in France. Multiple interviewees disagreed with this label, for example:

If you look at France you will see that according to almost any macroeconomic indicator we

52 Famous is the quote of Commission President Juncker on 31 May, 2016 when he was asked why France received such leniency to which he responded with ‘because it is France’, adding that fiscal rules should not be applied ‘blindly’.
are exactly in the middle between Northern and Southern Europe, competitiveness, deficit, these things. There are no major sustainability issues, some aspects deserve attention and should be improved, labour market, labour cost even, the French system has to be adapted to a new environment, there’s no denying that. But the Commission cannot make a case for major imbalances in the French economy. (Interview 52 - Le Cacheux, economist)

... the French growth model is not jeopardising a smooth functioning EMU. We have some internal problems, we recognise them. But we are not a threat to EMU. I have not seen any clear arguments that are convincing in this regard. (Interview 57 - Ministerial official)

Chapter five discussed the fact that the decision to label France with excessive imbalances had little to do with the scores on the indicators. The decision stemmed from a general sense in the Commission that the larger Member States needed to put in a bigger effort in order to assure a smooth recovery for the euro area. In Italy, there was a clear sense that reform effort was slowing down and the Country Report strikes an alarmist tone about reform effort. In the reports for France this language is clearly absent. For France, the real issue was rising debt levels, but as argued above, it would have been better for the euro area if France stimulated growth through supply-side reform rather than engaging in austerity. The Commission therefore decided to use the MIP rather than the EDP. In the same year that France was labelled with excessive imbalances, it was also granted a two-year extension to meet the fiscal target in the EDP. One Commission official admitted that he personally thought all these labels and the duplication of procedures only made things more complicated: ‘it does not make much sense’ (Interview 51). Another Commission official explains it as follows:

In 2015 there was a situation in which the Commission could have escalated the Excessive Deficit Procedure for France. Instead what happened, was that France was labelled as having excessive imbalances. There was by some commentators the impression that instead of using the proper instrument, the instrument that was used was the MIP. The answer is yes. Perhaps this is problematic from the viewpoint of proper use of the instruments and if the Commission has to be compliant with the purpose and the spirit of the different regulations. (...) The decision on France was a difficult one, not an obvious one. Ex-post it is not clear whether this was a good decision. (Interview 74)

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53 This decision was criticised by, amongst others, the ECA, which argued there was no analytical basis for it as only the fiscal deficit was excessive. The Commission responded that for this decision it took the systemic risk for the euro area into account and the French economy’s strong trade and financial linkages with other Member States (ECA, 2018).
In France, the move on excessive imbalances is interpreted as a political move rather than being based on economic grounds. France has always disputed this label of excessive imbalances and has pushed back against duplication of the procedures. At the same time, it is not a major controversy either; on the state of the economy in 2015 one can have discussions, but the negative trend has been clear. Or as one official puts it:

“We agree that we are experiencing imbalances. On the concept of excessive, we differ from the Commission. But it has never been a big controversy. We agree that debt is increasing and the current account is not ideal. On the facts, we agree.” (Interview 57 – ministerial official)

This line of argument continues if we look at the labour market. No one in France disputes that there is a serious problem that requires policy action, but whether and in what way it is linked to economic imbalances is much less obvious. The official explanation of the link between labour market segmentation and the imbalances is the one of productivity. ‘A highly segmented labour market would result in uncertainties for a large share of employees, reducing incentives to increase their human capital and hence productivity’ (EC, 2013f: 9). The Commission considers flexicurity-enhancing reforms, in particular related to flexibility in the EPL, as stimulating a more dynamic reallocation of labour employees towards more productive activities. This would impact competitiveness, especially inter-sectorial adjustment towards the tradable sector would help correct current account imbalances (EC, 2013f). This type of reasoning seems to be in line with ECB thinking, for example when they argue that ‘strict EPL makes it more difficult for firms to respond quickly to changes in technology or product demand that require reallocation of staff or downsizing, thereby inducing them to use their resources less efficiently’ (ECB, 2016a).

But the link between EPL reforms and productivity is not very obvious. Researchers have found it hard to measure, aggregate and compare flexibility in the labour market between countries. The IMF, long known as a staunch supporter of deregulating labour markets,
recognised in a study on the effects of structural reforms that labour market regulation has ‘no statistically significant effects on total factor productivity’, possibly due to measurement problems (IMF, 2015b; 105). Even the ECB admits in their studies that the empirical assessment of the link between the strictness of EPL and productivity is not conclusive. This lack of analytical clarity shows that one cannot blindly increase flexibility and expect productivity to pick up. For France, it should also be remembered that on the basis of indicators it cannot be argued that France imposes excessive constraints on firms; it has similar EPL strictness on permanent contracts and individual dismissals as Germany, the Netherlands or Belgium (as measured by the OECD EPL strictness index) and even higher employment participation than the latter two (measured in fte as % 15-75 year-olds employed in 2016) (CBS, 2017).

Commission officials in interviews admit that perhaps they ‘stretch a bit the argument that this is about the allocation of labour and so it is about productivity. (...) this is also the discussion we have in the Commission, about the MIP not being enough social. But the linkages that are created with the labour market are not very significant’ (Interview 51). Another Commission official admitted that linking EPL strictness to productivity and human capital allocation is only one way of looking at the issue, ‘you could also say that if you are stuck with workers you have to train them better in order to improve their productivity’ (Interview 48). But in official documents the productivity narrative is clear. The 2017 Annual Growth Survey states: ‘Precariousness, segmentation of the labour market and their impact on productivity growth need to be addressed in this context to reduce their negative impact on internal demand and productivity growth’ (EC, 2016m; 10).

None of this is to say that France cannot improve productivity through better labour market functioning. For example, having a high percentage of workers on temporary contracts can lower productivity amongst other reasons because they tend to have lower access to vocational training, which reduces employment in the longer term (Boeri and Garibaldi, 2007). Beyond the links with temporary employment, activation and the need for a skilled labour force, there are also clear indications that the French labour market suffers from a lack of competitiveness in the tradable sector. The French newspaper Les Echos illustrates this point well: the French economy saw a significant increase of public sector jobs between mid-2013 and mid-2015 (+233,000), but the private sector in France created only 57,000 new jobs in that period, as opposed to 651,000 in Spain, 482,000 in Germany and 288,000 in Italy (LesEchos, 2016). This supports the claim that

excessive constraints on firms and thus discourage job creation and necessary reallocation (OECD, 2013).
inter-sectoral adjustment towards the tradable sector is necessary. But the reports of the Commission do not present clear data on inter-sectoral adjustment apart from the general fall in productivity (they do show that competitiveness in the automobile sector is particularly low, whereas it is much higher in aircraft and defence).

The Commission links segmentation to the MIP, primarily because it wants to send a message that a comprehensive reform package is necessary including also the labour market. Besides, for countries that have been labelled with excessive imbalances all CSRs are linked to the MIP. But it is questionable indeed – and not understood by some of the French actors - whether an issue that seems to be structural and long-term should be linked to an instrument such as the MIP (as opposed to a normal Semester CSR). Cost-competitiveness issues, spending issues or product market reforms were seen by both Commission officials and French officials as more directly linked to the core of the imbalance. The issue of segmentation is problematic for the economy, but above all a social problem. One of the main concerns with France for the Commission, although expressed in a more pronounced way in the interviews than in the reports, is the problem of the low-quality employment trap towards normal employment. The next section will argue why.

8.3 The issue of segmentation and pre-crisis reform

France traditionally has a strong model of social policies and employment protection. It includes a set of standards and practices that have been built up over the years by the social partners in key industrial sectors, the unions of the public sector and state policies. French labour law stipulates that the open-ended contract – Contrat à durée indéterminée (CDI) – should be the norm. And indeed, around 88% of workers are employed under a CDI. The recourse to a fixed-term contract – Contrat à durée déterminée (CDD) – should remain exceptional and can only be offered under a number of conditions: to replace an absent worker, or to fill temporary increase in activity of the firm or seasonal work. CDDs cannot be offered to fill positions that have been made redundant for less than six months (Labour Code L. 1242-2). A CDD can be renewed only twice with a maximum cumulative duration of 18 months. Like the CDI, the dismissal possibilities for workers on a CDD are restricted; dismissals must be justified by a serious and genuine cause and cannot easily happen on economic grounds. Severance payments

Famous in France is the quote from former President Mitterrand who complained in 1992 that he had ‘tried everything against unemployment’. 
and notice periods for dismissals are mostly in line with other European states. Workers with a CDD are thus well-protected under the labour code, as constraints on employers are similar to permanent contracts.

And yet despite these legal safeguards the French labour market has transformed to a segmented system of “ins” and “outs”. Those who have a CDI are well-protected, those at the margins face significant uncertainty. The CDD is supposed to be an exception or a stepping-stone towards a CDI, but the chances of moving from a CDD to a CDI have dropped from 45% in the mid-1990s to less than 10.6% in 2010, half of the EU average of 25.9% (EC, 2013g) and 72% remain in temporary employment (EC, 2013f). With an unemployment rate that has been hovering around 10%, this in practice means that those at the margins of the labour market – the young, the low-skilled, migrants, those living in the banlieue neighbourhoods around Paris – often remain stuck in periods of unemployment and periods of temporary employment.

At the same time, those workers that do have a CDI tend to hold on to their positions out of fear to fall back into the margin of the labour market, thus hampering efficient human capital allocation. France has the lowest rate of labour mobility according to the EU Labour Force Survey, with an average seniority of 11 years (in 2016). This is one of the arguments put forward in European documents when they link segmentation to productivity. But perhaps more importantly, workers with a CDD tend to feel less secure and without a CDI it is more difficult to get a mortgage, car loan or rent an apartment. And the recourse to CDD hampers integration of migrants, who are disproportionally hit by labour market segregation.

Another important issue is that over the years exceptions have been introduced to the standard principles of the labour code; consecutive reforms have been layered on top of one another. This has made the system seemingly opaque and easy to misuse. The biggest issue is with the temporary contracts. Over the years their variety has increased: there are special CDDs for small businesses, for older workers, and for skilled workers. A clear example where this has led to segmentation is the introduction in the 1990s of the contrat d’usage, a particular type of CDD without limitation to its duration and without severance pay. In theory, this means they can be renewed on a daily basis and indefinitely. This contract is only permitted in 30 sectors where fixed-term contracts are more customary, most of them in the tertiary sector (which is relatively large in France) such as hotels and catering.
Over the years the number of very short contracts (such as the contrat d’usage) has increased to such an extent that they have become the norm in certain tertiary sectors. At the same time, the duration of these contracts has shortened. In the sectors where this contract applies, more than 86% of contracts had a duration of less than one month in 2011, amounting to 7.4 million contracts. In total in 2011, there were 13.2 million contracts in France with duration of less than one month (ACOSS, 2011). The French labour market might be known to be highly rigid; in fact it is highly flexible for those at the margins. In no other European country are very short-term contracts so common among those with fixed-term contracts as in France (OECD, 2014). This also means that marginal groups bear a significant part of the adjustment during times of economic uncertainty when employers are even less eager to hire on a CDI. As a Commission official sums up the main problem:

So the worrying trend is the fact that it is shorter and that short-term contracts are becoming positioned in the economy. You don't have the short-term contract as a way to enter the company or as a way to do a new project, as is normally the case. You have actually long-term contracts that are organized as a succession of short-term contracts. That is the issue of segmentation that we are confronted with. (Interview 51)

This two-tier system has grown over the years through historic compromise starting in the 1980s. Trade unions of key industrial firms successfully resisted major changes in employment protection for their political base of permanent contract holders, but also faced growing pressure to accept increasing flexibility for other types of jobs (Palier and Thelen, 2010). Increasing possibilities for temporary contracts at the margins was a way of avoiding unemployment when employment in core sectors shrank. In the non-core sectors, especially the rising services industry, a secondary labour market emerged with less security and more flexibility. The institutionalisation of segmentation in the labour market has gone hand in hand with a recalibration of social policies targeted towards those at the margin: a rise of state-subsidized jobs, tax credits for employment, activation schemes and all sorts of minimum-income benefit programs covering around 10% of the French population. The effect is that state spending as a percentage of GDP was never seriously put on a downward path of below 50% of GDP, despite lowering social charges being a primary objective of employment policies over the last three decades.

The recasting of the French system also correlated with the main ideas promoted at

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57 This is over the entire year, so not at one instance.
European level. Many European states struggled with segmentation and structural unemployment thus pressing for the need to learn from one another’s practices within the framework of the European Employment Strategy. In the years preceding the crisis, it was especially the models of the Netherlands and Denmark that attracted interest. Both countries – in very different ways - managed to combine low unemployment with a strong welfare state and high competitiveness through flexible labour markets. Inspired by their models the concept of flexicurity became a central objective of EU labour market orientation from 2005 onwards. Flexicurity aims to combine flexible but reliable contracts with active labour market policies, Lifelong Learning Programs and a solid social security system (EC, 2007b). Flexicurity has been the underlying policy paradigm of many labour market CSRs in the Semester (Bekker, 2018).

In parallel with European developments, the ideas behind the flexicurity concept gained prominence in the debates in the ministries, the public debate and in the (counter-) proposals of trade unions. The Sarkozy government that was installed in 2007 warmly welcomed flexicurity. Key officials such as Finance Minister Lagarde pushed the ideas of flexicurity high on the French agenda and it became an important goal of the French Presidency of the Council in 2008 when France chaired a mission on flexicurity together with the Commission (Council, 2008). France is also among the top spenders on Active Labour Market Policies (OECD, 2015). In domestic debates, the government’s agenda in this domain was referred to as flexicurité à la française. This terminology is meant to appease the trade unions but it is not exactly clear what is particularly French about this style of flexicurity. In the French political discourse referring to European documents or debates is mostly avoided for political reasons (de la Porte and Jacobsson, 2012). Despite explicit reference, the reforms over the years can still be seen as based on the ideas of the EU’s flexicurity paradigm. As a Ministerial official confirms:

... during the Sarkozy years in France, the intention was to have more flexibility in the French labour market, but in the framework of flexicurity. France has always had the same message; this willingness to go into flexicurity... it was never only flexibility, always also security (Interview 58)

In the years before the crisis, the Sarkozy government introduced a wide set of new initiatives to tackle unemployment and segmentation in the labour market; including new forms of contracts, and redundancy and redeployment schemes. The reforms showed a clear trend of incremental expansion of the toolkit in labour market policies. Each reform by itself might be well-intentioned and meaningful, but also adds to an
increasing web of tools, contracts, and procedures whose complexity negatively impacts awareness among employers, which hampers their effectiveness (EC, 2013f).

Sarkozy also aimed to introduce more fundamental reforms, but these faced heavy resistance from social partners (from both sides). For example, Sarkozy proposed to introduce a single contract with a gradual increase of rights. The idea of a single contract is heavily supported as a way to tackle segmentation by prominent labour economists (e.g. Blanchard and Tirole, 2004; Boeri and Garibaldi, 2007; Cahuc, 2012). The unions feared that the contract would result in too much flexibility being introduced. It would also have an impact on the power of social partners. For years French trade unions have been famous for protests and strikes that governments have learned to fear whenever they feel that social rights are under threat. But while trade unions have the ability to mobilize large crowds during protests, their membership is very low compared to other Member States (below 10%), and less than a third of French people tend to trust the unions (Cahuc and Zylberberg, 2017). At the same time, their strength goes beyond membership alone. The unions play a leading role in the organization of the labour market; 98% of French workers are covered under industry-wide contracts negotiated by unions and union representatives usually occupy key positions in local workers councils.

The unions ended up accepting (not all willingly) some measures that included both internal flexibility and external flexibility. Among the more prominent reforms of the Sarkozy government in this area is the introduction of *rupture conventionnelle*, a dismissal procedure for open-ended contracts by mutual consent. It includes a higher degree of discretion for bargaining between employee and firm on severance payment in addition to unemployment benefits and can thus be seen as a way of introducing external flexibility (see L. 1237-11 to L. 1237-16 of the labour code). Employers widely saw it as a way to circumvent the burden of dismissal costs for economic reasons, which is perceived as highly rigid. In the years that followed, the *rupture conventionnelle* exceeded layoffs for economic reasons greatly, which casts doubt on the statement that the French layoff procedure is rigid, as employers like to say (Le Barbranchon and Malherbet, 2013). This brings us to another aspect that defines the segmentation issue: the fact that despite...
successive reforms that have made the CDD more expensive than the CDI (e.g. in terms of social security contributions), employers in France are afraid to sign permanent contracts because they perceive possible dismissal of a worker on a permanent contract as too risky. Employers seem to value certainty of the contract over the cost of the contract.

In France, employers face heavy redeployment obligations for collective dismissals and while costs of economic dismissals do not stand out as excessively high, employers fear lengthy and costly proceedings around them. Individual economic dismissals must be justified by a serious and genuine cause. In order to ensure that dismissals only occur as a last resort, employees can only dismiss employees to safeguard their competitiveness and not to improve it. But the definition of what constitutes a genuine cause and when competitiveness is safeguarded or improved is difficult to define. This leads to a lot of court cases and subsequent jurisprudence. In practice, it means that economic dismissals are almost impossible as long as a firm is making a profit. French judges are known to rule in favour of workers in the majority of cases on unfair dismissals and it is possible to open a case up to a year after the date of dismissal. As a result, no less than a quarter of workers dispute their lay-off in special labour courts (prud’hommes). This results in a system of lengthy and costly proceedings (Fraisse, Kramarz and Prost, 2011).

The pre-crisis reforms of Sarkozy may have followed the flexicurity logic, but they failed to reduce segmentation significantly. They did not include any substantial measures to reduce the share of extremely short contracts and despite the rupture conventionelle being popular, this did not lead to higher uptake of permanent contracts. The reforms also suffered from bad timing. When the crisis broke out shortly after the reforms were introduced, employers became more risk adverse and segmentation increased. Between 2008 and 2012 unemployment rose by 2.4%, not as severely as what was seen in Southern Europe around that time, but the burden of adjustment in France fell almost completely on the periphery of the labour market. Job losses were severe among temporary employed and youth unemployment surged to 25%. As a result, the Commission notes the problem of segmentation of the labour market in France as the second most important challenge (after the budget) in its first Semester documents (EC, 2011b).

60 Unemployment figures should be treated with caution; the argument above is only to show that the adjustment fell primarily on the shoulders of particular groups. Another way of looking at youth unemployment is the NEET-ratio (Not in Employment, Training or Education), which in France stood above — albeit only slightly — the OECD average in 2012 at 16.5% versus 15%.
The 2011 CSR argues that the reforms did not tackle contractual segmentation and fell short of what is needed to resolve dualism in the labour market. It asks France to review selected aspects of employment protection legislation while improving human capital and upward transitions. It also asks France to ensure that minimum wage adjustments are in line with job creation and increase training and active labour market policies (Council, 2011b). In the context of the debate on the social character of CSRs, it should be noted that the documents do not speak only of the need to increase flexibility in the labour market. France managed to add the part on human capital and upward transitions, which could be taken to mean a transition from short-term to long-term contracts, to clarify further that this is not just about flexibility. However, the second part of the CSR on minimum wages simply means that they should allow for downward wage adjustment.

**8.4 Tracing the process: the continuation of French-style flexicurity**

The years preceding the introduction of the MIP were marked by a series of labour market reforms across the EU. European states, including those most severely hit, such as Greece, Portugal, Italy and Spain, engaged in reforms that all included some form of relaxation of regulations on either individual or collective dismissals. The OECD speaks in this context of a clear tendency towards deregulation since the onset of the financial crisis (OECD, 2013). This trend seems to be in line with what was promoted at European level. For example, a Commission report on labour market developments in 2012 clearly argues against overly strict employment protection legislation, claiming that reforms in this area (relaxation) could be a key driver for reviving job creation (EC, 2012g).

Proponents of flexibility argue that by lowering costs of dismissals firms would be more willing to hire. However, the evidence for such claims does not appear to be very strong (Boeri, 2011). As a matter of fact, certain forms of flexibility can be quite harmful during an economic crisis. Spain, for example, had laxer rules on the use of temporary contracts and a larger gap between dismissal costs of workers with permanent and temporary contracts than France. Spain saw a stark increase in unemployment, especially among temporary contracts in the construction sector. A modelling exercise by a group of labour economists found that had Spain adopted the more rigid French system, it could have avoided an astonishing 45% of its unemployment surge, a conservative estimate according to the authors (Bentolila et al., 2012).
As stated before, the Commission did not unequivocally promote flexibility. The Commission report also talks about the need to balance flexibility with appropriate social security. And CSRs directed to Italy and Spain in the early years also focus extensively on improving security elements such as unemployment benefits or active labour market policies. Also, looking at the documents for France, one can find both criticisms of overly strict employment protection legislation – albeit mostly focused on the legal clarity with regards to dismissals - and calls to strengthen support mechanisms. But these nuances did not manage to convince actors involved. The Commission faced heavy criticism from trade unions who felt the Commission was promoting unbalanced reforms that were strongly tilted towards flexibility (Schömann, 2014). French officials with a long-term involvement in discussing labour market policies with the Commission had similar impressions: flexicurity disappeared completely during the years of Barroso, we had flexibility, but not flexicurity (Interview 58).  

With the election of a new president in 2012 came new reform momentum. Hollande asked the well-known French industrialist Louis Gallois to come up with a plan for a ‘competitiveness shock’ for the French economy (Gallois, 2012). Deleveraging in Italy and Spain had put further stress on French competitiveness and so Gallois advised to combine labour market reforms with significant reductions in labour costs. In response, Hollande presented a competitiveness pact, with at its centre a 20 billion euro tax cut for businesses on charges for those earning up to 2.5 times the minimum income (crédit d’impôt pour la compétitivité et l’emploi – CICE). The CICE was welcomed by employers but was also criticized by economists who saw it as a stopgap measure that added further complexity to an already incomprehensible fiscal system and distracted from a much-needed general overhaul of the tax system (e.g. Piketty, 2017). The Commission saw the competitiveness pact as a step in the right direction, but insufficient for the competitiveness problems at hand (EC, 2013g). In part, the Commission agrees with the critique of complexity; it later recommended France to simplify the CICE and speed up payments from it.

The competitiveness pact was followed by a wide-ranging labour market reform, on the basis of an inter-professional agreement by most of the social partners. The agreement was presented as a deepening of flexicurité à la française as it included both flexibility and security elements. On segmentation, it foresees an increase in social security

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61 The perception on the basis of discussions seems clear, but on paper the claim does not seem to hold. For example, the Employment Guidelines of 2010 were drafted under the Barroso Commission and start by underlining the flexicurity principle (Council, 2010).
contributions for the very short CDD. And it sets a minimum number of hours per week for this contract. At the same time, social security contributions for young adults recruited on a CDI are lowered for the first few months in SMEs. The shift in the taxation of contracts was propagated by the trade unions based on the philosophy that recourse to the CDD is to be seen as a luxury for which employers have to pay more than for the CDI. On flexibility they reform the scope of collective economic dismissals by allowing for firm-level agreements between social partners without the involvement of the civil court and reduce the statutory period for individual redundancies. At the same time, they try to develop possibilities for conciliation through out-of-court settlements, to reduce the uncertainty of legal proceedings in case of dismissals.

On the internal flexibility side, they introduce so-called *accords de maintien de l’emploi*, agreements to preserve employment that broaden the scope for firms to derogate from sectoral agreements on working conditions and wages if sufficient support is found among the social partners in the firm (they are similar to the earlier described competitiveness agreement). The rationale here is that when companies are in economic difficulty they can rely on such internal flexibility by having part of the workforce fall back on part-time work and thus maintain employment. Combined with a personal training account, the worker can follow training in the remaining hours so that overall productivity will not be negatively impacted and so that workers can more easily move across sectors.

The French government saw the reforms as a breakthrough in French-style flexicurity. They proudly referred to the OECD, which had called the agreement “far-reaching” with the potential to change the image of France (République Française, 2013). But the Commission was less euphoric: they admit that the reforms indeed address key weaknesses of the labour market and are a step in the right direction, but labelled them as “some progress” on the CSR (EC, 2013g). Labelling the reforms as ‘substantial progress’ would have implied toning down the CSR for the following year or even taking it away as is customary. But labour market reforms take time to take effect and implementation is often troublesome. The Commission thought it better to continue the CSR. Besides, the reforms were seen as incomplete as the fiscal shift on contracts did not include the more than two million workers on an interim contract. Another recurring issue in French reforms is the issue of complexity: by the end of 2014, only six companies had signed an internal flexibility agreement to preserve employment. The Commission supported the introduction of these agreements but urged France to simplify the procedure and promote their take-up by companies.
An important element here is also the reliance on social partners’ ability to deliver; negotiating a negative agreement is something culturally new to trade unions. French trade unions not only have the lowest membership of the EU but they are also notoriously fragmented along ideological lines. It is quite common for one or two trade unions to hold up collective agreements for substantial or ideological reasons, although commentators also suspect political motives being behind these decisions (e.g. Hancké, 2016). All in all, the social partners struggled to find sufficient support among workers to meet the 30% threshold of worker support that is needed for these agreements. More successful was the new procedure for collective dismissals: Commission officials explained that this new procedure on the basis of negotiation among social partners grew to be used in over half the cases for collective dismissals.

The fact that reforms take time to take effect was bad news for President Hollande. He struggled to regain the upper hand in the polls in an environment of low growth and rising unemployment. The CICE in its first years did not result in an increase of investment in R&D nor in job increases and the Hollande government grew impatient. In a move that was widely interpreted as a policy shift towards pro-business supply-side economics, Hollande introduced his second big labour market reform: ‘The Responsibility and Solidarity Pact’. The pact consisted of widespread cuts in public spending and a new 30 billion euro tax deduction for business in exchange for their commitment to creating jobs for the young. The move contributed to France being at risk of non-compliance with the recommended fiscal path under the EDP. A series of heavy discussions followed between France and its European partners in the spring of 2015, as will be discussed in the next section. In the meantime, France was placed under specific monitoring and labelled as having excessive imbalances.

Often reforms take time for effects to appear, but some reforms also simply fail. The increase in social security contributions on the very short CDD is a clear case in point. The Commission turned out to be correct in warning of the consequences of exempting interim workers from the reform. This exemption gave an incentive for firms to switch to this contract to avoid extra costs. Revenues collected from the increase in contributions were two times lower than expected (EC, 2015i). Partly this can be explained by the interim workers, but there is also another issue. In France, the unemployment benefit system is organized in such a way that it is possible to accumulate income by combining partial employment with unemployment benefits. Workers receive a short-term contract and then draw unemployment insurance before getting a new contract. This incentivizes chaining of contracts, which is possible under the most unstable of the CDDs: the previously discussed contrats d’usage. These can even be issued as a one-day
contract and renewed indefinitely. Employees can work part of the week on a short-term contract and draw unemployment benefits for the rest of the week. This is advantageous for employee and employer, but also precarious for the worker and leading to heavy costs for the public purse.

A study by the French Economic Council shows that the reform has further incentivized the use of this contract. The normal CDD entails a 3% increase in social contributions, but due to this layering and the way the unemployment benefit contribution is calculated, the increase for the *contrats d’usage* is only 0.5 percentage point. The use of the *contrats d’usage* rose to represent 70% of total hires in 2014. With recourse to the extremely short contract employers should, according to the rationale of the reform, contribute massively to the unemployment benefit system, but in fact, it is the other way around. The sectors in which the *contrats d’usage* are customary create a significant deficit that the surplus of other sectors is not able to fill (for details see: Cahuc and Prost, 2015). This policy failure added further costs on an already deeply indebted system, which surpassed 30 billion of debt in the years after.

Interestingly enough, the Commission did not go so far as to recommend France to rewrite their labour code with the aim of reregulating the conditions and exemptions of the CDD. And in the CSR on reforming the unemployment benefit system, France is recommended to bring the system back to budgetary sustainability and to provide incentives to return to work, but there is no mention of the incentives for using the *contrats d’usage*, which is inherent in this system. The recitals of the 2015 CSRs do mention that a reform of the legal framework governing contracts would help to reduce segmentation, but direct reference to the organisation of contracts in the CSRs would encroach too far on the terrain of social partners.  

It shows the thin line the Commission is walking not to overstep its boundaries. But the Commission also believes that the problem is broader than just the *contrat d’usage*, which only represents part of the segmentation issue. Instead, the Commission went for the more politically neutral formulation of ‘reform the labour law to provide more incentives for employers to hire on open-ended contracts’ (Council, 2015c).

Over the years different alternatives have been discussed to reform the framework of contracts, but the social partners never came to an agreement. The employers’ organisation MEDEF campaigned for introduction of the *CDI de projet* as compromise between flex and secure. This is a contract that falls in between the short- and long-term contract on the basis of the length of a project (minimum 9 months). But the CGT and FO trade union saw it as an attack on the CDI, which for them was a red line not to be crossed (FranceInfo, 2017).
France indeed responded to this CSR. Hollande had promised not to run for president in 2017 if unemployment numbers did not improve and his new reformist team of Manuel Valls and Emmanuel Macron was eager to continue with reforms. In 2015, they launched a series of new reforms, including a new set of measures aimed to further expand the path that had been set in motion in 2013. The government introduced the new provisions as a ‘French-style Jobs Act’, referring to Renzi’s labour market reforms in Italy. One new measure allowed the CDD to be renewed twice instead of once while keeping the maximum limit for the use of this contract at 18 months. At the same time, a bonus of up to 4000 euro was introduced for SMEs that hire on a CDI or a CDD with a duration longer than 6 months. This so-called ‘Macron Law’ further reformed the procedure for dismissals, now making a distinction between simple and complex cases to allow for a more moderate procedure for simpler cases and introducing compensation ceilings that differ on the basis of the size of the firm. The aim was to tackle the issue of complexity and insecurity around dismissals, but the French Constitutional Court rejected an important part of the reform. This decision was seen as a serious setback and delayed the entire package.

The CSRs on segmentation are – in their formulation – relatively modest. It is sometimes thought that the EU has been pushing France for radical Hartz IV type of reforms on the labour market (Thillaye, 2016), but the documents do not seem to confirm this. One can find arguments in favour of more flexibility in the Country Reports, but the CSRs mostly speak about legal clarity for dismissals and improving existing procedures. They include nothing that can be considered a radical overhaul of the labour code. There is, however, one interesting exception on promoting flexibility. In 2015 a part of the CSR reads: ‘Facilitate take up of derogations at company and branch level from general legal provisions, in particular as regards working time arrangements’ (Council, 2015c). This specific call for internal flexibility does not feature in the CSRs in other years, nor is working time discussed in the Country Report or February MIP monitoring mission. This is usually the norm for issues that feature under the CSRs. If one follows the paper

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63 This sub-CSR was discussed in the EPC, where France tried to argue that employers already have the opportunity to adjust working time through company-level agreements. The ECB on the other hand wanted to add a call in the CSR for more firm-level flexibility to deviate from branch-level agreements in terms of remuneration in addition to working time. Both amendments failed to gain a sufficient majority and were not included in the final text. It is quite common for the ECB not to find majorities for its amendments. For the French amendment it has to be borne in mind that the accords de maintien de l’emploi, which indeed already offer opportunities for internal flexibility, are only possible for large firms. Since the 2008 reforms it is also possible to derogate from the 35-hour workweek for employees in smaller firms (the average working time of full time employees is 39,2 hours per week), but there are significant costs attached to overtime. (Source: French proposed amendments to the 2015 CSRs – unpublished)
trail of Commission reports, the recommendation seems to come out of the blue. However, it is clear that the Hollande government was reconsidering the role of collective bargaining in French labour law and labour standards at the time. In spring 2015, Prime Minister Valls asked Jean-Denis Comrexelle from the French Council of State to carry out a review of collective bargaining with a view to reforming the labour code. His more far-reaching proposals opened a window of opportunity for the Commission to include this in its CSRs because the domestic environment allowed for it. But given the lack of any analytical backing for this CSR it is quite an opportunistic move.

The Combrexelle report contained a wide set of recommendations to decentralise bargaining towards the level of firms. The report formed the basis of the 2016 Loi du Travail, or El-Khomri Law, named after the Minister of Social Affairs. The El-Khomri Law is perhaps the most well-known reform of the Hollande government due to harsh negotiations between the government and trade unions. These were accompanied by months of strikes and protests. On 31 March 2016, people took to the streets in no less than 250 cities to protest against the law, with the majority of the French supporting the views of the protestors (e.g. Sapir, 2016a). Decentralisation of bargaining, especially on working time, turned out to be one of the most contentious issues of the reform. The government had to give in significantly to get trade union approval (in the end only the moderate CFDT supported the reform).

The law aims to make collective bargaining on issues such as overtime pay more efficient by reducing the number of branches and introducing the majority principle for the adoption of bargaining results. Similarly, any trade union representing more than 30% of the employees can request the organisation of a referendum within the firm on this result. These steps can be interpreted as a weakening of the position of some of the more radical trade unions. Again the philosophy is the one of German-style internal flexibility: firms can adjust wages and working conditions to maintain employment. In this reform, it can be done through accords de développement de l’emploi. These can be agreed in an earlier stage when a firm faces trouble than the accords de maintien de l’emploi. And they can be used by smaller firms on the basis of elected officials instead of unions.

The El-Khomri reform also expands the possibility for economic dismissals. France was known to have a rather strict interpretation of when economic circumstances allow downsizing of employees. With the new law, a decline in demand or turnover computed over time and depended on firm size would be the legal base on which to judge economic dismissals. This would increase legal safety for employers to hire on
an open-ended contract. The government wanted to go further; an initially envisioned cap on compensation for unfair dismissals was dropped during the negotiations with unions. In order to balance this increase in internal and external flexibility the reform also includes an expansion of the *compte personnel* (the individual training account for employees); the financial safety net; and personalised coaching for young people under the Youth Guarantee.

So, has France reformed its labour market during the first six Semester years? The governments of Sarkozy and Hollande introduced labour market reforms in every single year between 2008 and 2016, together covering every aspect of the labour market and increasing both flexibility and security. Some commentators argue that Hollande was probably the most reformist president France has had for decades (Thillaye, 2016). Critics argue that his reforms started promisingly, but mostly ended up as small and insignificant steps during the negotiations with social partners (Interview 75). Hollande’s reforms – and style of governing – made him deeply unpopular with the French public. Hollande himself warned his successor not to further increase flexibility because he had already reformed enough. The Commission agreed. In the following Country Report, they recognised that the situation in the labour market had not improved during Hollande’s term in office: it appeared more and more segmented, especially among non-EU migrants; the *contrat d’usage* had not been reformed; the unemployment benefit system remained in deficit, educational inequalities had been widening; access to training and low-qualified apprenticeships remained low despite all the new additions to activation; employment had been picking up, but with a pace that was not nearly as impressive as some of its neighbours. But the bonus system for uptake on a CDI introduced in 2015 showed some effects, the CICE had a positive impact and the El Khomri law tackled some of the major rigidities in the labour market, opening the way for rewriting the labour code in the future. As a result, France was labelled in 2017 as having achieved ‘substantial progress’ on the labour market CSR (EC, 2017k).

France continued to receive a CSR in 2017 on its labour market, but only focussed on vocational training and minimum wage developments; the part on segmentation and contracts was taken out. This step was not completely at the discretion of the Commission: on 18 February 2016, the Employment Committee (EMCO) advising the Council already concluded that with the El Khomri law in sight, the CSR on labour market segmentation should not now be repeated. This shows once again that both actors, Council and Commission, are driving the Semester process. Commissioner Moscovici also gave reassurances for the French for the future, as one Ministerial official explains:
... the Commission told us that next year we could be removed from the excessive imbalance category because the situation is improving, we have implemented reforms. Now we see in the core indicators that the situation is improving, so on the basis of these indicators, they could remove France from the excessive category. (Interview 57)

Two-and-a-half months after the Commission told France it had achieved substantial progress, the French population elected a new President who had the deterioration of the labour market and the need for more fundamental reform at the heart of his campaign.

8.5 France and the MIP

French policymakers have over the years refrained from explicit reference to European influence. But their policy orientations have long been closely aligned with European labour market orientations, formulated in the European Employment Strategy (Caune, Jacquot and Palier, 2011). Hassenteufel and Palier call this a process of ‘silent Europeanisation’, but similarly warn that Europeanisation is growing louder than before with the introduction of the Semester. The obligatory nature of EU processes has increased, resulting in a state of permanent welfare reform stress for France, so they claim (2014). The authors give good examples such as the pension reforms that were not announced in political programmes but still executed due in part to EU pressure. The question thus becomes, do we find any evidence of breaking the silence in the case of labour market segmentation? Or, has the MIP acted in a hierarchical manner here?

A distinction that has to be drawn between the analysis in this chapter and that of Hassenteufel and Palier is that pension reforms have a more direct legal link to the SGP. Since the effects of pension reforms are calculable, their effect is taken on board in assessing whether a country reaches its MTO. Labour market reforms and fiscal effort might have been discussed in a holistic manner at some point at the political level, but the official link between the SGP and labour market reforms is very weak. Here there is a clear parallel with the Belgian case; there are widespread perceptions about linkages, but finding smoking-gun evidence is hard (although in the Belgian case the evidence of a link is a lot stronger). Also, under the Two-Pack regulation, France is obliged to come forward with an Economic Partnership Programme. This is a one-off document, in which France outlines how to bring the country back to sustainability in the longer term. The NGO Corporate Europe Observatory believes this proves that labour market reforms are directly linked to sanctions under the SGP (CEO, 2016). However, the document actually
seems more like a paper tiger. It reads like an exact copy-paste of the last NRP; officials admit that its value is quite low and nobody really looks at it (Interview 57).

Furthermore, the package of reforms that was introduced in 2015 (known as the Macron law) was introduced a week before the Commission’s decision not to propose a fine for France under the SGP. It was adopted by executive order to bypass opposition by Hollande’s own party in parliament. The combination of these two facts has led some commentators to conclude that fear of sanctions and effective European pressure was behind the introduction of this reform (Erne, 2015). An advisor to Macron believed that a lack of reform would indeed have sent the wrong message to the Commission, but the link should not be exaggerated. Others argue that while the Commission might indeed have made implicit linkages (for example when they escalated within the MIP instead of the EDP in 2015), the French themselves reject the linkages:

... on process there is no link. You cannot say I want you to do more on reforms in exchange for fiscal leniency. Maybe behind closed door they can ask France to do a bit more on the structural side, but not officially, it is not supposed to be linked. (Interview 57 - Ministry official)

A very strong message from France is to stop messing up the two [EDP and MIP], we have a tool for public finances that covers both debt and deficit and it is called the SGP. There is no reason nor interest to talk about public debt issues in relation to the MIP. And there is some truth to that. (Interview 51 - Commission official)

When in 2015 the Commission escalated within the MIP, the Country Report warned that the EIP could be opened if France did not come forward with sufficient plans in the NRP (EC, 2015). In the Economic and Monetary Affairs Committee of the European Parliament Commissioner Moscovici also repeated that France could indeed face sanctions if it did not come forward with sufficient plans to address their imbalances (EUinside, 2015). And indeed, the Netherlands, Germany and the ECB have called upon the Commission to open the corrective arm of the MIP for France in EPC discussions. One Dutch official remembers heavy discussion in the EPC: pressure was put on France to come forth with serious plans and the CSRs introduced a clear time path.64

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64 On the issue of deadlines: when a Member State is placed under the excessive category, they can receive more time-bound CSRs. The CSRs called upon France to introduce a reform ‘before the end of 2015’ on some occasions. The Commission makes extensive use of this instrument, between 2011 and
The Commission warned that France would be put into the EIP if it did not deliver a sufficient response in their NRP (Interview 5). But if this is as hierarchical as it gets, it certainly did not make a big impression on the French administration. They knew that the Commission and other Member States were never in favour of sanctions. There were definitely a lot of questions, but the discussion on sanctions was very short. ‘It was not really seen as a big issue, it was clear quite rapidly that we would not be put in any procedure’ (Interview 57).

The assessment of excessive imbalances for France is already quite shaky; opening up the corrective arm would simply not have been understood. The Hollande government has been quite aligned on reform priorities with the Commission and the government was delivering, albeit in small steps. The call for sanctions by the Netherlands and Germany was interpreted as a misuse of the MIP, whereas both countries really wanted the Commission to be tougher on the EDP. The label of excessive imbalances can still be a shaming tool in itself, even without sanctions. But it is not one that seems to make much of an impression on the French, as a few telling examples indicate. When the newspaper *Le Monde* reported about the Commission assessment, it mentioned that France was experiencing excessive imbalances, then went on to discuss the Commission’s appreciation of the reforms that were already taken and spent the majority of the article explaining imbalances in Germany (Le Monde, 2016). Similarly, when employers’ organisation MEDEF – which supports the assessment of excessive imbalances - showed a matrix to a group of CEOs and investors that had the French flag on the side of excessive imbalances with Bulgaria and Italy the response was the following:

*This was really bad for many people. “We know we are bad, but the Commission is even worse than we are because they publish such documents, blaming and shaming our country.” The shaming did not work.* (Interview 56 - MEDEF)

Or, as another interviewee put it:

*It does not make much sense to put this label of excessive imbalances on France. It does...*
not impress politicians, it does not do much. (...) I went several times to talk to the French parliament and I can tell you that the members of parliament that are aware of the process is less than five. And they have no idea about excessive imbalances or not. (Interview 59 - economic advisor to the government)

The step to label France with excessive imbalances might be too bureaucratic, but overall the MIP is still causing political tension. The specifics of the MIP are not well-known, but there is a general idea that Brussels is involved with reforms, which leads to similar political tensions as in Italy. Despite Hollande’s efforts to explain that Brussels ‘does not dictate us what to do’ when it comes to structural reforms (Telegraph, 2013), opposition parties use the narrative that the French social model should be saved, amongst other things, from EU imposition. As interviewees explain:

... at the very beginning of the mandate the government tried to sell the reforms with mention of Brussels (...) but quickly they dropped this because they were not able to benefit from this. They were pushed in a corner by Melenchon and the far left, they were saying ‘you’re only doing this to please Brussels’. (Interview 54 - political advisor)

We need to make reforms for the sake of the country, not for the sake of Brussels. You hear this a lot in the French debate. (Interview 59 - economic advisor to the government)

Front National and the extreme left were saying that this is a reform which is imposed upon us [the 2016 El Khomri labour law].65 And the problem is, they are wrong, but not 100%. In the end, it is difficult to distinguish these things. We did these labour market reforms because we believe they are good for France, but also in some part because there is a bit of a groupthink among policymakers where they think that we need to liberalise the labour market, because the Commission says this, the IMF says this, so we need to do it. But in the end, I am afraid we need a national debate on this. (Interview 75 - advisor to Macron)

This latter view is more common among French experts. There is the idea among some that even if the Commission is right in pointing out issues, it should not say so,
Part II: In-Depth Case Studies

because its involvement is counterproductive and distorts the national debate. These considerations were also present in the debate inside the Commission on whether or not to take the CSR away after the introduction of the El Khomri law. On the one hand, this was a discussion (supported by the Council) on how to correctly apply the MIP: whether the CSR should be taken out if the Member State has done its homework, or if they have solved the issue. With labour market reforms there is no objective yardstick to measure whether enough has been done, especially since reforms take time before effects appear. But the controversy over the role of the Commission in the El Khomri debate was also on the minds of the Commission when they made this decision: ’the idea was to take a bit of a step-back approach’ (Interview 48).

This step-back approach already started before the El Khomri debate. The CSR has been formulated in an increasingly open manner over the years so as to not take a clear side in the political debate on the appropriate level of flexibility. In later years the Commission recommended France to reduce segmentation by providing more incentives to hire on open-ended contracts. This reflects a broader trend in the MIP in later years: Portugal, Spain and the Netherlands received similar CSRs and Germany was recommended to facilitate the transition to standard employment (away from mini-jobs). Commission officials admit that incentivizing hiring on open-ended contracts is a bit of an empty formulation, but they also did not want to be seen as promoting liberalisation. As an official explains:

We do not want to steer the direction between the more left-wing approach of subsidizing long-term contracts versus the more right-wing approach to giving more flexibility to dismiss workers. So we try not to take a position in these types of debates, that’s why we use these types of wording. (Interview 51)

French officials have appreciated this cooperative line based on an open formulation of the CSR. As argued before, there was the idea that under Barosso the focus was overly tilted towards flexibility and that the Commission was quite prescriptive in telling countries what to do. This tough line was counter-productive in their view, but the line of the Juncker Commission has been perceived in more positive terms:

The fact that we now have regular missions, so that they better know what the political constraints are in the Member State, this allows them to better frame their recommendations, in order to have a better impact in the Member State. So that it is not a recommendation
which is completely out of the box and so has no impact in the country. (Interview 58)

All in all, the French case shows that political considerations have been involved in operating the MIP. But there are no clear indications of a hierarchical use of the instrument. In contrast to France’s step-by-step worsening position in the MIP, Commission officials argued in interviews that they have been mostly happy with the commitment and effort of France. And French officials argued that they were mostly on the same line as the Commission in terms of the content of the recommendations. Where controversy has arisen this has mostly been on the part of the trade unions. These have not always accepted the EU as a legitimate actor in the debate on the French social system. They see the Commission as recommending a growth model that is unfit for French society. The controversy has not been directed all that much at the segmentation part of the CSRs, where trade unions are not aligned and some of the trade unions even partly agree with the Commission. It is especially the fiscal CSRs and the CSR on better control on wage growth that have been criticized (Interview 53; 55). On wages, the trade unions worked together with the administration in their attempt to convince the Commission to tone down its position. This has not been without success, as officials felt that their position is now slowly being recognised in Brussels.

With the relatively modest approach of the Commission and open formulation of the CSR, the question becomes whether the MIP has had any influence on the French reform agenda? With more than 10% unemployment, the French do not need an annual reminder by the Commission that their labour market is not functioning well. Without the MIP there would have also been reform. But there has been a high level of interaction and information exchange on labour market policies that goes beyond the MIP and indicates broader Europeanization influence. The flexicurity paradigm has been influential in French thinking on labour markets as explained in this chapter. French politicians are also inspired by the German model of internal flexibility and often refer to it, even to the annoyance of critics of the government (and of the German model). The French administration is very much aware of what happens in other EU states, they have social counsellors in embassies in the UK, Italy, Spain, the Nordic countries and others.

At the same time, the French administration has been very active in trying to correct the Commission. For example, in 2016 France proposed 40 amendments to the 5-page CSR document. And it had 18 pages of comments on the Country Report, where others usually only had two or three pages. The corrections concern mostly nuances and factual issues and the Council have only taken a part of them on board.
These counsellors report on labour market reforms and their implementation, and they organise missions for French officials: for example, to Italy after Renzi’s Jobs Act.

Obviously, there is also exchange within the Semester framework. In the Employment Committee the Member States organize peer-review sessions. The French have organised one on youth unemployment and have presented on social bargaining after the El Khomri law and on the personal training accounts (Compte Personelle d’Activité). The bilateral meetings between the Commission and the French administration are held at the highest level and include officials from the cabinet of the President and officials of the secretariat of the Prime Minister (Secrétariat Général des affaires Européennes). Even for answering to the Commission’s questions, we take this very seriously, all the Ministers are there (Interview 58 – French official). The introduction of the Semester as an upgrade to the Lisbon process has also increased the political salience of the process. The Stability Programme and the National Reform Programme are seen as a clear update, as they are written by the top officials of the Prime Minister’s office. Neither documents have a lot of public power, but internally they are considered as the main document outlining the government’s economic strategy.

The NRP is sent to parliament, but primarily for information purposes. There is no parliamentary vote, unlike in most other countries. France has experimented with voting on the Stability Programme in 2014. But this led to internal strife in the Socialist Party, where 41 of its members voted against the budget. For the next year, the Prime Minister decided that neither the Stability Programme nor National Reform Programme would be voted upon. As a result, the recommendations are only discussed in the committees in a rather shallow way (Maatsch, 2017). France, in general, does not have a very strong parliamentary culture and these types of processes are mostly in the hands of the government. However, some see the fact that at least there is some discussion now as clear progress:

The fact that the draft budget is becoming part of the political debate is pretty new and I think it’s a modest, but a positive side effect of the Six-Pack. (…) there was some debate before, but it was mostly confidential. If you look at the budget of France in the last 40 years, there was never a balanced budget. But now, with the Semester, I dare you to hide a big controversy in the press over the fact that Paris is having a budget deficit. (Interview 54 – political advisor)

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67 This view is also supported by Jančić (2016), who shows that while the executive is dominant in the budgetary field, the French Parliament has become a lot more active in this domain in recent years in
While the MIP message does not travel very far outside the administration, the effects on the latter should not be ignored. The constant interaction with the Commission – including with the MIP monitoring missions – has helped to break down the silos of government and disseminates the message of the Commission through the administration. As ministerial officials explain:

*I would say that before, with the old process, we had recommendations on the labour market, but these recommendations would lead their own lives. (...) But having this MIP recommendation, I would say, speeds up the debate. So we have it on the political agenda. There is really a pressure. Second interviewee: Now you have the Minister of Finance who officially deals with all these issues. I really have the feeling that this economic view influences more than before the trend and the time of the labour market reform. There is now a real dialogue between the two Ministries [Social Affairs and Finance].* (Interview 58)

*... the fact that Brussels told us plays a role to implement some reforms. The people designing the laws are aware of Brussels’ pressure, we know that we are asked to do this and that. We anticipate what they ask us because we have discussed our plans beforehand. And the way we design our reforms is inspired at least by the recommendation.* (Interview 57)

The added value thus seems to lie in getting all the relevant players aligned around a single set of reform priorities. This is where effects appear and how pressure is translated. When aggregating from the specifics, it should be noted that the government is clearly aware that they have to show reform effort to the outside world, and the MIP is part of this international reputation. This latter aspect has become a stronger driver for reform in the administration of Macron (Schild, 2018), but his period in office falls outside the scope of this thesis.

8.6 Conclusion

The role of the EU institutions in the French reform debate has been a bit uncomfortable. On the one hand there are those who feel that France makes a mockery of budgetary rules and the Commission should have been much tougher on it. The Commission (and Council) on the other hand have felt that reforms have been more important for

the context of the Excessive Deficit Procedure.
the French economy than stricter fiscal austerity; it has granted flexibility on the SGP, but the Commission decided to step up the MIP. But at the same time, its approach on labour market reforms has been rather cautious and generally supportive of the steps taken by the French administration, at least where it concerns segmentation. There is a realisation that the Commission should not overstep its boundaries in the fragile economic, social and political equilibrium in France. Political considerations have been taken into account at least as much as economic considerations. It is doubtful whether a more rigid approach would have yielded more results. In later years, the Commission has taken a bit of a step-back-approach, which can also be related to the fact that its role became suspicious in the eyes of opposition forces who framed the EU as being opposed to the French social model.

The uncomfortable position also leads to questions about the appropriate use of instruments. One consideration is whether the MIP is enough social, another is whether the MIP is actually the right governance tool to address social issues. There is an argument to be made that well-organised labour institutions help in adjustment and increase shock resilience and are thus an indispensable part of governing imbalances (Bertola, 2017). Also, the French case shows that the fact that this is linked to the MIP has ensured that various actors within the administration needed to be better coordinated, due to the increase of missions. This has led to increased issue salience by making sure that everyone is aligned. The MIP missions have also led to better understanding of positions. At the same time, the issue of EPL is politically thorny, segmentation is a rather structural long-term social issue, linkages to productivity are at best not-proven, elusive linkages of the issue with the SGP raise confusion, and there is a lot of intellectual uncertainty over the right approach. The broader effects on reform can be classified as general Europeanization effects, with only very indirect linkages to the MIP in particular.

These issues all cast doubt on whether a different governance model than the MIP would not be more suitable for segmentation. A different governance organisation could help

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68 Even within the Commission it is sometimes quite difficult to find a consistent line on these issues. On the one hand, there are documents that refer to securiflex instead of flexicurity as a new narrative and which stress the need to come to a more socially-balanced approach on the labour market as part of a package of structural reforms 2.0 (Buti, 2017). On the other hand, there are documents that represent a rather classical economic perspective on labour market and wage-setting flexibility as essential for economic resilience. In a note to the Eurogroup, the the Economic and Financial Committee Secretariat draws a clear connection between strict EPL and employment growth and argues that flexible EPL is necessary in the economic recovery phase to allow for reallocation. As discussed in this chapter, these linkages are not so clear cut and heavily debated in the academic literature. The evidence provided by the Commission to support the argument is also not immediately convincing as the regression line is only mildly positive and is presented without any of the caveats on these linkages that you find in the OECD reports. (EC, 2017d)
in addressing some of the political delicacies, by building CSRs on stronger consensus, as this quote indicates:

*Flexicurity has been the political line for quite some time now, it has been contested strongly since the crisis based on the argument of ‘flexibility now and security later’, with some good examples for this. So now we are a bit in the situation where we try to say let’s try to be less in the political debate between flex and security. Member States have to tackle the issue they face on segmentation, but the balance is up to national politicians. And then we try to have another discussion in a separate forum on what kind of social principles we want to implement. So, we have the pillar on social rights. Here the idea is to be a bit more specific on flexicurity. What are the principles we should implement? In the future when we have this pillar, it would be much easier for us to do a CSR saying they should fight against segmentation by converging faster towards the principles written in the pillar, because the Member States will have signed up on it.* (Interview 51 – Commission official)
Part II: In-Depth Case Studies
Chapter 9

The Dutch Housing Market

9.1 Introduction

One of the main focus points of the MIP is to monitor the evolution of private debt levels as a potential source of imbalances. Countries with high private debt to GDP ratios are more likely to experience financial crises (Obstfeld and Rogoff, 2009). A large component of private debt concerns household debt, primarily in the form of mortgages. Housing market developments play an important role in economic and financial cycles and a number of crises in recent history have their origin in the housing market. The housing market also played a key role in the euro crisis, especially in Spain and Ireland. As a result, banks – as holders of mortgage portfolios – have come under closer scrutiny with the Banking Union. Financial supervisors in twenty EU Member States have introduced all sorts of macro-prudential measures, such as caps on the amount that can be lend or adjusted risk-weights on mortgage portfolios (EC, 2017e). But there is a macroeconomic element to this debate as well. Many Member States have fiscal incentives that induce debt accumulation, either in corporate taxation or with regards to mortgages. Accordingly, the MIP is an important instrument on this issue as well.

The Netherlands is a clear case in point. It might not be the biggest problem child of the euro area, but the recession in the Netherlands was surprisingly deep and long. The Netherlands saw stronger GDP contraction than Belgium or France during the crisis years. While issues such as falling external demand and consumer confidence due to pro-cyclical policies have contributed to the depth of the crisis (CBS, 2018), the analyses of various institutions also point at the housing market and high levels of household debt as an important source of economic instability (e.g. EC, 2012d; SER, 2013). After Ireland and Spain, the Netherlands has the largest boom-bust dynamics of the euro area. The private debt level of the Netherlands stood at 223.7% of GDP in 2011, one of the highest in the euro area and far beyond the threshold of the Alert Mechanism Report (133%). An important part of this debt (106%) and the most important driver of the rapid
increase in private debt in recent years has been outstanding residential mortgage
debt. Accordingly, the Netherlands has been identified as experiencing macroeconomic
imbalances, mostly relating to the housing market and its mortgage financing.

The focus of most of this chapter will be on the CSR for the Mortgage Interest Deductibility
(MID), a fiscal stimulus for homeownership that allows mortgage costs to be deducted
from income tax. More than a third of Member States have a tax system that includes
subsidies for mortgage debt financing, mostly forms of MID. Countries that have a
generous MID, such as Belgium, Sweden and Denmark are all characterised by high
housing prices and high indebtedness of households (EC, 2017e). But nowhere is the
MID as generous as in the Netherlands, and nowhere are the effects on the economy as
acute. The Commission has argued over the years that the MID induces the accumulation
of debt and that reducing this incentive would help in making the Dutch economy less
vulnerable to shocks in the financial cycle. Accordingly, it placed the Netherlands under
MIP surveillance. But the Dutch debate on MID has also been a politically charged one.
Homeowners are a powerful interest in any society, so that politicians are hesitant in
making significant changes to existing structures, also in order not to upset the market.
The Dutch government introduced a number of changes before the decision to place
the Netherlands under MIP surveillance, but have refused to re-open this debate on the
basis of the Commission's CSR.

Before the MIP started addressing the issue of the MID the domestic technocratic
consensus for reform had already taken shape and much of the political debate had
already occurred. Contrary to the Italian case, the MIP was only seen as one voice
among many in calling for further reform. With a strong technocratic consensus and
the obstacle to reform being primarily political, the pressure from the MIP has been
significantly lower than in Belgium. But this chapter will argue that the pressure from
the MIP has also not been completely in vain.

This chapter is structured as follows: the first section will explain some of the particularities
of the Dutch mortgage market and why this can be seen as a macroeconomic imbalance.
Since the only reform of the MID took place before the Netherlands was placed under
the MIP, the process tracing in the second section has a strong focus on the pre-MIP
period. This period is crucial to understand why the MIP had little subsequent effect.
The third section analyses the debate that followed between the Commission and Dutch
authorities when the Netherlands was placed under MIP surveillance in order to assess
the net effect of the MIP in the final section and conclusion.
9.2 The housing market as a macroeconomic imbalance

The Dutch housing market has been shaped by highly interventionist policies spanning decades. Over the years the policy package has come to include: a very generous mortgage interest tax deductibility (MID), counterbalanced by taxation on income from housing (imputed rent); financial guarantees for mortgages; supervision and regulation of housing associations; and control over the supply of housing through zoning restrictions and various types of rent regulations. In the Netherlands, space for housing is limited and, accordingly, spatial planning is a prominent government task. This leads to a relatively controlled and rigid housing supply. In the post-WWII period, much of the policy focus has been based on a political compromise between the Christian parties and Social Democrats. The Christian political parties propagated home ownership based on ideals such as emancipation and responsibility and thus supported incentives to increase home ownership. It was common practice among banks in earlier decades to supply mortgages that would only partly cover total costs, with buyers providing down payments from savings for up to one-third of the total value. The Christian parties' goal was to make the owner-occupied market more accessible for the middle classes who did not always have sufficient savings. At the same time the social democrats – the second big political force at the time – propagated collective arrangements for the working class by focussing on housing associations and corporations.

The policy focus contributed to a major shift in the composition of the housing market: between 1947 and 2009 the share of owner-occupied housing doubled from 28% to near 60%, while the share of social housing more than doubled from around 12% to 33% of the total, leaving only a very small margin for the private rental market (Haffner, 2011). This composition is not extreme in comparison: multiple European countries know homeownership rates above 70%. But the small private rental market, the very large social housing sector and the incentives for home ownership have made the market rigid and price-inelastic. With the private rental market being small and the social housing sector large, the Dutch housing market primarily offers two flavours: an expensive property segment and a relatively cheap but also highly restricted rental sector. A more expensive rental sector or cheaper property sector remains relatively undeveloped. Lack of available private rental houses can hamper labour mobility and social housing often involves long waiting lists and many tenants with a relatively high income under subsidised housing. This structure is also seen as further stoking up housing prices and leading to unnecessary risk-taking for starters who are almost forced to buy. The MID is a key element in this structure, it benefits homeowners, but also has serious adverse effects.
The MID has long been an issue of low political salience. A relatively small group profited from the MID, so it was tolerated. The costs of the measure to the public purse, however, rose steadily both in terms of the number of households making use of the MID and the deductible amount per household. At the same time, the 1990s had seen a rise in popularity of innovative financial products, which amplified the effects of the tax incentive. The most notable is the interest-only mortgage; with the rise of this financial product homeowners would stop amortising their loans and thus maximise their profit from the tax deductibility by keeping the mortgage debt constant. By 2009, when the crisis seriously started impacting the Dutch economy, more than 90% of mortgages were amortisation-free. But Dutch households also started borrowing more. In the mid-1990s, there was still a prudent culture of saving before buying a home. Average loan-to-value (LtV) ratios - the amount borrowed as a percentage of the total appraised value of the property – stood at around 50%, and the norm was to amortise the loans. But due to rising income and the steady rise of housing prices, banks started lending more to customers. This was obviously a profitable business. At the start of the crisis, the average LtV ratio for new mortgages had risen to a peak of near 120%. Even in the USA, where banks were famous for risky lending to homeowners did the LtV ratio not rise above 90%.

The clear fiscal incentive not to amortise the mortgage, combined with generous mortgage lending by banks contributed to an increase in gross private debt from 186% of GDP in 2000 to 223.7% of GDP in 2011. This increase is almost entirely accounted for by the increase in household debt. From the mid-1990s up until the crisis bank loans to the real estate market increased from 30 to 60% of GDP and became the dominant part of bank portfolios. These figures are significantly higher than most other European countries. And in accordance with this excess lending housing prices have risen continuously, from an average of 100.000 euro in 1995 to 250.000 at the start of the crisis. Mortgage debt saw an even stronger increase in this period, from 180 billion euro to 680 billion (CBS, 2012). Even more so, without a change of policy direction the share of amortising loans from the 1990s period would rapidly decrease and be replaced by new non-amortising mortgages at a much higher value, meaning a further strong increase in total mortgage debt (see Vandevyvere and Zenthöfer, 2012, Lejour 2016 and Bezemer et al., 2016 for further analysis, graphs and statistics).

The high private debt levels and housing market of the Netherlands had been repeatedly pointed out as a concern by international organisations (e.g. OECD, 2004; IMF, 2006).

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69 The Dutch figures have to be interpreted with caution, as the high LtV ratios for example also reflect extra borrowing to pay tax levies on housing purchases.
Yet, successive Dutch governments largely dismissed these warnings. Price increases were deemed in line with fundamentals. In other words, while there was a boom in housing prices, the authoritative institutions did not believe that there was a housing bubble, due to rigidity in supply and simultaneously rising income. When the IMF warned the Netherlands in 2008 – the year before housing prices started declining heavily – that they were overvalued, the warning received strong criticisms from the Ministry of Finance, the Dutch Central Bank, economists and bankers (NRC, 2008).

Moreover, supervisors looked primarily from a microprudential viewpoint at the risks for individual banks. The Dutch mortgage market had been characterized by low default rates due to the strong legal protection of the lender, with losses incurred on mortgages by banks remaining below 0.04% before the crisis, one of the lowest rates in the euro area. Accordingly, Dutch banks paid low risk premiums on securitisations to finance mortgages (NVB, 2014). And perhaps most importantly in the argumentation of the Dutch: the high private debt levels were seen as being offset by assets. With its large pension funds, the Dutch gross financial wealth position stood at 280% of GDP, also very high in international comparison. This means that the net financial position – assets minus liabilities – was around 115% before the crisis. So, while the MID itself had over the years become a topic of controversy – as will be explained in the next section – the private debt levels were generally not seen as a serious macroeconomic imbalance.

The crisis showed that this argumentation was incomplete at best. Looking at the net financial position, one might be inclined to think there is no imbalance, but the gross position can still reveal all sorts of vulnerabilities. And when the housing prices started to drop from 2008 onwards, the vulnerabilities of the mortgage market started manifesting themselves. We can distinguish between three types of vulnerabilities: macro-prudential vulnerabilities, macroeconomic vulnerabilities, and fiscal vulnerabilities. The latter concern had always been the dominant argument in the public debate. Left-wing parties were the main actors to bring this argument to the fore and the crisis only amplified it. Simply put: the MID is quite expensive for the public purse. The net costs of the MID for the public purse – costs of MID minus the gains from the imputed rents – had over the years risen to a peak in 2014 of 10.7 billion euros in foregone tax revenue. It is especially the wealthier households with larger mortgages who benefit from the measure, giving it a regressive redistributive effect. With the Netherlands in the Excessive Deficit Procedure for most of the crisis years, the MID became a considerable component of the discussions with the Commission. Lowering the MID would help bring down the deficit. But the Commission also argued that alternatively if the Dutch government were to lower the MID, the gains in tax revenue could be compensated by lowering taxes.
on labour, thus increasing competitiveness. Other financial vulnerabilities for public finances, such as the national mortgage guarantee system have manifested themselves to a lesser extent, due to continued low delinquency rates during the crisis years.

But, despite low delinquency rates, new macro-prudential vulnerabilities emerged that were not so well-recognized before the crisis. The rapid growth of mortgage debt in the 1990s went hand-in-hand with a shift in financing. Whereas pension funds and life insurers used to be the primary funders, these have over the years slowly moved overseas and banks have stepped in (De Vries and Schoenmaker, 2016). Accordingly, Dutch banks have come to hold relatively large mortgage portfolios compared to other EU countries: 27% of bank assets, compared to the 15% EU average in 2009 (EC, 2012d). And since banks can only partly fund these through savings deposits, this leads to a funding gap. The funding gap of Dutch banks was larger than that of any other EU Member State. Dutch banks relied on securitisation to provide the extra funding for the mortgages to fill the gap. So, while the Netherlands overall has a positive net financial position, banks were capital importers. This left them vulnerable to developments in the capital markets.

Securitization in mortgage lending has become a point of increased awareness since 2008, due to its toxic effects in the US subprime crisis. In Europe, capital markets became more expensive and less accessible during the crisis years, leading to a significant decrease in the market. With banks overall coming under considerable stress during the crisis and the mortgage portfolio making them even more vulnerable, lending to the real economy started to decline. The risks of a funding gap can really be identified as a new element in the debate, which had a considerable impact on the eventual change of policy direction. As interviewees confirm:

*Before the financial crisis, little attention was paid to the risk side of the mortgage debt, meaning; the consequences for banks and the consequences of high household debt. (...) I remember that in the Dutch debate, especially among economists, the core of the debate was about market disturbances and the fact that you can be more efficient with tax money.* (Interview 10*, advisor to the government on fiscal affairs)

*In 2008 this changed because housing prices started dropping, that is when we saw that the risks started manifesting themselves. We were always conscious of the risks for households, but the insights on the funding gap is something that has really emerged during these crisis years.* (Interview 21*, financial supervisor)
Macro-prudential risks are assessed in the MIP reports for the Netherlands but have also found their way in other forums such as the European Systemic Risk Board and the Single Supervisory Mechanism, as will be explained in later sections. There is also a more purely MIP story to the Dutch mortgage market. With high mortgage debt, households become vulnerable to fluctuations in housing prices. When housing prices start dropping especially younger households with high loan-to-value ratios risk falling into negative equity. As a response, households become more careful, start saving, and accordingly subdue demand, thus affecting the overall performance of the economy in a pro-cyclical manner. The Dutch government has always argued that the high private debt levels should not be seen as a risk, because they are offset by the asset side, leading to a positive net financial situation for the country. However, those with the highest debt are mostly young families, while those with the assets are the elderly. Hence, high private debt levels can still cause a considerable drag on the economy. Secondly, from a micro-prudential viewpoint, banks are relatively safe with their mortgage portfolio because they enjoy strong legal protection. In the USA you can default on your mortgage and hand over the keys to the bank, but in the Netherlands this is almost impossible. The result is that households become more risk-sensitive when housing prices drop, which again feeds a decrease in consumption. From a macroeconomic viewpoint, the high mortgage debt makes the Dutch economy vulnerable to shocks in housing prices. Problems in the financial sector can more easily spill over to the real economy.

The macroeconomic consequences of high mortgage debt indeed proved to be a strong explanatory variable of why the Dutch crisis was so deep. Close to a third of households fell into negative equity after housing prices continued dropping, reaching a peak of 1.5 million households in 2014, a staggeringly high number (EC, 2016h). As a result, Dutch consumer confidence reached historic low-points in the 2011-2014 period, with depth in 2013 lower than crisis-ridden Spain. The mortgage debt thus has strong pro-cyclical effects. Not only in the bust, but also in the boom, when housing prices rise, so does consumer confidence. Countries like Sweden, the UK, Ireland, and Spain suffer from a similar dependence of the economy on the housing market, whereas this dependence is much lower in France or Belgium (DNB, 2018). Sweden and the UK have also been recommended to introduce measures to lower mortgage debt under the MIP, while Spain and Ireland have received bail-out support. The Social Economic Council (SER) points to the vulnerability of households to housing market developments as one of the primary causes for the prolonged recession in the Netherlands. Roughly half of the fall in consumer confidence at the time can be explained by falling housing prices. Pro-cyclical fiscal policies and pension contributed to the rest. The economic crisis, so the SER concludes, was mostly homemade (SER, 2013).
Interestingly, while the effect on demand has been the main point of concern among domestic economists, the Commission also brings another argument to the fore. Namely, that the fiscal treatment of housing creates distortions in capital allocation. The argument here is as follows: the fiscal incentives for buying a house are so strong in the Netherlands that this pushes households to allocate more resources to housing than might be desirable. At the same time tax is levied on other types of investments, for example in financial assets. The Commission argues that if less capital were allocated to housing, capital would be freed for more productive investments, thus increasing the growth potential of the Dutch economy. Such choices are of course not fully politically neutral, as it can be a deliberate choice to incentivize household investment towards less risky markets, such as mortgages. Before the Netherlands was placed under the MIP, the CSR document even cited this argument as the main issue. As a Commission official explains:

> So people are incentivized to hold very high debts, rather than having money left to buy stocks or something. A house is a house, a business would use that money to invest. So we were focused on growth and investment, and that is still a valid argument for us, also if you consider this within the larger picture of the current account surplus. We try to connect these things, by saying ‘there is a lot of money in housing, instead of investment’. (...) While with the MIP we also ask ourselves the question ‘is there a systemic risk?’ (Interview 9* - Commission official)

The capital allocation argument is perhaps a bit far-fetched and has certainly not been seen as among the more important reasons to address the MID in the domestic debate. But all in all, the vulnerability of the financial sector and the linkages to consumer confidence shows that the Dutch mortgage market is a clear source of macroeconomic imbalances, with the MID amplifying its effects. However, the Commission was not the first to make these arguments; far from it, they were well known in the domestic debate. Over the years the consensus among economists had grown on the adverse effects of the MID. The IMF, OECD and a wide range of domestic economists and institutions had been making similar arguments for years. The decision to place the Netherlands under the MIP and the recommendation to lower the MID did not come as a surprise to Dutch politicians. By the time the Netherlands was placed under the MIP, the debate on the MID had already been marked by a long history of political struggle.

70 The Netherlands has one of the highest current account surpluses in the euro area. An increase in domestic investment could potentially lower the surplus. The Dutch surplus was seen as an imbalance from 2016 onwards, despite being above the 6% threshold for all of the MIP years. For a discussion on current account surpluses see the chapter on Germany.
9.3 A political debate in deadlock

In the 1990s, the MID and overall mortgage debt were issues of low political salience, but things slowly started changing in the early 2000s. The strong increase in housing prices served as a warning that risks could emerge. In 2001 a tax reform was adopted which limited the MID to primary residences and only for a period up to 30 years. These were later followed by a number of smaller changes, such as the requirement to invest the profit from a housing sale into the new mortgage in order to be eligible for MID in 2004, and some changes to the system of imputed rents in 2005 that would give a fiscal stimulus for amortisation, although not as strong a stimulus as lowering the MID would have been. These measures did not result in any significant policy shifts but rather aimed at confining the more extreme elements of the fiscal framework. In the political debate, however, the MID increasingly became a topic of controversy between left and right-wing parties.

Left-wing parties started arguing against what they saw as an unfairly favourable fiscal treatment for wealthier households who benefit most from the tax benefit. Right-wing parties on the other hand, heavily protected the MID, since they saw it, amongst others, as a means of countering a perceived overly progressive tax system. The size of the tax discount gives a strong political incentive to vote for right-wing parties. And with homeowners being an important part of their constituency, prominent right-wing parties Volkpartij voor Vrijheid en Democratie (VVD) and Christen-Democratisch Appèl (CDA) refused to discuss the issue. This discussion should be seen in a broader framework of various fiscal stimuli, such as rental subsidies for lower incomes, which were in turn heavily protected by left-wing parties. The MID itself became seen as a sacred cow in this discussion; former CDA Prime Minister Balkenende repeated often in debates that under his leadership there would be no changes to the MID. Even more so, discussion on the issue would only lead to unrest in the housing market and should thus be avoided. As one interviewee recalls:

_Balkenende claimed at that time that we shouldn't even do research on the MID; we weren't even allowed to think about changes. The fact that he felt compelled to say that was of course in response to increasing debate._ (Interview 7° - Dutch official)

While politically the debate on reform of the MID seemed deadlocked, interviewees confirm that at a technocratic level a broad consensus emerged that the housing market, including the MID, had to be reformed. The Dutch governance system has a strong
network of technocratic institutions and research institutes, which had been warning from the early 2000s onwards in increasingly alarmist tones about the malfunctioning of the housing market and adverse effects of the MID. These included amongst others: the Dutch Central Bank (DNB), the Bureau for Economic Policy Analysis (CPB), the Social Economic Council (SER), the Council for the Environment and Infrastructure (RLI), the Netherlands Environmental Assessment Agency (PBL) and the Council of Economic Advisors for the Parliament. Most of their analysis is consistent with what the Commission reports would later argue.

These reports led to an intensification of the debate at the technocratic level, but little actual reform momentum was built up politically. In 2007, the Council of Economic Experts concluded that the government shied away from reforms in areas with vested interests, such as the housing market, labour market and pension system (REA, 2007). Another report heavily criticized the government for failing to see the malfunctioning of the housing market as a problem and for pursuing ineffective and inconsistent policies with regards to it (VROM Raad, 2007). At the same time, Prime Minister Balkenende proclaimed during the annual debate on policy directions that the Netherlands was simply tired of reforms (hervormingsmoe). In his analysis of the political debate before the eventual reforms, tax expert Lejour argues in this context: ‘the economic arguments about distortions in the housing market and the fact that effectiveness gains could be achieved by reforms did not seem to be authoritative arguments in the political discussion. Reforms would lead to visible losses for some, while the benefits would be diffuse and only materialise in the future. Political parties did not want to risk losing voters by introducing structural reforms’ (2016; 16*).

The financial crisis can be considered a turning point in the debate. The deterioration of the housing market and falling housing prices made matters considerably more acute. In 2010 the government introduced a gradual increase in the imputed rents for houses above 1 million euro. Finance Minister Bos – a supporter of limiting the MID – described the measure as a change of the MID ‘through the backdoor’ as it would decrease the net benefit for homeowners. He predicted that the deduction would not be maintained in its current form in the next government (2009). Bos’ prediction was only one among many similar views in a debate that had gradually evolved over the years. The many warnings contributed to building reform momentum. During the crisis years, potential buyers halted their purchases, giving politicians an incentive to provide for clarity on future policy direction to let the housing market regain confidence. As summarized by one of the interviewees:
.. the polls showed that the majority of Dutch people already expected the MID to be tackled. This was also thanks to all the attention it received from international organisations and the CPB and DNB, basically everyone who constantly stated ‘Netherlands, this is not sustainable’. Something simply had to be done. And at a certain instance, it breaks. You can say ‘it’s nonsense’ a few times, but if everyone says it and repeats it and all Dutch think something will happen … (Interview 10)

But even though housing prices started dropping significantly in 2009, it took another three years before reforms were announced. For the VVD and CDA, the MID became a political taboo and was even named a ‘breakpoint’ for a new coalition in the 2010 elections. One of the negotiators for a new progressive-liberal coalition that was to be formed after this election – the leader of the Greens Halsema – observes in her political memoirs that the MID was perhaps the most significant disagreement between left and right, which led to a failure of the talks, after months of negotiations (Halsema, 2017). Instead, a right-wing government was formed with three parties (VVD, CDA, and the Partij Voor de Vrijheid (PVV)) who had all strongly opposed changes to the MID in the elections, thus diminishing reform momentum.

In 2011 – the year of the right-wing pro-MID Rutte 1 government – things started moving. With a lack of political will to move the dossier forward, the banking and insurance sector took it upon themselves and proposed a code of conduct on mortgage lending (Gedragscode Hypothecaire Financiering 2011), which was later backed by parliament. The code of conduct introduced – for new mortgages - the abolition of full non-amortising loans, limiting the amortisation-free part to 50% and total lending to 104% of the market value of the property (including 2% capital transfer tax, this makes for a 106% Ltv ratio), as well as a set of new guidelines aimed to better match lending to income. Especially the abolition of the full non-amortising loans, which were the vast majority for a long time, can be seen as an important step in the right direction. Later that year incoming Central Bank (DNB) President Knot further increased political pressure by stating that the mortgage market contained perverse incentives not to amortise mortgages (the MID), leading to an aggregate mortgage debt that can be seen as an important risk for the financial system, and credit rating agencies became increasingly worried. His statement was widely interpreted as a call to limit the MID and various politicians from governing parties cried murder (Volkskrant, 2011). But behind the scenes the need for change slowly became obvious.

In spring 2012 the Dutch government had to find new austerity measures worth 9
Part II: In-Depth Case Studies

billion euro in total to meet the SGP criterion before sending its Stability Program to the Commission as part of the European Semester process. The three coalition parties agreed to look not only to the short-term, but also to discuss the longer-term sustainability of the public budget, including structural reforms. ‘There can be no taboo at the table’, Finance Minister De Jager proclaimed at the start. However, after seven weeks of negotiation (Catshuis overleg), the PVV left the table and the Rutte 1 government fell. Tired of a lack of reform, alarmed by the need to send a clear signal to Dutch citizens and the financial industry, and motivated to stick to the deadline for sending the necessary documents to the Commission, a number of opposition parties joined the outgoing government in a new agreement that was reached within 48 hours. The pace for reaching this deal, which involved a substantive austerity package, was seen as unprecedented in Dutch political history and still surprises many.

As part of the package, the so-called ‘Spring Agreement’ proposed to make the MID for new mortgages available only for those which will be fully amortised by annuity or by similar means within a period of 30 years starting in 2013. This measure can be seen as significantly stimulating the amortisation of loans and thus reduction of debt levels. The fact that it would only apply to new mortgages, however, means that its effects will only be significant in the longer term. A second measure included a limitation of the maximum LtV ratio from 106% to 100% in annual steps of 1% per year over the next six years. This measure was combined with making permanent an earlier temporary reduction to 2% of the capital transfer tax – the tax levy on housing purchases – which also reduces the need for buyers to borrow extra to pay for it. The limitation of the LtV can be seen as a change in policy direction since the government had for a long time believed that the mortgage was a private contract between lender and client where the government should not intervene. It was the code of conduct of mortgage lenders themselves that limited the LtV to 110% and later to 106% in the preceding years. As stated before, the years before the crisis saw ratios of up to 120%, but in the crisis years banks became conscious of the risks associated with such ratios and decided on a common norm to avoid competition on LtVs.

Limitations to the MID were a step too far for the governing parties, which had won the elections with promises that it would not be touched. But at this stage, all parties were conscious of the troubles in the mortgage market. The reforms of the Spring Agreement were not met with widespread resistance in the public debate. This opened the door for further reforms. In the elections that followed in 2012 the housing market and MID were again important topics. With the economy still in poor shape, political parties were convinced of the need for structural reform as well as to put public finances on
a sustainable footing. The VVD, for example, had toned down its sharp defence of the MID somewhat. While the party’s 2012 election program still opposed changes to the MID it did recognise the need to stimulate amortisation of mortgages, the fragility of the mortgage market and the need to reduce debt levels. The VVD would join forces with the left-wing Partij van de Arbeid (PvdA) in the Rutte II government that was installed in November 2012. Both parties had insisted on the need for a reform-minded government to overcome the crisis; all cards were to be put on the table, resulting in what can be seen as a major breakthrough in the debate. As the VVD finance spokesperson explains:

... there was momentum to start reforming because that is what the electorate expected of us. We had to create clarity on what would be the policy direction in the mortgage market for the years to come. Due to the insecurity starters were stalling their purchases and we wanted to stimulate the housing market. (Interview 12*)

Starting from 2014 the maximum tax rate for the MID would be slowly reduced for all mortgages from 52% to 38% over the next 28 years, by 0.5% a year. So, until 2014 the mortgage interest could be deducted from the highest tax bracket of 52%, which meant half of the interest paid would be returned in tax savings. The reduction of the MID by 0.5% per year means that only the highest incomes are targeted at first. The majority of households have the highest part of their income in the 42% tax bracket, meaning they will only be affected by the measure in 2035. A gradual and slow reduction is generally seen as the safer approach so as to not upset the housing market. However, whether the speed of the phasedown of 0.5% annually is not overly cautious would become the main topic of discussion between the Dutch government and the Commission.

The reduction of the MID was part of a more holistic new policy approach for the housing market. The gains from reducing the MID were mitigated by lowering income taxes for those groups most strongly affected by the measure in a fiscally neutral way. This can be seen as an important precondition for the VVD, which has long argued that the MID is a compensation for an overly progressive tax system. At the same time, the property market would be stimulated by fiscal incentives and a 50 million euro fund for first-time buyers. Additionally, a tax break was introduced for residual debt, to compensate the many households with negative equity. This can also be seen as linked to the decision on the MID, given that parties believed that a stimulus package and tax break in times of austerity should go hand in hand with structural reforms. The reforms of the property segment were furthermore to be combined with reforms in the rental market. A first step was the introduction of a differentiated rent system, with valuation better reflecting
market value and annual increases becoming partly income-dependent. Due to the strict regulation both of rent levels and increases, the market had become rigid, with many examples to be found of people with a high income, but very low rent. And finally, the social housing corporations were required to refocus on their primary mission, thus limiting their accumulation of excessive property portfolios.

Some interviewees described the new policy direction as a compromise between left and right. In this view, the right (VVD) has loosened its position on the MID in exchange for its long-desired wish to make the private rental sector larger at the expense of the over-large social housing sector, much in line with the Commission recommendation. Left-wing politicians, by contrast, would rather see an increase in the total housing stock in the rental sector to make housing better available for the middle class, than stimulating a shift by making prices more market-oriented. Left-wing politicians would resist this interpretation, arguing that their view towards the social housing sector has not been as dogmatic as the fierce protection of the MID among right-wing politicians. As a Labour Party spokesman explains:

*Of course, the rental sector is a bit more sensitive for us. But it is not true that we only wanted to reform the property market and not discuss the rental market. (...) As a politician, I cannot accept that people have to wait for 7 years before being able to obtain a house in the rental sector, which really was the case before.* (Interview 14*)

To conclude, the new policy direction can be seen as a breakthrough in the debate after years of deadlock. The government hoped to dispel the uncertainty in the housing market - after years of speculation about change - and return to stability. And while it is difficult to establish causality, it is noteworthy that shortly after the installation of the new government and the announcement of the new policy direction, the low point in housing prices was reached and from 2013 onwards the market slowly started to recover. The government at the time made it clear to the markets and the electorate that this would be it in terms of reforms, while the focus would henceforth be on restoring calm. The controversy in this case, however, is that the proposed reforms were seen by the Commission as simply insufficient.
9.4 The Dutch housing market and the MIP

9.4.1 The MIP came late

The Netherlands was placed under MIP surveillance in 2013, the second round after its introduction. The 2011 Semester cycle did not include a CSR on housing. The Commission Staff Working Document, which provides the supporting analysis for the CSRs, mentions the housing market including the financial vulnerabilities of high mortgage debt and the fiscal incentives stimulating this debt, but quickly goes on to repeat the traditional Dutch arguments on the net financial position, which supposedly offset the high debt. Excluding the housing market is interesting, given the fact that the IMF in its Article IV consultations dedicated considerable attention to the adverse effects of the MID in the same year (IMF, 2011). The explanation for the lack of attention to this issue in the 2011 CSRs was bureaucratic, according to interviews with officials. The Commission services were aware that the housing market was a bigger problem than previously assumed, but they needed time to make a case for a CSR.

*You need to build a good case, with research or other things. In one way or another, you need something to convince your colleagues, management and eventually the College of Commissioners that this is a point of concern. So it is also a matter of time.* (Interview 6* - Commission official)

In 2012 an Economic Paper by DG ECFIN staff was published with a full assessment of the Dutch housing market, which can be seen as providing the basis for the CSR on housing, which was issued not long thereafter (Vandevyvere and Zenthöfer, 2012). The 2012 Commission Staff Working Document (SWD) welcomed the steps taken in the Spring Agreement but took a stronger worded tone otherwise. It argued that there were underlying structural problems in the Dutch economy that required a fundamental policy response. “The economy is in need of far-reaching structural reforms in several areas (among which the labour and housing markets, pensions and public finances) in order to relaunch itself on a path of sustainable growth.” (EC, 2012d: 5)

The Alert Mechanism Report of 2012 did not assess the Netherlands as experiencing macroeconomic imbalances warranting the opening of an In-Depth Review (IDR), due to the positive net financial asset position. Interviewees describe this decision as ‘a close case’; putting the Netherlands under the MIP was considered, but not pushed through.
This changed in 2013 when the Commission decided to open the MIP and start with an IDR. Commission officials deny that this decision had any links with the change towards a more reform-minded government with regards to housing. Rather the assessment was based on the continued worsening of the housing market and economy, together with the simple fact that the Commission believed that the announced measures were not enough. The 2013 AMR described the decision as follows: ‘there has been deterioration in growth prospects linked to domestic demand. Risks to the economy in the Netherlands mainly relate to the housing market and high private household debt, as a result, the private sector debt indicator is significantly beyond the indicative threshold. Although households have a strong net financial asset position, the debt-to-asset ratio continues to rise and this is a source of risk for household balance sheets.’ (EC, 2012e)

The eventual CSR that the Netherlands received on the housing market has the reduction of the MID as the main element but also includes a second part, relating to the private and social rental sector. The Dutch were asked to reduce the large housing stock of the social housing corporations and make the system of rents in the private rental market more market compatible. Interviewees broadly considered this a logical supplement to the recommendation, as they agreed that the housing market needed a holistic approach dealing with all three sectors (property, private rental, and social housing). The rationale was to broaden space for the relatively underdeveloped private rental market. The large size of the social housing sector and the decoupling of rents from incomes help to compress the private rental sector, thus increasing the incentives for owner-occupation, which in turn is a key source of private debt. The part of the CSR on social housing and the rental market was mostly in line with the 2012 coalition agreement of the Dutch government and substantial progress has been made in this domain over the years.\footnote{While market-based pricing in the rental sector and reducing the social housing stock has been introduced as a strategy to increase the private rental market, the consequences have been severe, especially in some of the larger cities. These include issues such as: international hedge funds jumping into the market for high profits, significant hikes in rent and lower and middle income households being driven out of the larger cities (Hochstenbach, 2016). The division between social housing stock and private sector housing is among the most divisive issues between left and right-wing parties in municipalities like Amsterdam.}

The fact that the MIP was opened for the Netherlands in February 2013, several months after the new policy direction was announced, including the decision to limit the MID, de facto means that the procedure as such did not influence this decision. Given the long history of the debate, the many comments in the media, the many reports on the housing markets, the expectations of the public, the warnings of financial supervisors,
and other factors that contributed to building reform momentum, the 2012 CSR – published a few months before the election – is also not likely to have had a clear impact on the change of policy direction. To assess causality, one has to consider the counterfactual: would the MID have been such an important topic in the 2012 elections if the CSR had not mentioned it? Given the history of the debate, it is safe to assume that this is likely to have been the case. The CSR should simply be seen as one voice among many in a crowded debate. The sober analysis of a Commission official is telling in this regard:

*You could even argue that we were lagging behind events a bit, but that does not really matter, you don’t want to push things too far during elections and make bolder statements than others have already done. But I don’t think the influence has been very strong. Our SWD is simply an analysis, our Economic Paper is an analysis, and the CSR really should be seen as an invitation to open a discussion on the issue.* (Interview 6* - Commission official)

Indirect influence has rather come from the EDP. The quest of the Rutte I government to find 9 billion euro in additional savings to meet the SGP requirements presented the government with the opportunity to discuss longer-term sustainability issues. It should be noted here that the measures presented in the Spring Agreement – limitation of LtV ratio and limitation of MID to annuity mortgages – do not do much for the public budget in the short term, nor does the later introduced limitation of the MID. The real effects would only come in the long term. It is impossible to determine the influence of the EDP in exact terms; we will never know whether the Rutte I government would have decided to start discussing the longer-term sustainability of public finances at that time if it was not for the EDP. However, the fact that an ad hoc coalition was able to present a draft policy plan within 48 hours to meet the Semester deadline of handing in the Stability Program and National Reform Program can be seen as a clear indication that the external pressure of the Semester was taken seriously.

### 9.4.2 Why the Commission believed the reform was not sufficient

The 2013 Commission SWD welcomed the change in policy of the Rutte II government as a step in the right direction but quickly added that the pace of reforms was slow and needs to be stepped up. Consequently, it argued that only ‘some progress’ had been achieved in addressing the 2012 CSR (EC, 2013c). This is quite a sobering assessment, given the fact that domestically these steps were considered as a breakthrough in the debate. The Commission services noted a number of criticisms, most important of which was that
the 0.5% annual reduction of the MID was seen as overly slow. This pace would mean that the limitation would only start impacting the bulk of mortgages after two decades. For the first 20 years, only 18% of households would be affected. Similarly, the stricter eligibility rules for the MID, namely the requirement to amortise the loan by annuity or similar means, were only applicable for new mortgages. This means that the bulk of non-amortising loans are not affected. Going after the existing stock of mortgages would be a lot more effective, but would also result in heavy political opposition.

Another dampening factor is that when old mortgages are refinanced, borrowers are still able to transfer their tax benefit to a new loan. As a consequence, what can be seen in the mortgage market after the reform is that for starters nearly all mortgages are annuity mortgages, meaning they will be fully amortised. However, many mortgages are being refinanced, or rolled-over, for which a substantial part continues to be interest-only. All in all, the Commission concludes that ‘the proposed measures lead to an overly back-loaded adjustment in the owner-occupied segment, as they are geared towards preserving advantages for existing borrowers. Therefore, the planned reduction in mortgage interest deductibility should be accelerated in order to reduce disincentives to amortise and lower the fiscal drag. This will mean putting a larger part of the burden of adjustment on existing mortgages’ (EC, 2013c; 23). Consequently, the 2013 CSR asked the government to accelerate the planned reduction in the MID.

The Dutch government disagreed with this analysis, arguing that with all the measures proposed the tax facilities available for the MID will be reduced by over 40% by the end of 2042. In their 2014 NRP they argued: ‘The government has deliberately chosen for a sensible balance between the rate of change of the tax treatment of mortgages on the one hand and stability of the housing market and household incomes on the other. The government believes that the housing market currently benefits from stability, which will give the housing market time to recover, and considers it most prudent to not increase the speed of reforms' (Ministry of Economic Affairs, 2014; 8). This is a highly questionable statement. First of all, experts agree that a phase-out of the MID should be done in small steps, so as to not upset the market and household income. They draw lessons from earlier cases, such as Sweden, which introduced a relatively quick phase-out in the 1980s, which considerably affected housing prices and the UK which introduced a more gradual phase-out and which is taken as the example for Dutch policymakers. Secondly, it is very difficult to establish an exact rate of annual reduction that can be considered as a sensible balance. But, most interviewees – apart from the politicians of the governing parties – agreed with the Commission’s assessment that an annual rate of 0.5% is very low and in theory, it would be sensible to speed up the pace. For example:
.. for the VVD 0.5% was the maximum that was politically acceptable. This is, of course, a very low pace. Obviously people have their planned payment duties, but you could have easily done 1% per year, some people might have complained, but it would definitely have been possible. (Interview 10* - advisor to the government on fiscal affairs)

I think we should reduce the rate further because the risks have not disappeared. If you look sec at the reduction then a slow and gradual change is a good thing, but I think we should do it faster, 1% annually or something. (Interview 21* - financial supervisor)

The Commission reports themselves do not mention a preferable rate of annual reduction, but the 1% annual reduction mentioned in the interviews was often referred to. A reduction of 1.1% per year was for example proposed before the elections by a group of 22 economists in their six-step reform plan for the mortgage market (Bartelsman et al., 2012). The reason for deciding on a 0.5% change is seen mostly as a matter of political acceptability for the VVD. The PvdA had proposed in their election program to combine a gradual limitation of the MID from 52% to 30% with the introduction of a gradual cap on the maximum deductible amount of a mortgage in relation to the average housing price. Both measures were to be introduced over a span of 30 years (PvdA, 2012). Especially the cap on the maximum deductible amount – not taken on board by the government – would substantially lower the impact of the MID.

Obviously, the PvdA as a member of the government coalition publicly defended the steps taken as sufficient, as argued by their finance spokesman:

.. you have a transition phase of course, but in the longer term, there is a limitation. So if you look at the sustainability of the subsidy in the longer term, and limiting the LTV helps here as well, we have taken the right measures. (...) I do feel that the Commission does not show enough appreciation for what we have done. (...) You can do a lot within one government period, but you cannot take away all the imbalances of the past 20 years. That is an illusion. (Interview 14*)

9.4.3 The absence of a direct effect

Despite the recommendation and the decision to put the Netherlands under the MIP, it has been obvious that within this government period there would not be a second
round of reform to the MID. In this sense, the CSR had no direct effect. Politicians of both governing parties promised calm after the reform and continued to reiterate the argument that any talk of new reforms would only further upset the housing market (e.g. Volkskrant, 2016). Also, the Dutch political system is characterized by relatively watertight coalition agreements; hence introducing a new and substantial reform that has not been announced in the coalition agreement would be highly remarkable. As explained by one of the interviewees:

> On the one hand, you could argue that we have not done enough, so we should do more. But there are quite a number of counterarguments. People want to know what they can expect when they buy a house. And if the government has just introduced new measures and communicates that these are aimed at restoring calm in the housing market and despite this you introduce further reforms (...) There are some disadvantages to that. (Interview 7* - Dutch official)

The argument of required stability in the housing market is also one with which the Dutch government managed to convince other Member States to agree to amendments to the recommendation in the joint sessions of the Council advisory Committees (EMCO and EPC) in 2013, 2014 and 2015. In each of these years, the Dutch managed to obtain a reinforced qualified majority\(^7\) to include a small sub-sentence that waters down the recommendation by stating that stepping up reforms to the MID should be done ‘while taking into account the impact in the current economic environment’ (Council, 2013a), ‘when the economic environment allows for it’ (Council, 2014), or ‘with the strengthening of the recovery’ (Council, 2015a). Housing prices reached their low point in 2013, started recovering slowly in 2014 and were seriously picking up, albeit not in all geographic regions, in 2015. It should be noted here that amendments to the CSRs seldom get the support of a reinforced majority of Member States for such profound changes to the substance of a recommendation against the Commission’s opposition. But the support was widespread, as another country’s representative recalled the first debate:

> I remember in this meeting (...) the Netherlands presented their case and when asked

\(^7\) In order for a CSR proposal to be amended, a reinforced qualified majority is needed within the Council. A reinforced qualified majority comprises 72% of Member States accounting for 65% of the Union’s population. This is officially a vote in the Council, but takes place in the preparatory committees as a signaling device. It should not be confused with the reversed qualified majority voting, which refers only to the procedure for imposing sanctions in the SGP and the MIP.
whether there was support for the Dutch amendment immediately a couple of countries intervened and said ‘yes, of course, we see why this is indeed very country specific so we think we should support the Netherlands’. And I remember the Commission desperately trying to explain why this shouldn’t happen (...) there was a general understanding that their case sounds quite logical. (Interview 22)

With the amendments accepted, the Council showed itself to be milder than the Commission. The revised CSR read that no further reforms are needed until the housing market has fully recovered. At the same time, the impact of these changes should not be exaggerated, since the decision to amend the CSR is made at the Ministerial service level, while the politicians interviewed were not aware of any such changes. They simply interpret the recommendation as a political signal that more needs to be done, to which their answer is that they feel this government has done enough. The bilateral discussion between the government and the Commission – which happens at least three times a year – revolves around interpreting various analyses of the housing market to discuss the situation and to what extent the mortgage debt still poses threats to the economy with possible spillover effects. These are not very heated discussions since the positions are already known and unlikely to change. Interviewees acknowledged that the meetings have mostly focussed on other topics, such as the labour market or pensions where more fruitful discussions were to be found. For example:

For the larger part we understand one another, they understand our arguments, we understand theirs, these discussions do not turn into a fight. It really is a matter of interpretation, the glass is half full or half empty. (Interview 7° - Dutch official)

It’s about the theoretical question of ‘what would happen if the Netherlands would limit the MID not in 30 years, but in 25?’ Then we would argue that this would not seriously affect the housing market. That is our interpretation of the housing market. And the Dutch government would argue that the housing market is still too fragile. (Interview 6° - Commission official, 2016)

At this point, as a reader, one might wonder what the purpose is of the entire MIP exercise in the Netherlands. Both parties already know that nothing will change. At the start of the Semester, the process received considerable traction in Dutch politics, with the Parliament aiming to really be ‘on top of things’. But the debate on the 2016 National Reform Programme in Parliament had quite a different tone, as this statement of a
Christian Democrat MP indicates:

The least exciting is the National Reform Programme. By now this exercise is turning into a ritual dance. The European Commission dances from Brussels to The Hague with a pile of recommendations on our household debt, pensions, and MID and the Dutch government dances along for a bit before sending the Commission back to Brussels with a copy of the coalition agreement ... Everybody happy and next year we’ll do the exact same. (Bruins-Slot, 2016*)

It is understandable that politicians interpret the process in this manner. The documents from both the Commission and the Dutch government in later Semester cycles indeed read mostly as a copy of previous years. In Commission circles, there has also been a continuous debate on whether to uphold the recommendation or not. As one official explains:

... so then you get to the question, we know they are not going to do anything, should we take the recommendation away? Or do we leave it to create additional pressure? The elections are next year already, so they can take this on board. And this is a question we constantly have to keep asking ourselves, not just for the Netherlands, also for France or Italy. (Interview 9° - Commission official)

But in the end, whether or not there is reform appetite in the Member State is not the driving rationale behind a CSR. The Commission remained of the opinion that while the craziest aspects of the Dutch mortgage market had been dealt with, the structural issues were still insufficiently addressed. The bulk of mortgages remain untouched by the measures introduced and therefore the debt bias continues to exist. The argument of strengthened boom-bust dynamics due to high mortgage debt has even become more valid throughout the years, as total mortgage debt has continued to increase (Janssen and Brosens, 2017). This is due to old amortising mortgages from the mid-1990s being replaced by new ones at a much higher value. Taking away the recommendation, or taking the Netherlands out of the MIP, would confirm the Dutch narrative that enough had been done. At the same time, keeping the CSR intact would keep the issue on the agenda, whereas political attention to the problem was waning domestically.

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73 As a response the Minister for Economic Affairs denied that the Semester process has turned into a ritual dance and went on to praising the reform effort of the Dutch government.
9.4.4 The MIP as one voice among many

Political appetite for further reform was low in the Rutte 2 government, but economically the circumstance for reform improved significantly. From 2015 onwards housing prices started picking up with significant speed in the Netherlands, especially in the cities. With the housing market showing a strong recovery in most parts of the Netherlands and interest rates at a historic low due to factors such as quantitative easing, a window of opportunity emerged for more fundamental reform of the MID without significant costs. The Dutch government might have been excused by the Council for not intervening too heavily in the housing market during a period of stress, but in later years the position against further reform slowly became indefensible. Officially the Dutch continued to argue that calm in the market was still required because not all households had moved out of negative equity (Ministry of Economic Affairs, 2016). But the real reasons against further reform were political, not intellectual. New political momentum would have to be created for further steps in a future coalition.

To help build up the pressure for further reforms multiple economists argued in 2016, the year before the next elections, that this would be the time to lower the MID (e.g. Boot and Bovenberg, 2016). As the famous saying goes: you have to fix the roof when the sun shines. If monetary policy would normalise again, interest rates would rise and new issues could emerge for households with high mortgages. In 2016 the reports of advisory institutions on the need for further reform started to pile up again. Two reports that stand out in this regard are a joint exploration by the Bureau for Economic Policy Analysis and Environment Assessment Agency which presents a menu of policy options and their related cost and benefits and a report coordinated by the most senior of civil servants from all ministries on reform and investment needs for sustainable growth (CPB and CBL, 2016; SDG, 2016). Both reports present a menu of policy options that can serve as inspiration for political parties when drawing up their electoral programme and both have further sobering of the MID listed as a key reform.

The reports can also be seen as paradigmatic for the deeply embedded nature of technocratic advice in Dutch policy making. They are more detailed and bolder in terms of policy suggestions than the Commission’s Country Reports and hence are better suited to serve as inspiration for politicians. Interestingly enough, no reference is made in either report to the Commission’s analysis of the housing market, or the CSR. Finally, the Central Bank continued to draw attention to the issue, arguing that for the sake of financial stability it would be best to not only further limit the MID, but also further limiting the LtV to 90% (DNB, 2016). But calls to further lower the LtV limit leads to
furious responses in parliament.

The position of the central bank in the debate is interesting, as stated in the introduction: the MIP has worked in parallel with macro-prudential policy in this domain. Taking a broader perspective on the pressure that comes from European economic governance, the effects are more acute.\textsuperscript{74} The build-up of macro-prudential oversight, including warnings from the European Systemic Risk Board to the Dutch government (ESRB, 2016) pushes economic advisors to think critically about issues such as the Dutch Loan-to-Value ratio, which still stands a lot higher than in neighbouring countries or other elements of possible systemic risk caused by the mortgage portfolios, such as the funding gap of banks or the still high number of interest-only mortgages. As one interviewee explained:

\begin{quote}
If you are the outlier, you constantly have something to explain. And these types of discussions keep it on the agenda. It keeps us sharp. We can share our concerns. The international consensus is very important here. (Interview 21* - financial supervisor)
\end{quote}

Inspired by European developments in the macro-prudential debate and wary of further developments in this domain, Dutch banks have become more conscious of the risks associated with their pre-crisis model of market-based financing and have sought to increase their long-term sources of finance. Also, with the Single Supervisory Mechanism for euro area banking, Dutch mortgage lending is coming under a different type of scrutiny, which is more harmonized and less sensitive to arguments based on local conditions. Dutch banks and supervisors increasingly have to defend themselves in discussions with the ECB (or the Basel Committee) that the culture of payment is strong in the Netherlands and that underwater mortgages do not present large risks. The impact here is more direct, as the ECB can demand certain capital ratios on mortgage portfolios. In their assessment of the first months of the Banking Union, de Vries and Schoenmaker write the following in this context: ‘the ECB is closely monitoring Dutch mortgages. To gain further evidence about the risks and performance of Dutch mortgages, European banking supervision (spurred by DNB) has started an on-site

\textsuperscript{74} One can also think here of single market rules, such as the Mortgage Credit Directive, issued in 2016. This directive has an impact on the penalty consumers have to pay to open up the mortgage contract in order to take out a different loan and as such makes it easier for consumers to deleverage. Also relevant are the legislative acts of the Capital Markets Union project, which aims to achieve more simplicity and transparency in mortgage debt securitization.
review of mortgage portfolios. (…) For this reason, Dutch banks are currently selling parts of their mortgage portfolios, partly to pension funds and insurers, and have reduced the supply of mortgages' (2016: 134-35).

The focus on Dutch banks is important, but given the low delinquency rates and low non-performing loans ratio, the Central Bank deems the macroeconomic argument of pro-cyclicality still to be more important (DNB, 2016). This brings us back to the political debate on the MID. The Commission (and those commentators mentioned above) hoped that by continuing to draw attention to the issue it would reappear on the political agenda in the next election. But after years of heavy debate before 2013, the MID barely featured in the 2017 elections. The VVD did not include a statement on the MID in its electoral programme and the only appearance the issue made as an official discussion topic in the campaign was in a debate between financial specialists broadcast only on Facebook (RTLZ, 2017). As the VVD finance spokesperson described the situation from his point of view a few months before the elections:

_For the MID there is less momentum, because the electorate simply wants the MID and because the housing market is sufficiently stable._ (Interview 12*)

Or, another interviewee:

_No. Look, you have some people calling for this, you have these reports, but it is like the 2000s, we also had all these reports and people calling for reform then, and nothing happened with it. In economic terms, this would be the moment for further reform, but politically there is no reason to do so, there is not a sense of urgency._ (Interview 10* - advisor to the government on fiscal affairs)

Officially the period of analysis for the case studies in this thesis stretches to the Spring 2017 Country Report. However, for the Dutch case, the events thereafter are simply too important to leave unmentioned. None of the interviewees expected much to happen on this dossier, yet the government that was installed in October 2017 announced a new tax plan which would include a lowering of the MID by 3.5% per year, starting 2020. This is a much more significant limitation than expert reports had proposed. The move is extra surprising since the two biggest parties in the new government – the VVD and CDA – had traditionally been those most opposed to any meddling in the system of MID. But the coalition talks had presented political momentum for reform.
In addition to the economic factors, a number of specific political factors were important: first, after years of deadlock, the previous government had broken the taboo by taking first steps in 2013. Second, the VVD – the largest party and biggest opponent of reform - had not lost out electorally from the previous reform. Third, the second biggest party of the government – CDA – had come up with a plan for an overall tax reform that would reduce the number of tax brackets and simplify the overall system. This would imply an overall lowering of taxes for higher-income households, which would then be compensated for by things like lowering the MID. The coalition agreement had taken inspiration from these plans and announced a package which linked a lowering to the MID with a reduction of tax brackets from four to two and a resetting of other incentives such as the system of imputed rents and the 2005 tax break for amortised loans (Wet Hillen). This would make the lowering of the MID neutral in terms of the overall tax burden for most households. The other two parties of the coalition – D66 and the Christen Unie - had strongly advocated lowering of the MID. These domestic factors were key to open space for further reform, but the recurring MIP CSR was not completely in vain either, as the next section will argue.

9.5 Analysis and conclusion

The MID in the Netherlands has presented a classical dilemma of structural reform for Dutch politicians: short-term pain for long-term and more diffuse gain. Lowering the MID would hit a large electoral constituency directly in their wallets and the argument of lowering pro-cyclical effects is economically strong but does not give a tangible result for right-wing parties with an agenda of lowering taxes. The story of reforming the MID has been mostly one of overcoming political hurdles, not one of heavy intellectual disagreement. The consensus on the adverse effects of the MID among a wide range of economists and domestic and international institutions was strong, so that the additional layer of analysis presented by the MIP reports did not add many new elements to the already matured debate. Similarly, the CSR was not seen as overly prescriptive, as most people would simply agree that lowering the MID would be a key factor in reducing the mortgage debt. Although minor disagreements were still to be found, the primary case against reform was political.

For years it was a heavily contested issue with strong positions that created a situation of deadlock. Some interviewees believed that in the years before the first reform, right-wing politicians also understood and agreed with the economic arguments, but thought that changes were simply too risky in electoral terms. The fact that reforming the MID
was on the table in the all-right-wing and anti-MID-reform Rutte 1 government before it fell seems to confirm this suspicion. The challenge was to find the political momentum to introduce changes. The 2013 reform here is most noteworthy, it might not have been labelled as a major reform (“some progress”) at that time, but it was a very significant moment in political terms, breaking the taboo and setting the stage for further reform.

MIP recommendations do not necessarily create this political momentum. Domestic political factors have been decisive. We should characterize the role of the MIP as one voice in an orchestra of institutions and commentators that continued to draw attention to the issue. The MIP was not the dominant voice in the debate, but the CSRs and all the reports contributed to keeping the issue on the agenda, pushing opponents further into a corner and providing authority to the arguments for reform. As such it created pressure, which made a modest but still important contribution to the reform agenda. With some reform enacted in 2013 and the craziest aspects of the housing market dealt with, there would be an incentive for politicians to think that the issue has been dealt with and stop talking about it, but the MIP helped to keep the discussion alive. In this sense, the pressure is useful for pro-reform politicians, as the statement on the 2017 reform by the D66 spokesperson on fiscal affairs indicates:

*If all these economists say: “watch out, there is an imbalance here”, this matters. And what you see is that sometimes there is momentum for reform, especially with the housing prices on the rise and with the two brackets tax system that was discussed. In this setting, we were successful in pushing for it [lowering the MID] in the negotiations. I am very pleased with this result. And in the debates, you can hear us refer to both the domestic and the international institutions, like the European Commission, who were warning us for this imbalance in the housing market.* (Interview 72* - Steven van Weyenberg)

Or as a Dutch official puts it:

* .. we have always defended this measure, me too. But slowly we realised that things weren’t going so well with the MID. ... Does it help if international organisations constantly tell us ‘guys, you have to reform this’? The answer is yes. All those conversations, constantly referring to this issue, you should not underestimate what that does. The Netherlands is a country of technocrats, typically a country that is very sensitive to the fact that there is a continuous discussion with international organisations on this issue.* (Interview 76* - Dutch official)
The pressure from the MIP came mostly from the persuasiveness of the argumentation; political pressure from peers or direct pressure from the Commission has been rather modest. The Commission has always seen the Dutch as a reliable partner on reforms when they are most necessary. The CSR should be read as a signal that reform should happen sooner rather than later. Interviewees describe the bilateral meetings and discussions in the Council Committees as a ‘learning process’ (Interview 5) with ‘open discussions’ (Interview 9) that ‘contribute to idea formation’ (Interview 8). At the same time, they acknowledge that the most fruitful discussions have rather been on other topics, such as labour market and pension reform. Furthermore, the Council has been quite conciliatory towards the Dutch; many representatives in the Council simply bought the Dutch argument that at a time of housing market stress you don’t reform too deep and you don’t introduce one reform after another in a short period. It shows that the CSR has been quite contestable for the Dutch. But in later years holding off reform became increasingly indefensible due to better economic circumstances. Ideally, pressure for reform should be strongest in good times when reforms are least costly, but there is no indication that the Commission changed tactics. There has been no clear indication of a hierarchical use of the MIP towards the Dutch. This would not be seen as credible by Dutch politicians, who immediately refer to lacking pressure on Italy and France when asked about pressure on themselves.

As one Commission official describes his view of the Dutch:

_The Dutch are a good example. Obviously, they don’t do exactly what we tell them to, and the other way around. But they present themselves as a reliable partner, their organisation is solid and they have a well-structured story on the basis of facts and analyses. And when they really have to, especially on the fiscal side, they stick to their commitments. We shouldn’t exaggerate our role, in the end, it will have to come from the country itself._

(Interview 15*)

The key story of this chapter is the MID, but when taking a broader perspective on the Semester in the Netherlands, there are a number of final side notes to underline. First of all, it is quite striking how the Dutch political elite used the Semester framework in the early days of the crisis. The Netherlands did not face high borrowing charges or serious risk of speculative attack from financial markets, despite a negative outlook away from the triple-A rating. Yet, Dutch politicians interpreted the Semester’s fiscal targets with rigour. The 2012 Spring Agreement, negotiated with unprecedented speed to meet the Semester deadline, included a significant package of social cuts, but also measures
that would hurt growth in the short term, such as an increase in VAT, while consumer confidence was at a significant low point. The only rationale for such measures seemed to be to meet the fiscal targets as soon as possible. The Semester provided useful external pressure for political parties that wanted significant cuts. But, looking back - with the benefit of hindsight - some of the choices were strongly pro-cyclical. And the strategic use of fiscal rules by Dutch politicians shifted part of the blame towards the EU on the basis of a there-is-no-alternative logic. Such developments have given the Semester a bad reputation among opposition parties, who started referring to CSRs as “dictates” in debates (e.g. VK, 2012).

Secondly, while the fiscal rules were perhaps taken too seriously, in other domains the Commission at times struggled to remain relevant. In 2014 the Netherlands received a CSR that called on more differentiated wage increases, using the existing framework. The Dutch government only took note of the CSR and declared that social partners were free to make use of the existing framework any time. The year thereafter this CSR was taken out, whereas no general wage increase of significance occurred. Similarly, the Dutch received a highly prescriptive recommendation on their pension system in 2015, where the government was asked to reduce contributions to the second pillar of the pension system for young workers. The recommendation was not implemented, because the Dutch did not agree with the specific measure that was prescribed, but the overall theme of intergenerational solidarity in the pension system is a problem that is recognised. In 2015 the relevant Minister was working on a pension dialogue with the sector and experts to analyse the problem and come up with suggestions, so the broader topic was taken seriously, despite a lack of implementation of the specific recommendation. The Commission – after being criticized by the Dutch representatives – recognised the issue and indeed speaks of intergenerational fairness in later CSRs. The examples show that the Commission has to balance its aims of setting ambitious targets while also trying to remain relevant in domains that are recognised as problematic.

All in all, we can conclude that the MIP made a strong case on the MID but was far from the only one to make it. The MID presents a clear incentive for the accumulation of private debt and as such increases the vulnerability of the Dutch economy. Excessively high mortgage debt strengthens the business cycle, both in the up- and in the downturn, leading to a financialisation of the economy (WRR, 2016). The impact of the MIP on the Dutch debate on the MID has been modest, but helpful to keep the issue on the agenda and increase political cost of non-action. A broader perspective shows that the MIP has acted in accordance with macro-prudential policy and banking supervisors claim that they are increasingly confronted with a European way of thinking about financial
stability, which translates itself into the domestic policy domain in a more abstract way.
Chapter 10

The German Current Account Surplus

10.1 Introduction

Many see Germany as the economic powerhouse of the euro area. Having been famously called ‘the sick man of Europe’ in the early 2000s, Germany is seen as having climbed out of stagnation through pervasive structural reforms. Many of its firms excel in exporting products and Germany showed remarkable resilience during the crisis with record-low unemployment and a budget in surplus. To others, the German economy is marked by mysterious behaviour. To put it bluntly: while the Germans make a lot of money through exports, the managers do not invest it at home, the workers do not receive higher wages and the government refuses to bring education, research, and infrastructure spending to higher standards. This has resulted in lower demand levels and - because the money is not spent in Germany - in the highest current account surplus of the world in real terms, close to 250 billion euro in 2017, about a third more than the number two: China.

Since each surplus is matched by a deficit elsewhere, the German surplus has an impact on the global (and euro area) economy. Germany ultimately relies on the fact that others behave differently from itself: where Germany saves, others sustain demand, import and need the capital to do so. About 20% of deficits globally are matched by the German surplus. These imbalances warrant the attention of policymakers since they played a key role in how the financial crisis morphed into the euro crisis. And the continued divergence in current account positions is seen as a sign that the euro might be good for some, but not for others.

But there is also a lot of ambiguity around surpluses. While they are the counterpart of...
deficits elsewhere, they do not behave in symmetrical ways (Unger, 2017). There are many underlying economic dynamics that are not captured by the current account position. The surplus is the outcome of millions of individual choices in consumption, saving and investment of households and corporations. These dynamics are only indirectly affected by policies. This makes it a difficult economic variable to use as the basis for assessing internal and external risk or to act as a target for economic policy. Economists see persistently high current account imbalances as a symptom of distortions in the economic and financial landscape of a country. But since it is the outcome of so many factors, establishing causal pathways on how they are distortive is notoriously difficult. The case of the German surplus stands out in the MIP in terms of its depth and complexity. It encompasses the entire economy and the thinking about the surplus is still taking shape.

The role of the German surplus in the EMU has also led to considerable debate among politicians and the broader public. Politicians in France and Italy have repeatedly called upon Germany to redress the surplus. Germany has over the years taken a tough stance against deficit countries but is sometimes seen as not playing its part in the process of rebalancing, whereas it takes two to tango. But the German case differs from the others. French actors agree with the Commission that unemployment should be tackled and Italian actors agree that growth should be enhanced, but in Germany, the disagreement with the Commission runs much deeper. It goes to the questions of whether there is a problem at all, and whether policies have the ability to address it. The debate involves powerful policy frames of export strength, the surplus as the result of the others’ weaknesses and a thrifty culture of saving. Unlike the Dutch case, the taboos still had to broken and there is no technocratic consensus on the issue. This also means that there is more scope for the MIP to be a factor of influence. However, the Commission has struggled to build a consensus around a different view of the surplus. This chapter will argue why this is so.

Much has been written about the surplus, but usually, authors end up by taking a position on what causes the surplus or whether the Commission should be tougher. This chapter picks up where most authors leave the discussion: it examines the efforts that have been taken to address the issue, why there has not been more effort and what the effect has been of the Commission’s approach in this domain. But before doing so, the first sections dive into the analysis of why and how the German surplus might be distortive for the EMU. This will be done on the basis of three narratives that describe how it may affect others, but also why each narrative has drawbacks that make it easy for the German administration to argue against it. For the assessment of what is being done
to redress the surplus the chapter focuses on the CSR for public investment, one of the key debates between the Commission and the Germans, while also paying due regard to some of the other CSRs.

10.2 The current account position as an ambiguous indicator

Google the terms “Germany”, “Eurozone” and “problem” and you will get a host of op-eds and articles arguing that the German economy represents one of the core problems of the euro area. German reluctance to address their surplus is widely seen as an important obstacle in euro area rebalancing. But the public debate seems surprisingly distant from the economics of the issue. A VOXEU survey shows a wide majority of economists believe that the German surplus is a threat to the euro area (den Haan et al., 2016). But that does not mean that there is agreement on the way in which it is a problem. It is by no means easy to show through what causal mechanisms Germany’s surplus has an impact on others in the euro area, since it is the symptom of deeper issues in the economy. And economists disagree deeply about the way in which it constitutes a macroeconomic imbalance.

Before analysing the various arguments, it is worth first unpacking the current account position a bit. The current account includes the trade balance (exports minus imports) plus the net income balance from assets held abroad, such as profits, interest, and dividends. This represents the real economy reading of the current account. The second way of reading the current account focuses on the financial side and looks at private and public savings minus total investment; the financial account. To put it simply: in a closed economic system, when country A exports to country B, country A has a surplus in the trade account; it then receives money from country B to pay off the product or service, which is captured by the current account. But country B can then also borrow money from the banks in country A, which is captured by the financial account. The sum of the current account and the financial account of each country is by definition zero, as they are a mirror image: if you have a surplus on the current account, you have a deficit on the financial account.

As a side note, it should be mentioned that the terminology of current account, capital account and financial account can sometimes be confusing. The current account is usually used as a synonym of the current account and the capital account. At the same time, many authors use the term capital account where I use the term financial account.
The terminology has changed over time and is not universally applied in equal ways. Following the definition of Eurostat the capital account includes capital transfers and represents only a small part of the current account. The financial account is the mirror image of the current account and reflects transactions in financial assets and liabilities.

Since the current account and the financial account are two sides of the same coin, the current account balance is often described as the balance between savings and investment. A surplus in this conception means that the inflow of capital from exports is not fully being used for consumption and domestic investment, but also for investment abroad or accumulation of foreign claims. In other words, if you are a surplus country, then you are a net lender to the rest of the world and vice versa. Furthermore, the current account is a flow variable, which represents annual change; the stock of international assets minus liabilities is expressed in the net international investment position (NIIP). The NIIP, however, does not perfectly match the cumulated current account position, since there are also revaluation effects. (For more on current account balances, see Krugman and Obstfeld, 2006).

The current account position of a country explains whether it is a net lender to or borrower from the rest of the world. Current account asymmetries allow for spreading expenses over time. For example, countries with ageing populations can run surpluses to delay consumption. Countries with deficits are typically catch-up economies that need investment now but will repay later. As such, the asymmetries can be useful and are the natural consequence of international economic interactions. They can potentially lead to a more efficient allocation of capital, as returns on investment can be higher in upcoming economies. It also allows for international risk diversification, as domestic risks are shared with international investors.

“When the Maastricht Treaty was negotiated, current account positions were never discussed as a significant policy indicator” (Collignon, 2017: 276). It was thought that within a monetary union, internal current account imbalances would not matter. A deficit is not problematic so long as the country in question can attract private capital to finance it. And in theory, within an integrated financial system with a single payments system (TARGET 2), the geographical location of the bank that provides capital should not matter. In the USA, this logic seems to hold. Banks operate across state lines and current account imbalances between the states have so far not created serious problems. The current account position of individual states is not even measured. The USA does not have an equivalent to the MIP. In the euro area, divergence of current account positions was seen as in line with
what theory predicted, since the EMU was meant to allow countries with excess savings to invest in peripheral states (Blanchard and Giavazzi, 2002).

But instead, the crisis showed that large and persistent current account differentials in the EMU concentrate rather than diversify risk. Chapter three tells the story of the unwinding of current account deficits. But while the deficits have been painfully corrected in the euro area, surpluses of countries like Germany or the Netherlands did not show symmetrical adjustment but have continued to rise. Surpluses and deficits must equal one another, but any individual current account position can be matched by changes in assets and liabilities in any part of the global financial system. The surplus of Germany and the Netherlands showed high correlation with the deficits in the rest of the euro area before the crisis (EC, 2012b), but it is impossible to establish a clear causal connection between any specific surplus and deficit. The current account position is just the tip of the iceberg; there are a lot of underlying dynamics that the current account balance does not capture. It captures net in- and outflows of capital, but excludes the underlying changes in gross flows and their contributions to existing stocks of foreign assets and liabilities. These are usually about tenfold higher and this is where much more volatility occurs.

For deficit countries, the risk is relatively obvious. But for surplus countries the risk factor is much harder to establish. In Germany, you often hear that the surplus is necessary for an ageing society. But the question is up to what point this argument holds: does an ageing society need a surplus that reaches 8% of GDP? It is widely believed that large and persistent surpluses are a symptom of economic distortions in the domestic economy and are also distortive for the global (or euro area) economy, since they are the counterpart of deficits elsewhere. But where this distortion lies is not easily established. Not every surplus is the same. A 2012 study on the eight EU countries running persistent surpluses finds considerable differences in what causes them and in what way they can be risky for the domestic economy or for others (EC, 2012b). In some cases a persistent surplus can signal subdued demand and investment or excessive saving (Germany); in other cases it can be the result of the large financial sector (Luxembourg) or the structure of the pension system (the Netherlands). The level of a current account, therefore, does not immediately tell you whether there is also an imbalance.

One argument that I do not discuss in this chapter, but which should be mentioned nonetheless is that the measurement uncertainty of balance-of-payment statistics is worryingly large. Mügge (2018) shows that there is significant deviation in what the Netherlands counts as export to Germany and what Germany counts as import from the Netherlands.
Assessing whether there is an imbalance starts with examining the drivers of the surplus. Assessments of the drivers are based on models with large variation in the choices and design of explanatory variables. For example, the IMF attributes half of the German surplus to fundamental factors such as demographics (the elderly are more prone to save) or manufacturing intensity (IMF, 2015a). The Commission attributes only roughly one-eighth of the surplus to fundamental determinants (EC, 2016i). A telling fact here is that in the first In-Depth Review, the Commission concluded in one of the statistical annexes that in its model-based analysis: ‘by far the largest component, almost 4 pps, is the one that remains unexplained. In other words, neither the position in the business cycle (Germany’s or its partners), nor policy choices or underlying economic needs, explain the level of the surplus’ (EC, 2014; 100). (For one of the most elaborate attempts to construct an anatomy of the surplus see Kollmann et al., 2014.) All in all, we can state that the current account is a rather ambiguous indicator: it hides a lot of information that should determine whether there is indeed a problematic situation.

10.3 Is the surplus distortive for the EMU? Three narratives and their limitations.

10.3.1 The competitiveness narrative

The competitiveness narrative is perhaps the most well-known narrative on EMU rebalancing. It focuses on the real economy identity of the surplus; the strength of the German export sector. One can find many variants of this narrative, but it basically holds that wage moderation created such a cost advantage for German exporting firms that they managed to outcompete firms in the periphery. In Germany, wage formation was led by unions in the sectors that are most exposed to price competition. They have a tendency to keep wages down to preserve jobs. Peripheral states did not have the corporatist infrastructure to pull off such wage restraint and wages often followed trends set by the sheltered sector. The peripheral Member States thus had higher wage costs and, as demand rose, inflation increased. Germany had low inflation and an increase in firms’ cost competitiveness. As such, firms in the peripheral states saw German firms undercutting them.

Before the coming of the euro, high-inflation countries like Italy compensated for these tendencies by devaluation. Germany, on the other hand, saw multiple nominal revaluations of the Deutschmark. These were associated with the continuous surpluses
Chapter 10: The German Current Account Surplus

that Germany has since the end of WWII. The introduction of the euro is seen as having reinforced divergence in competitiveness by fixing the exchange rate so that nominal exchange rate appreciations would not occur. The setting of a fixed exchange rate with the single currency was meant to break the cycle of competitive devaluation, but Germany managed to continue down this path through other means. And because they were the first one to embark upon such strong wage restraint, they gained a significant competitive advantage. This led to their export strength, corporate savings and hence, the surplus. And since Germany is the largest economy of the euro area, this competitive advantage is bound to have an effect on the others. Germany’s reliance on external demand in this narrative is seen as a beggar-thy-neighbour strategy (for examples of this narrative see: Iversen and Soskice, 2013; Johnston, Hancké and Pant, 2013; Wren-Lewis, 2015; Scharpf, 2016; Flassbeck and Lapavitas, 2016).

The German economy has indeed relied heavily on exports. Almost half of German jobs are directly or indirectly linked to the export sector. And contrary to most Western states, Germany managed to hold on to its export market share in recent years, even expanding in certain markets (Fratzscher, 2018). In addition to the exporting giants such as Volkswagen, Germany has a lot of medium-sized firms that export high volumes of goods in specific niche markets. These firms produce products such as machinery that are in high demand in emerging economies, especially in Asia (Sachverständigenrat, 2014). This partly explains why the German economy was less affected by the demand shortage due to the euro crisis. At the same time, Germany has seen continuous wage moderation starting in the 1990s, when steel and metal unions decided to trade wage increases for job preservation. This practice became widespread in order to increase employment. The Hartz labour market reforms fed into this dynamic by expanding the low wage service sector. It should be noted that Germany entered the euro with an overvalued exchange rate. This explains part of the wage moderation in the years thereafter. However, German wage restraint can easily be called excessive (see also chapter six of this thesis on Belgium). And while Germany managed to recover quickly after the crisis, over a longer time horizon German economic growth has been far from impressive: 1.3% per annum between 1999 and 2016 on average (Priewe, 2018).

But while Germany has relied on a strategy of wage moderation and relies heavily on exports, the argument that it has undercut the competitiveness of others in the euro area fails to convince. German export products are to a large extent intermediate and high-end products that are relatively price-insensitive. Its export sector has the highest diversification and product complexity of the euro area (Abdon et al., 2010). Cyclical factors such as the euro exchange rate or oil prices had an effect on Germany but did
not alter the overall trade surplus to a significant extent. Of course, pure non-price competitiveness does not exist: there is always a price-quality balance. But the quality component of German products is more explanatory of export success and fluctuations are mostly explained by global demand patterns (Breuer and Klose, 2015). This also explains why German exports have not suffered the losses in market share that France and Italy have seen since the rise of Asian economies. More importantly, surplus countries such as Germany are the main trading partners for peripheral states, but the reverse does not apply. Econometric analysis shows a positive link between the exports of surplus states (primarily Germany) and the exports of peripheral states. In other words, they have benefitted from the increase in exports of German firms, because their exporting firms are integrated into the supply chain (Hobza and Zeugner, 2014).

An analysis by the Commission concludes that there is no evidence for the claim that exports of surplus countries have crowded out the exports of the euro area periphery. Among exogenous factors of competitiveness loss in peripheral states, they point to a host of other issues, such as emerging markets, changing patterns of global demand and enlargement of the EU (EC, 2012b). German exporting firms compete primarily with firms in Japan, USA, and South Korea, whereas firms in other euro area states have benefitted from Germany’s export surge (despite not being able to keep up with technological progress to become a competitor of German firms). It is important here to remember that peripheral states in the run-up to the crisis got into trouble not because of declining export, but rather because of import booms (Jones, 2016). Wyplosz in this context argues that there is no evidence of exogenous competitiveness shocks being at the root of the crisis for the peripheral states. Interpretations of the crisis on the basis of rising ULC and appreciation of the real exchange rates in peripheral states for him amount to nothing more than a ‘competitiveness legend’ (2013).

In the German public debate, the surplus is often interpreted within the competitiveness framework, where national economic performance is described in terms of being an export champion (Jacoby, 2017). Commission reports repeatedly stress that they are not out to raise prices for exports or punish Germany for over-competitiveness, as German press sometimes holds. None of this is to say that Germany should not raise its wages, but the way this affects others is not through the export channel, but rather through the import channel. Wages are very much endogenous to demand; higher wages will

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77 For an elaboration of this perspective, see also Storm (2016) in response to the competitiveness narrative of Flassbeck and Lapavitsas (2016) or Kollmann et al. (2015) for econometric analysis to support this argument.
lead to more imports. For a large country, Germany has quite a significant gap between imports and exports (Priewe, 2018). And the lack of demand in Germany also prompted lower ECB interest rates. But the causal connections between wages and the current account position are not always straightforward. One model holds that had Germany adopted a macroeconomically oriented wage policy between 2001 and 2015, this would have negatively affected the growth in real exports. But because export prices would have risen, the current account surplus would not have been significantly smaller (Horn et al., 2017). Gabrisch and Staehr (2015) argue that there is a link between current accounts and competitiveness, but sometimes the causality is interpreted the wrong way; the way to think about this link is that capital inflow for countries is a significant determinant for upward pressure on relative unit labour costs (which can be taken as a proxy for competitiveness, see chapter on Belgium). This analysis on the basis of capital flows brings us to the next narrative.

10.3.2 The creditor nation narrative

A second narrative moves away from the export and import channel and focuses on the other identity of the current account; the financial account, or the mismatch between savings and investment. Germany has a strong propensity to save; households have lower debt than most other euro area countries and have deleveraged significantly since the crisis. At the same time, household saving is moderately higher than most other euro area states and relatively stable in size. German public debt has been on a declining path since 2010. The government has ran fiscal surpluses since 2014, despite the favourable financing costs for Germany due to the high demand for safe assets. But most importantly, the non-financial corporate sector has been deleveraging since 2003 and has among the lowest debt of the euro area. It has switched from being a net borrower to a net lender: from -1% of GDP in 2008 to +3% in 2015 (EC, 2017f). In other words, the corporate sector uses the surplus to pay down corporate debt. The savings behaviour of the corporate sector explains a significant part of the surplus. For a country like Spain, it would make sense to deleverage, but for Germany, this excessive savings pattern is not always so virtuous.

The core story of this narrative is that these excess savings do not just sit in banks, but are transformed into loanable funds that fuel capital expansion in other countries. According to proponents of this narrative, a focus on trade in financial products rather than real economy trade flows is more revealing for explaining how the surplus of Germany is interconnected with crisis dynamics. Financial flows are much more volatile.
than trade flows (Fuller, 2018). You can find variants of this narrative, but the main line of argument broadly runs as follows: Germany’s deliberate (or policy-induced) strategy of low domestic investment and low domestic consumption pushes banks and investors abroad. Germany has become a creditor nation, which through its size and behaviour impacts global capital markets.

Proponents of this narrative hold that Germany not only financed but also deepened the deficits by flooding peripheral states with capital, resulting in inflationary growth based on weak fundamentals. Peripheral states had few means to control or avert the trend of unproductive capital boom. Germany’s economic strategy relies overly on financing the demand surge abroad that it lacks at home and on the revenue stream from foreign assets. This results in growth models based on capital exports in the core states of the EMU and a debt-driven growth strategy in the periphery, whereby both sides of this same coin bear responsibility for rising imbalances (e.g. Jacoby, 2017; Priewe, 2018). Their argument builds on what has become known as the ‘global savings glut’: a theory that holds that surplus countries push world real interest rates down. And in a world of low interest rates and already awash with capital, there is little need for an excess of savings which is not absorbed domestically (Bernanke, 2005; Krugman, 2009).

Before the crisis, the German trade surplus with the euro area and the rest of the world were roughly the same, yet the export of capital (a deficit on the financial account) to the euro area was much larger. The trade surplus of Germany might be positively correlated with export expansion in the peripheral states, but the same is not true for the financial account. If your main financial partner runs a surplus, you are more likely to run a deficit and vice versa (EC, 2012b). As argued before, it is not possible to establish a clear causal connection between the deficit and surplus of any pair of two countries, but the surplus of Germany showed high correlation with the deficits in the peripheral states. A geographical breakdown of gross financial flows shows that banks and other financial actors (e.g. insurance companies) in Germany played a dominant role in financing the peripheral states’ current account deficits. It did so both directly and through intermediating financial flows from outside the euro area towards the periphery. For example, German banks bought a lot of Spanish bank bonds that fuelled the construction boom. French banks, on the other hand, specialized in the intermediation of financial flows towards Italy and Greece. Financial flows have been the dominant factor in driving the intra-euro area imbalances, whereby surplus countries financed the deficits of the peripheral states (Hobza and Zeugner, 2014).
This criticism should be understood from the perspective of how Germany has operated as a creditor nation. In the years preceding the crisis, German banks participated fully in the global credit expansion: gross assets had stayed around 50–70% of GDP before the introduction of the euro but rose to beyond 200% of GDP by 2007 (for a full analysis, see Bibow, 2013). The divergence of net positions in the euro area occurred simultaneously and in correlation with this acceleration in gross capital flows (Lane, 2013). A large creditor position means that the assets are outside of national control and thus that wealth is vulnerable to shocks elsewhere. On the positive side, you could see this as portfolio diversification. But in practice what happened was that the German lending market was served by small Sparkassen (local public banks). When the larger Landesbanken lost their state credit guarantee as public bank they needed to raise rates of return on investment and turned to supposedly safe foreign real estate markets with high credit ratings (Deeg and Donnelly, 2016). German Landesbanken and commercial banks were heavily exposed to Spanish real estate, but also to the triple-A rated subprime mortgage debt securities in the USA. This turned out to be a risky bet; German banks were the hardest hit of all in the EU when that market collapsed. In total, German investors faced valuation losses of up to 550 billion euro between 2007 and 2011 (EC, 2012b). Valuation losses might not become real losses, but the figure shows the sensitivity of German banks to international market volatility. Had these valuation losses not occurred, the NIIP would have been considerably larger (EC, 2014).

In the months directly after the first big shock from the collapse of the American mortgage market, German banks re-evaluated their risk strategy and were the first to start pulling out of peripheral markets to a massive extent. Gross capital flows contracted and reverted, as Germany reduced its exposure to most peripheral states almost completely. Gross capital flows plummeted in the euro area, falling from a peak of 40% of GDP back to about 5%. This level of cross-border capital volatility is far larger than what other regions experienced during the financial crisis (Lane, 2013). As a result, peripheral states could not finance their current account deficits and had to adjust sharply. The consequences for peripheral states were severe, but it also showed a massive misallocation of capital on the side of German banks. Around half of the net investment position that banks had built up was eroded in the crisis years (EC, 2014).

Banks in peripheral states had to turn to their central bank for liquidity, which in turn had to rely on the Eurosystem for liquidity. The excess liquidity in German banks

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78 Both the net and gross asset position has risen even further to 50 and 250 percent of GDP in 2017 according to the IMF.
was channelled back into the Eurosystem through the Bundesbank. In this manner, capital flows from banks of surplus countries were replaced by intra-Eurosystem claims, as reflected in the widening of the TARGET 2 balances. In other words, while German banks saw their net investment position erode, their losses from pulling out of peripheral markets were contained, because the Eurosystem provided liquidity to roll over the debt in these states. Had this intervention not occurred, the decline in asset values in peripheral states would have been larger and core states’ banks would have likely faced a more extensive debt restructuring. It goes to show that who suffers from the issue of external debt sustainability, whether actors in the surplus or deficit state, is dependent on the institutional setting. In this case, it meant a public socialisation of private losses and deep trouble for the deficit states. Bibow speaks in this context of a multi-billion favour paid by the ECB to German banks (2013). But overall it goes to show that Germany was a major player in the imbalances and their unwinding. Their behaviour – so proponents of this narrative claim – is rooted in a particular capital-exporting growth model.

There is no denying that Germany played a major role in the crisis. But the narrative has a number of drawbacks that make it difficult to serve as the intellectual basis for recommending Germany to redress its surplus under the MIP. First and foremost, there is an element of fighting yesterday’s battle in this narrative now that the deficit states have redressed their current account position. The geographical composition of Germany’s surplus has changed from euro area to non-euro countries such as the UK and the USA, although a sizeable surplus vis-à-vis France has remained. Where the surplus vis-à-vis the rest of the euro area explained 60% of the total surplus before the crisis, this has shrunk to around 20% in the period 2013-2016 (EC, 2017f).

But there are also analytical and conceptual problems with this narrative, which limit its usability as a basis for the MIP. The linkages between the German savings culture on the one hand and capital flow volatility and deepening deficits on the other hand are not so clear-cut. Would the deficits in peripheral states have been less deep, had Germany not had a thrifty culture of saving among households and corporations? In a world of global capital markets, it is not at all clear whether the surplus itself is the villain in this

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79 Interestingly enough, nowhere have the divergence in TARGET 2 balances (which occurred as a result of this ECB intervention) become so suspect as in Germany. For a discussion on the role of TARGET 2 and the criticism of leading German scholars such as Sinn, see Schelkle 2017.

80 At the same time, it could be argued that yesterday’s battle is not yet fully won: the peripheral states need substantial and persistent surpluses to reduce their negative NIIP (Pierluigi and Sondermann, 2018).
story, rather than dysfunctional capital markets, the structure of financial products or the behaviour of banks and large investors.

Much of the analytical difficulty goes back to the argument that the current account position is an elusive indicator. The current account position of a country is not a clear explanatory variable for understanding patterns of global finance, because it says very little about changes in gross flows, financial intermediation or valuation changes in stocks. It used to be the case that financial flows primarily existed to facilitate trade, but in the financialised world of today, this is no longer the case. And the current account tells you very little about these bilateral financial relations. You can have a trade surplus with one country, yet be a capital exporter to another. France, for example, has a tiny deficit in its current account but was – before the crisis – an even more important financier of the euro area periphery than Germany (Hobza and Zeugner, 2014). One has to bear in mind here that most banks and multinationals are transnational, hence the nation-state as a locus for analysing financial risk and patterns is not always relevant. Also, the bulk of gross financial flows consist of trade in financial assets and capital being pushed around for tax purposes; such data is not adequately captured by current account positions. Obstfeld argues in this regard that: ‘large gross financial flows entail potential stability risks that may be only distantly related, if related at all, to the global configuration of saving-investment discrepancies’ (2012; 5).

For Germany, the analysis above shows that – looking at gross flows – German banks and financial actors were major investors in deficit states. Yet it remains questionable whether focussing on excess savings is the right target. The interpretation of excess savings’ fuelling capital booms relies on the basic premise that global savings and investment must equal one another; this is usually taken as an accounting identity. German savings have been channelled directly into deficit countries (EC, 2012b), but this is only part of the story. As pointed out by scholars such as Borio and Disyatat (2011) and Mody and Bornhorst (2012), one has to be cautious in the use of terms such as ‘savings’ or ‘investment’. Investments or expenditures require financing, not saving. And the financial system can endogenously generate financing on the basis of demand for capital and does not need underlying savings backing beyond the constraints set on credit creation by capital requirements.

A country can have a fully balanced current account and yet have all of its investment

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Goldman Sachs economists Guvenen et al. (2017) estimate that up to 50-75% of the USA current account deficit can be explained through tax avoidance.
financed from abroad. The Netherlands runs the highest current account surpluses of the EU (in relative terms), yet Dutch banks had to attract capital from abroad to fill their funding gap, which was also the largest in the EU (see chapter nine). Another case in point is the USA, where the dollar is so attractive in international capital markets that it can import products from around the world with money it has just printed. There need not be a surplus to finance such spending. Borio and Disyatat conclude that the line of argumentation as explained in this narrative tends to overestimate and miscast the role of current account imbalances in the crisis (2011).

It seems that the real issue at which actors have taken aim is the functioning (and volatility) of capital markets. The question is what responsibility creditor nations have for the sustainability of partner countries. As Wyplosz points out, one of the root vulnerabilities of the current account position is the lender's assumption that it will not face consequences for risk-taking abroad (2017). But it is questionable whether the focus on the surplus is the best way to go about this problem. It could well be argued that a different policy focus might be better suited. One can think of strengthening the bail-in principle or controlling credit growth through macroprudential tools. These are no holy grails in themselves but are perhaps better targeted to the real issue at hand.

With all these limitations, Obstfeld (2012) has started wondering whether the current account matters at all as a variable to monitor. His conclusion is that while it has severe limitations in making judgements about financial stability, current account imbalances can still be symptoms of economic and financial distortions. And since in the end surpluses and deficits must be matched, shifts in patterns of current accounts are also likely to be correlated with shifts in real interest rates, especially in a setting where monetary policy has hit the zero lower bound. In other words, the inflation effects of an overheating of the German economy could be good for debt sustainability and price competitiveness in peripheral states. This brings us to the last narrative.

10.3.3 The narrative of a demand and investment deficit

In a later statement, Obstfeld (2018) argued that while the surplus in itself is not bad - or at least this is difficult to prove - the measures to redress the surplus are good in themselves. They could help Germany in terms of growth, cohesion, educational quality, etc. There is also scope to take these measures, which could lower the surplus and help the rest of the euro area to rebalance. This is also the message that the Commission is trying to convey. In the series of reports on the surplus, this message sometimes gets
overshadowed by all the technical details (with very cautious claims on how it impacts the EMU). But in interviews, officials argue that rather than claiming that Germany has manipulative policies that distort the EMU, they simply believe that the surplus is not welfare-enhancing. Especially in an ageing society, Germany should not rely so much on its foreign assets, but increase domestic demand and increase investment to secure potential growth in the future. For example:

*If you look at a simple production function you have capital, labour and technological change, if the capital is more or less the same or declining, labour will be declining for sure because the baby boomers will leave the labour market starting 2020 and I don't think technological change will be enough to increase potential output if the other two factors are declining. This is our rationale behind focusing on investment, on dealing with the challenges of demographic change.* (Interview 62 - Commission official)

This is not an easy message to convey, since it is not directly obvious that the German economy – with almost full employment – is suffering from potential growth issues. Is there such a thing as being too careful in economic policy? As stated in the introduction, the economic situation in Germany has a shadow side. While the economy is booming, final consumption fell from 76.6% of GDP to 73.3% between 2003 and 2016. In the same period, total domestic demand fell from 96.3% of GDP to 92.5% of GDP (hence the surplus). And since the money was not consumed, net domestic saving has gone up in this period from 4.1% of GDP to 10% (Jacoby, 2017). These saving patterns are concentrated among wealthier households; Germany has higher wealth inequality than most other euro area states (Bach et al., 2018). At the same time, there are significant numbers of workers stuck in atypical employment such as mini-jobs, who earn barely above the minimum wage. Germany has one of the largest proportions of low-wage workers in Europe and the bottom third of workers have lower real wages today than in 2000, with 16% of the population at risk of poverty (Bertelsmann Foundation, 2015; Fratzscher, 2018). So when the argument is made that Germany saves because of an ageing society, the question becomes who is doing the saving? And is it welfare enhancing for society as a whole if the wealthy invest abroad?

Not only is the labour share in income falling in Germany (like in many Western states), but the capital stock is also lagging compared to peers. The previous narrative mentioned that the corporate sector has been deleveraging for the last 15 years and turned into

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82 As pointed out by Obstfeld (2018): Keynesian logic holds that if you lose on investment abroad you really lose. If you lose on investment at home, it is just redistribution.
a net lender. This savings behaviour should be seen in relation to the demand deficit since firms have to spend less on labour compensation. But the other side of this saving pattern is a subdued investment rate. Looking at fixed capital formation - expenditures going into assets and excluding changes in inventories - Roth and Wolff argue that in the private sector (accounting for 90% of total investment) gross fixed capital formation has fallen from 22% of GDP in 1991 to 18.1% in 2017. Net fixed capital formation (a proxy for additional investment) falling from 8.5% to 2.8% in this period. For the public sector gross fixed capital formation fell from 3.2% to 2.2% and net fixed capital formation fell from 0.8% to 0% (2018; see also Wolff, 2018). Fratzscher describes the lack of investment as the Achilles heel of the German economy: 'Germany is missing a huge opportunity to make itself ready for the future' (2018: 5). Fratzscher argues that looking at the investment gap – the difference between actual investment and required investment to achieve growth equal to that experienced during the prior three decades – Germany has had a negative investment gap for the past twenty years. And this gap has risen significantly over time. This amounts to 100 billion euros in lacking private and public investment every year (in 2017) to maintain the average growth rate (2018).

The argument of an investment deficit is controversial: not everyone in Germany is convinced about the scope and significance of this problem. The German economic research institute IFO, for example, argues that there is no convincing evidence of an investment gap in Germany. The surplus is a result of excess savings, not lack of investment, while excess savings make sense for both the private as well as the public sector due to demographic change. Besides, so the authors claim, if investment opportunities existed they would be realised because access to capital is easy and available public funds are not being fully used (Felbermayr et al., 2017). If the return on investment is higher abroad (this is still a big debate in Germany83) investors are still free to choose to invest somewhere else.

The Commission sides firmly with those who believe there is both a demand and an investment deficit in Germany. And while wage formation is in the hands of social partners and corporate investment and saving behaviour in the hands of the market,

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83 Many doubt whether Germany is not wasting its investments abroad (e.g. Fratzscher, 2018). For example, German banks hold large accounts at the Bundesbank, which show up in the balances of the intra-euro payment system TARGET2. Half of the NIIP consists of TARGET2 claims and these assets have a 0% interest rate. This reliance on TARGET2 balances has come under heavy criticism in Germany (e.g. Sinn, 2017). Busse and Gros on the other hand show that if you refocus the analysis from net to gross positions in investment, it shows that German returns on foreign investment is equal to peers, such as France (2017).
it believes that Germany has an institutional setting that is conducive to saving and suppresses demand and investment. Tax policies have shifted income from households to the high-saving corporate sector, while high social charges and regressive energy taxes put extra weight on low-income households that are less prone to save. A better transition from low-paying mini-jobs to full-time employment will lead to higher demand. Similarly, regulation is overly strict in the services sector, which as a result does not attract sufficient investment. All these issues can be found in the CSRs and Country Reports that Germany has received over the years. Simply put, with a different set of policies, funds could be redirected to the German economy, which would be good for the resilience of the German economy itself and could also reduce the surplus. As one interviewee aptly puts it:

*Exports are good, but you don't have to starve yourself for it. If you are a very competitive country, you have high export growth, then why not spend the money?* (Interview 64)

Before analysing the debate around the CSRs and why it is so difficult to simply 'spend the money', a final point of concern is the EMU dimension to this narrative. The basic argument here is that an overdrive of the German economy would result in inflation and raise imports from German households through higher demand. In other words, a fiscal shock in Germany would produce spillover effects on the rest of the euro area. In recent years a wide-ranging literature of econometric simulation exercises has appeared to capture the size of these spillover effects. These centre around public investment increases, which is in the hands of the German government and is widely assumed to have an effect on the rest of the euro area. If we take the analysis of DG ECFIN economist In ‘t Veld using the Commission’s QUEST model, it shows that a 1% of GDP increase in public investment would, if sustained for multiple years, lower the current account surplus of Germany by 0.3 to 0.4 percentage points (2016). On this basis, Commission officials admitted that to bring the German surplus to an appropriate level you would need a tenfold increase: a 10% of GDP demand shock to lower the surplus to around 3 to 4%. This is – everyone will admit - a highly unlikely scenario due to inflation effects and the breach of all sorts of fiscal rules. Instead, we could assume a 1% of GDP increase in public investment, amounting to a 50% increase (German public investment has hovered around 2% of GDP).

The model of In ’t Veld shows that a sustained 1% increase in public investment in both the Netherlands and Germany would result in a 0.2 to 0.3% increase in GDP in other euro area countries after two years (2016). A modelling exercise by IMF economists Elekdag
and Muir (2014) comes to similar results. As a result, in the 2015 and 2016 Country Reports, the Commission talks of ‘considerable’ positive spillover effects on the euro area from a boost in public investment (EC, 2015d; 2016i). This was greatly to the annoyance of the German government, which believes that such claims are unsubstantiated, even on the basis of the Commission’s own measurement. For example, another study of DG ECFIN economists shows that effects from an investment boost in Germany on the current account is likely to be weak and spillover effects on the GDP of the rest of the euro area are negative at first and only slightly positive in later years (Kollmann et al., 2015). The German Ministry for Economic Affairs finds spillover effects to the rest of the euro area that are only slightly positive at first (0.08%) and negative in the following years (BMWi, 2015). The Deutsche Bundesbank puts spillover effects on the euro area at 0.1-0.3% of GDP (2016). Belke and Osowski find that spillover effects from a German stimulus are primarily significant for Germany’s direct neighbours such as the Netherlands and Denmark, which already have high surpluses themselves. Effects for Italy are small and for Greece they are negligible (Belke and Osowski, 2016). Blanchard et al. find considerable spillover effects of up to 1% of GDP for the periphery but on the basis of a stronger and sustained stimulus by all of the core countries (Blanchard et al., 2015). Interestingly enough, one IMF simulation finds that some peripheral states would actually be better off from a fiscal stimulus in France rather than Germany (Dabla-Norris et al., 2017).  

The results are quite diverse to say the least. The models depend on many stylised facts, such as the inward spillover effects from structural reforms in the periphery, or whether part-time employment suggests unexploited room for more economic activity, which would lower the effect of a stimulus on inflation. But the biggest one concerns the role of monetary policy. If you assume that a demand shock in Germany will lead to inflation and as a result the ECB responds by increasing the interest rates than external GDP effects are mostly nullified and can even be negative for certain states, as in the model of Kollmann et al. If you assume that monetary policy would not respond to inflation in Germany, because the euro area is at the zero lower bound and could use some inflation, than effects can go up to 0.3 or even 0.4% of GDP in other states depending on the

84 I present the argument here on the basis of econometric analysis. But there is another way of looking at the issue. Sandbu makes a more theoretical argument in his FT columns. He argues that what matters for the aggregate macroeconomic stance in the euro area is not the size of the German surplus, but rather its growth. And since the size has not been changing, the impact on the macroeconomic stance of the euro area is negligible. You could compare it with fiscal policy: if a country changes its fiscal stance from 0% deficit to 3% deficit it counts as a stimulus to the economy, but if the next year the deficit stays at 3% there is no additional stimulus. Sandbu argues that this argument is equally true for external imbalances in the current account (2017; 2017a).
efficiency of the stimulus.

These discussions are held in technical committees such as the LIME committee attached to the Ecofin Council, where experts compare the various models and their assumptions (e.g. LIME meeting 15 June 2016). But in fact, the assumptions in the models hide quite strong political choices. Let us imagine the Kollmann et al. scenario where monetary policy responds to inflation. One interviewee argued that despite the Italians being amongst the most vocal opponents of the German surplus (e.g. Gros, 2016) a hike in ECB interest rates due to a German overheating is something that Italian officials have argued that they absolutely fear the most (Interview 66). It could be said that the possible monetary policy response is a classical (some would say neoliberal) argument against any fiscal stimulus. But let us imagine the in ’t Veld scenario where monetary policy does not respond to a German inflation hike: we can imagine that this would result in a vicious debate in German media about the role of the ECB. In the 2017 low-inflation scenario, the German Economic Council has already been warning for signs of overheating of the economy, which should caution against an overly large stimulus (this does not mean that they oppose a degree of public investment increase) (Sachverständigenrat, 2017).

The topic of spillovers is a highly sensitive one for the German administration and pressure on the issue comes all the way from the political top (Interview 71). It has also led to significant debates in the Council. As one German official recalls how this went down in the EPC:

*France, Italy, but also the Commission argued that there would be huge spillovers. They put this in the documents on aggregate fiscal stance and everywhere. But our empirical studies show that the spillover effects are rather limited. This was a huge debate. We invited this guy from the Bundesbank and then there was the Commission, and they clashed in the meeting with their models. But since this meeting, the Commission is less keen to say that we have substantial spillovers. They are still working on this, but my feeling is that this is still limited.* (Interview 63)

The general feeling among Commission officials is that while spillover effects are difficult to quantify, they are still important enough to care about. But there is also a realisation that so far the debate has not been very convincing:

*I think this is as good as it gets for the moment, in terms of quantification we are not there*
yet. We have not given up the fight; intuitively it makes sense that there should be spillovers. But we have to improve our tools for capturing those. (Interview 70 - Commission official)

Overall the analysis in this section shows that while so many believe that the German surplus is distortive for the EMU, proving how this might be so is tremendously difficult. As soon as the analysis focuses on the details, things quickly tend to get very complicated and causality becomes intractable. Arguments that Germany is deliberately stealing demand from others are not convincing. The general narrative that with the current monetary policy Germany should play its part in an overall process of rebalancing has more merit. The Commission also supports this view. But in the MIP, every claim needs to be backed up with evidence and on the details, the Germans have much to argue against and are not easily convinced.

10.4 Germany under MIP surveillance

10.4.1 The MIP as agenda setter

The discussion between Germany and the Commission on whether a surplus can constitute an imbalance started long before Germany was placed under MIP surveillance. As indicated by chapter three, whether or not to include an upper bound to current account balances in the MIP scoreboard was by far the most debated issue when it was being designed. Germany at first was not enthusiastic about the MIP. They believed the crisis was predominantly fiscal in nature and the MIP would distract from a strict application of fiscal rules (Interview 61). The Commission saw surpluses and deficits as two sides of the same coin in terms of whether they should be monitored, even when they might pose different risks. But Germany was vehemently opposed to treating deficits and surpluses in a symmetrical manner. A French official remembers that there were endless discussions on the inclusion of surpluses and that finding an agreement on the wording in the MIP regulation was ‘a nightmare’:

There was the idea of the symmetric approach, but that was “no way”. For them, there had to be a strong statement that a deficit is something bad and a surplus is not a problem. (Interview 49)
Or, as a German official remembers the discussion from those days:

... the principal argument has been that they [the deficit countries] should have used the windfall profits after joining the euro, so the interest rate drop, for responsible economic policy. So we should put more focus on the rules-based fiscal system. This is what we thought. And if we talk about the surplus we would say this is not an issue of Germany we just did what we did, the others were so weak that this just emerged. (Interview 66)

In the end, Germany managed to get its way. The MIP includes three safeguards. The regulation on the MIP makes an explicit distinction between deficits and surpluses (Reg. 1176/2011 Art. 3.2) and describes in its recitals that deficits require more pressing policy action, whereas the role of surplus states is described in softer terms. They should identify and implement measures that ‘help strengthen their domestic demand and growth potential’ (Reg. 1176/2011 recital 17). Secondly, and most famously, the lower threshold for current account deficits in the AMR is 4%, whereas the upper limit for surpluses is 6%. And finally - what is not commonly known - is the fact that Germany demanded the Commission to sign a letter of intent written by the staff of Finance Minister Schaüble stating that a surplus could never form the basis to open up the corrective arm of the MIP for a Member State. One German official described the letter as something that was requested at the political level, while at the administrative level they were not very happy about it:

... with this letter we now get into the awkward position of calling for the corrective arm to be opened for other countries and always being out yourself, this is strange of course. (Interview 63)

In the subsequent years, Germany (with the agreement of others) continued to stress the differences between deficits and surpluses and the fact that only deficits raise concerns about financing, a key criterion for triggering the corrective arm of the MIP (Council, 2011; 2013b; 2014a). In the first Semester document, the Commission barely paid attention to the German surplus. But in 2014, Germany was placed under MIP surveillance for its surplus. In the previous two cycles of the MIP, the AMR scoreboard

85 Stories differ on whether this so-called ‘Rehn letter’ (after the former Commissioner Olli Rehn), was a necessary condition for the Germans to agree to the MIP or whether this was just some extra re-insurance after the Germans had already signed up to the MIP. The letter was never published, but the Council documents cited above clearly refer to the impossibility of surpluses leading to sanctions.
Part II: In-Depth Case Studies

had the German three-year average current account balance precisely at 5.9% of GDP, just below the 6% threshold. And while the Commission has often stressed that the thresholds of the AMR are only indicative, in this case, it implied that the Commission saw no reason for an In-Depth Review. In times of heavy deleveraging of the current account deficit countries, the move not to investigate the highest surplus in real terms of the euro area came under heavy criticism. For example, whether the Commission should be more forceful on surplus countries has been a widely debated and divisive topic in the European Parliament, both during the design of the MIP and in later years (Interview 54 – political advisor EP).

In 2013, a statistical revision showed that Germany’s surplus had actually been above the 6% threshold since 2007, even exceeding 7% in 2012 and 2013. And while the trend was slightly downwards, the 6% threshold was not expected to be reached anytime soon. The document, therefore, describes the surplus as a challenge for the economy, setting the stage for placing Germany under the MIP the year after (EC, 2013d). This next step by the Commission did not come as a surprise, as the rumbling about the German surplus had been going on for a while and pressure on the Commission to take a position was mounting. The 2014 In-Depth Review is the first Commission analysis fully focussed on the German surplus. The tone is relatively mild: it reads mostly like an investigation into the drivers of the surplus and it argues that having a surplus is in line with the structural characteristics of the German economy and that over time it could fade with demographic change. But in the end, the conclusion is still that Germany should do more and that its surplus represents a macroeconomic imbalance (EC, 2014). At the same time, Commissioner Rehn presented the CSRs that year by stating that more symmetric adjustment in the euro area is ‘essential’ (2014).

The conclusion that Germany was experiencing imbalances meant that the government had to come up with a response. The decision led to considerable debate and fierce criticism. For example, the German Council of Economic Experts concluded that the MIP should be viewed critically, as it does not concur with large parts of the analysis and states that potential financial risks are already under surveillance under the Banking Union and the SGP (Sachverständigenrat, 2014). The German Central Bank argued in response that Germany’s surplus has benefited the countries that have been net receivers of capital, which themselves bear responsibility for its productive use. It furthermore describes the surplus as entirely appropriate for the German economy and any attempt to directly control macroeconomic developments through policy as unlikely to succeed (Bundesbank, 2014). The chief economist of the Finance Ministry described criticism of Germany’s surplus as barking up the wrong tree and surpluses as not harmful. He
furthermore argued that through its FDI, Germany helped secure 6.5 million jobs in other states. He dismissed arguments about subdued demand since German imports have grown four times more strongly since the crisis than those of Japan, the UK, or France. Finally, he argued that artificial demand stimuli are pro-cyclical and a waste of public money (Schuknecht, 2014).

The author and institutions above represent the traditional German view that surpluses are a by-product of national competitiveness. On the basis of such views, there is often the feeling that Germany fully rejects criticism on the surplus. But they do not represent all voices of the official institutions. In December 2013, the third Merkel government was formed, replacing the liberal Freie Demokraten (FDP) with the Sozialdemokratische Partei (SPD). The SPD had campaigned for raising investment and stimulating demand, and the Economic Affairs Ministry was taken over by SPD Minister Sigmar Gabriel. This Ministry had traditionally taken the view that surpluses are a sign of competitiveness of the German economy and as such not a problem (e.g. Der Spiegel, 2013) but Gabriel adopted a markedly different tone:

> Alongside its European partners, the German government is prepared to take measures to dismantle economic imbalances while complying with requirements for the reformed Stability and Growth Pact", Gabriel said. “In Germany, domestic economic dynamics will make this possible through increased employment, the introduction of a minimum wage, the orientation of part-time and temporary work on their core purposes, appropriate conditions for a responsible wage policy and strengthening investment.” (EUObserver, 2014)

A German newspaper even reported an internal memo of the Economic Affairs Ministry that described the surplus as an excessive and persistent imbalance that is harmful to the stability of the euro area (Süddeutsche Zeitung, 2014). As a result, Bundesbank President Weidmann criticised the coalition for taking a softer tone in this debate (FT, 2014). As such the MIP decision managed to put the issue more sharply on the agenda and raise internal discussion whereas it had largely been taboo before. Nonetheless, the Germans were not overly impressed by the MIP:

> It was perceived as disturbing. But in the end, because initially we were placed at the lowest level of the imbalances grading, it was also not seen as a very big deal. (Interview 64 - former German official)
The team at the Ministry of Economic Affairs wanted to take a less defensive view on the surplus. Their view was that Germany had not done anything bad to produce the surplus, but that does not mean that the current situation is a desirable outcome. They agreed with the Commission that the surplus reflected a weakness in domestic investment, which was neither in Germany’s nor Europe’s best interest. The Commission agenda coincided with that of Minister Gabriel to increase investment, so his team made use of the MIP decision to back up their claims. But while the Economics Ministry is in charge of coordinating the National Reform Programme, they still have to produce a compromise text with other Ministries, including the Finance Ministry. The latter takes a more conservative view on the matter. As one Ministry official explains:

... there is the view that the surplus is not necessarily something we are proud of, but neither is it our fault, that is more or less what you read in the National Reform Programme. [and on the position of the Finance Ministry:] The surplus is the outcome of market forces and we do not manipulate policy on any dimension, we cannot see an obvious distortion that has created the surplus, so we let it be. We let it be and focus on our domestic objectives and accept the surplus as an outcome. As long as the Commission cannot prove that we are doing something unfair in our policy they will accept it too. (Interview 64, former German official)

The 2014 NRP reads like a more balanced (compromise) response than some of the more critical voices cited above in the sense that it does not fully reject the claims of the Commission. In addition to underlining that the surplus mainly reflects competitiveness and structural issues that are out of the control of the government, such as demographic change, it also takes a more conciliatory approach in certain domains. It concedes that investment levels are too low in Germany compared to the OECD average, that capital export is associated with considerable risk and that Germany should strengthen internal growth forces (BMWi, 2014). As such, the 2014 NRP can be seen as a first opening in recognising that the surplus reflects more than just export strength, but is also a sign of imbalanced saving and investment behaviour. The question, of course, is whether this recognition translated into additional government effort.

10.4.2 The investment gap and associated policy responses

Formulating CSRs to address the investment gap has not been an easy task for the Commission. The largest gap is in the private sector, but it is a bit of a puzzle what precisely causes the German corporate sector to issue so little (debt-driven) investment.
There are a host of internal and external factors involved, such as international insecurity or the ageing society. One Ministry interviewee admitted that while there have been many attempts to find a clear explanation, basically nobody really knows (Interview 67). And secondly, the question is which policies could alter this behaviour. One official explained that there are is a wide range of small measures around issues such as mortgage refinancing, regulation for insurance companies or stimulating public-private partnerships that could collectively have an impact on investment behaviour. But the MIP is not the right instrument to be recommending a long list of detailed measures and it is doubtful whether the Germans would accept any kind of micromanaging (Interview 71).

Instead, the CSRs for private investment have focused on modernising the tax system and stimulating competition in the services sector, where investment has been particularly low. Over the years, Germany has made some changes to its tax system, but reform in the services sector has been a sticky issue with almost no progress being made by the German administration. According to German officials, there is wide support for this measure in expert circles in Ministries and if it were not for the Commission, politicians would not even pay attention to this problem (Interview 64). But besides the agenda effect, the influence of the MIP has not been strong enough to lead to a change in policy. Trade unions and business associations in Germany fiercely reject any effort in this area (Redeker and Walter, 2018).

One area where it is much easier to formulate a CSR is on public investment. Here the issue is pretty clear. German public investment has consistently been below the EU average and there is arguably scope for more investment in areas such as infrastructure, education, and research. And public investment could also stimulate further private investment and wage growth. All these areas have consistently featured in the CSRs. But over the years Germany has not achieved much progress in implementing this CSR. In general, the Commission reports strike a pessimistic tone on the issue. The debate on public investment can be seen as symbolic: corporate investment is mostly based on market forces, wages have been rising faster in Germany than the euro area average and are in the hands of social partners (EC, 2017f), but the lack of public investment increase can be interpreted as a sign that Germany does not take the issue of the current account surplus very seriously. Before describing which measures the Germans have taken, it is worth unpacking three main obstacles that explain this lack of effort on public investment: a lack of ambition, the federal structure, and redistribution issues.
The German administration picked up the MIP arguments on public investment because it coincided with the pro-investment agenda of Minister Gabriel. As a result, the administration tasked a study group to investigate the investment gap in Germany and look at structural measures. The report is known as the Fratzscher Report, after the President of the DIW economic research institute, a well-known pro-investment commentator in Germany on economic issues. The report describes a host of investment problems and opportunities (Fratzscher et al., 2015). The report pushed the issue higher on the political agenda and organised resources around it. But all in all, the real pro-investment forces were a minority in the government. Also in the Ministry of Economic Affairs the prevailing view used to be that Germany does not have an investment problem. A number of powerful actors – especially in the Finance Ministry - continued to argue along this line. Finance Minister Schäuble allegedly denied that Germany had any investment problem when the Fratzscher report was presented (Interview 67). This creates a tension between pro and anti-investment forces within the administration.

Standard Keynesian theory asserts that in good times Germany should run surpluses and reduce debt and not further stimulate an economy that is close to full employment. In the third Merkel government, the SPD ran on a ticket of increasing investment, but Merkel’s CDU/CSU (Christlich-Demokratische Union/Christlich-Soziale Union) won the election with an agenda of fiscal conservatism. And Germany’s public debt has persistently been above the 60% of GDP threshold. The 2013 coalition agreement contains both the goal to keep the budget in surplus and the goal of closing the gap between Germany’s investment level and the OECD average. These do not have to be conflicting goals. Germany has been reducing its debt quite significantly and started running budgetary surpluses from 2014 onwards; there is enough fiscal space for more investment. These surpluses are often celebrated by German newspapers with great exuberance and described as achievements. This is a bit misleading, as primary expenditure has actually been increasing in Germany. But due to the ECB stimulus and Germany’s status as safe haven, Germany saw massive windfall gains in the range of 162 billion euro since the crisis due to lower interest rates (Handelsblatt, 2018). In other words, Germany’s fiscal performance is largely thanks to the financial chaos in the periphery and QE. Where the peripheral states had to introduce austerity, Germany could let its expenditure grow and still see its debt being slowly reduced.

86 Some would argue that Germany has actually been quietly rebalancing all along, given the stronger wage rise in Germany than in other euro states and given the significantly higher increase of real total expenditure in Germany than in other euro area states (Di Carlo, 2018).

87 Schuknecht argues the other way around; according to him the fact that German fiscal policy is anchored in rule compliance creates positive spillovers through low benchmark interest rates against which others’ spreads are measured (2018).
The fact that not everyone in the German administration agrees on the significance of the investment problem also shows up in defensive behaviour. The NRP’s primarily stress that a lot is already being done on public investment (e.g. ‘the Federal Government has taken far-reaching decisions in order to strengthen public-sector investment’ (BMWi, 2016: 11)). In the Council, Germany has pushed for amendments in both 2015 and 2016 to the CSR by arguing that the term “fiscal space” (Germany is recommended to use the available fiscal space to increase investment) is not defined in the Treaties. According to top officials, the Commission faced heavy resistance on this issue and it led to ‘politically charged debates’ in the Council (Buti and Turrini, 2017). All in all, it is difficult to argue that the German administration has been highly ambitious in addressing the need to increase public investment. In interviews there seemed widespread agreement that in the end the result was not enough, also in the German Ministries themselves. For example:

*We do not refute the assessment of the Commission on “limited progress”, we acknowledge it.* (Interview 63 - German official)

*We tried. But only a few things [of the Fratzscher report] were implemented and these things were quite big steps, but not enough to address the imbalance. But in general the Commission’s label of “limited progress” is true.* (Interview 64 - former German official)

A second issue concerns the federal structure of Germany. When it comes to public investment, the majority is spent at the state and municipal level. The majority of public investment, including in the crucial areas of the investment backlog – education and infrastructure – is in the hands of the Länder and especially the municipalities. These account for more than half of total public investment. Investment spending by municipalities dropped from 17% of total expenditure in the mid-1990s to 9.7% in 2015 (Van der Putten, 2017). For 2016 the perceived investment backlog at the municipal level was estimated at 136 billion euro (KfW, 2017). For example, thousands of bridges in Germany are in pretty poor state and need repairing (Spiegel, 2016; FT, 2017). And Germany spends considerably less per child during the first six years of life than in comparable European countries (hence also the CSR on childcare facilities) (Fratzscher, 2018).

Germany has over the years shifted many tasks and responsibilities from the federal to the state and local level. Municipalities got the responsibility for large areas of social
security, as a result of which municipal spending increased significantly. It also resulted in significant stress on local budgets (Heinelt and Stolzenberg, 2014). At the same time, about 30% of municipalities are over-indebted from over-spending in the 1970s and 1980s. The federal government introduced a debt brake: a law that forbids municipalities from running budget deficits. The natural response is that when budgets are under stress, the municipalities cut investment first because cutting social expenditure will have an immediate effect (Fratzscher, 2018a). The debt brake also prevents municipalities from committing to long-term infrastructure investments, because they are not allowed to borrow for them.

A key factor here is the regional disparity. Municipalities in the rich Southern province of Bavaria do not have an investment problem; the issue concerns regions such as North Rhine-Westphalia and Saxony-Anhalt. This means it is very much an issue of redistribution. Another factor is technical expertise, planning, finding enough engineers, etc. The regulatory issues that hamper investment are widely perceived as problematic in the euro area. The Eurogroup has invited the Council to work more closely on this issue, resulting in thematic discussions in the EPC and EFC to identify common bottlenecks and barriers to investment (EC, 2016f).

In the end, the Merkel III government did take a number of measures. It increased investment at the federal level by almost 45%. It set up a municipal investment promotion fund of 7 billion euro to help free up fiscal space for investment for municipalities (0.2% of GDP). Some Länder and municipalities received debt relief and a relief of social expenditure in the form of taking on the costs of the old-age basic pension. It adopted a reform of federal fiscal relations that will enter into force in 2020 and will allow further fiscal space for investments at the local level by shifting more responsibilities to the federal level. And it took a range of measures, primarily in the area of taxation and regulatory burden, to promote private investment (BMWi, 2016). In 2017 this resulted in private investment picking up in line with overall economic growth in the euro area (Weichselberger, 2017). Investment in municipalities showed a slight improvement with the backlog decreasing from 136 billion euro to 126, and a planned increase of investment by municipalities of 15% (KfW, 2017). The Finance Ministry speaks in this regard of an unusually buoyant trend in public investment that lies ahead (Bundesfinanzministerium, 2017). And some interviewees were also mildly optimistic:

For years they [municipalities] didn’t replace or set free public servants and engineers and so on, they were not able to do the planning of infrastructure projects, they did not have the
technical resources. This is slowly changing now. (Interview 67)

The Commission, however, concluded in its 2017 Country Report that the measures taken have not led to a sustainable upward trend of investment as a percentage of GDP (as opposed to the noted increase in real terms), which has remained at 2.2% as opposed to a 2.8% of GDP on average for the euro area. It judged the measures taken to stimulate municipal investment as having only a limited effect. And their analysis showed that the surplus continued to rise from 8.5 to 8.7% of GDP (EC, 2017f). And while the formal scope of this thesis runs up to Spring 2017, as a final comment it should be stated that in 2018 trends turned around again. The backlog at municipal level grew to 158.8 billion (about 5% of GDP), 30% of it in educational facilities and 24% in transport infrastructure and net public investment still negative (KfW, 2018). The fourth Merkel government saw the Finance Ministry falling under the SPD, which again campaigned on a pro-investment platform. The first budget of the new SPD Minister Scholz announced a number of new projects, such as in digital infrastructure, but did not see a significant increase in public investment as opposed to the previous one; even a slight reduction in the short term (Wolff, 2018b). One commentator argued that this budget was an accident waiting to happen (Münchau, 2018). But according to Scholz himself when it comes to fiscal issues you simply ‘can't be too careful’, despite a 63 billion euro budget surplus and the debt to GDP ratio expected to fall to under 60% in 2019 (FT, 2018).

10.5 Analysing the role of the MIP in Germany

In March 2010, French Minister of Finance Christine Lagarde dropped a bombshell by stating in an interview that Germany’s surplus was unsustainable for the other countries in the euro area and that Berlin should boost demand. “Could those with surpluses do a little something? It takes two to tango,” she argued (FT, 2010). It was the first time the surplus was openly criticised at the political level in the euro area and Berlin did not take it well. It ‘was seen as an outcry’ (Interview 63). ‘It was absolutely impossible to have these types of discussions at the time’ (Interview 49 – advisor to Lagarde). But this situation has changed, it is clear that the taboo is no longer there. So much so that German newspapers describe the announcement of the MIP report as a type of ritual dance, for example, this article in Die Welt:

It has become a good tradition now that around the carnival time, the European Economic

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88 According to Germany, it went down from 8.6 to 8.3 per cent of GDP (BMWi, 2017).
Affairs Commissioner appears before the cameras to admonish the German government with a worrying tone. After which a horrified Berlin will deny any suspicion that there is something to feel guilty over. (Welt, 2017 - translated from German)

The MIP has played a role as agenda setter in breaking the taboo, albeit in combination with other factors. Interviewees acknowledge that the debate has changed and that the MIP has been useful in this regard:

*If it weren’t for this procedure no one would have cared, they would still think ‘we are export champion’. (...) Because five years ago a critique of Germany’s position as export champion would be unbelievable. This has changed.* (Interview 63 - German official)

Yes, it is fair to say that there has been a gradual change in the debate. But it is a bit like hen and egg because this change is also due to the fact that the SPD entered government and the surplus has risen. (...) It certainly did play a role, because obviously the whole European Semester and MIP is ... Germany tends to take it in a way serious, not the Finance Ministry colleagues, because they believe the CSRs that Germany gets are not very important, but because of the CSRs the others get. (Interview 67 - German official)

*I think the MIP was useful because it triggered an internal debate. I found it very helpful. It made it easier for me to argue for a substantial investment increase. And I could argue that having this surplus was not ideal, without having to carry the full weight of the argument myself. So I agreed with the Commission, including the CSRs. I found them helpful, but I was in a minority position and certainly my colleagues at the Ministry of Finance found it irritating. They kept telling the Commission off and demanding changes to the Semester while saying that the Commission didn’t really understand what was going on in Germany. I disagree, they knew perfectly well.* (Interview 64 - former German official)

While the debate is recognised and is now being held in Germany, this does not mean that the Commission’s arguments have become fully accepted. The German political-economic establishment remains divided into two camps, much as in the first discussions in 2014. In the public debate, you can find economists who argue mostly along the lines of the Commission and recognise that more should be done to address the surplus (e.g. Steinberg, 2017; Fratzscher, 2017; Bofinger, 2017). And you continue to find another group of economists who do not consider the surplus a macroeconomic imbalance, but rather something that will fade automatically with the effects of demographic change or when
the ECB normalises its monetary policy (Schmidt, 2017; Schuknecht, 2017; Fuest, 2017).

But in society as a whole, there are clear signs of a realisation that perhaps the surplus is not all good and that there could be more investment. While the German government has prided itself on its fiscal surplus, one opinion poll showed that a clear majority of the public wanted the surplus spent on investment in infrastructure rather than paying down the debt (DW, 2016a). In a study among 135 economic interest groups (trade unions, social policy groups, employer associations, etc.), Redeker and Walter (2018) find wide support for the claim that the surplus is macro-economically problematic. Among those groups who do not consider it to be problematic, they still find broad support for a demand and investment stimulus in Germany. The interest groups are deeply divided over what kind of economic strategy should counter the trend; whether tax measures and competition in the services sector or increasing wages at the lower end. According to the authors, this has prevented them from acting as a stronger cohort. But on the need to increase public investment, especially road and digital infrastructure, there was wide agreement (this also does not touch any of them directly).

The change in perceptions in Germany about the issue can, of course, not be fully attributed to the MIP. The OECD and the IMF have made similar arguments, the surplus has risen over the years, the SPD joined the government and the Trump administration has given new attention to the issue. But it is hard to deny that the MIP was a factor in triggering debate and position taking and that for some domestic actors it has helped carry the weight of their argument. The MIP is part of the intellectual arsenal behind the debate and this has led to gradual and indirect effects. The Germans now think differently about the surplus, but we should also not overstate the influence of the MIP nor its reach. The specifics of the MIP and the CSRs have not gained traction in all policy circles and has not disseminated throughout the entire administration. It has primarily been an instrument for a minority. In general, the Commission still faces an uphill battle. While interviewees widely agreed that the debate had changed in tone there is also strong scepticism about the salience of the CSRs. For example:

... in Germany the CSRs and so on are basically – I’m exaggerating of course – but on the political level, nobody cares, its an employment programme for civil servants. In small countries this is totally different, in France it is a bit mixed, but in Germany, it is ‘nobody cares’. (Interview 67 - German official)
Part II: In-Depth Case Studies

... the CSRs fall completely flat, they are not taken seriously. (Interview 68 - political advisor CDU)

To be honest, there will only be a few who understand this. People from the finance or budget committee are involved in other questions, not in macroeconomic questions. They focus on legal things, on budget things, but macroeconomics, no. (Interview 63 - German official)

From the side of Finance Minister Schäuble, it indeed seems that the Commission’s argumentation has not landed. In his final interview as Minister, he seems to turn the Commission's argumentation upside down:

In Germany, our experience is that sticking to the [fiscal] rules builds up trust. That’s the reason that domestic demand, consumption and investments are higher in Germany than in other European countries. (FT, 2017a)

At the same time, interviewees recognise that neoclassical economists feel the pressure growing. There is a constant need for justification; in this sense, it really is peer pressure. One interviewee recalled an internal discussion between ministries where it was argued that Germany is becoming more and more isolated in its stance on the surplus and investment and that it might be good to signal that at least the problem is understood. A prominent opponent of the Commission's view responded as follows:

... he was like ‘this is absolutely not true, it’s only the USA ..... uhm ... and Japan, oh and Italy and the OECD and the IMF and yes also the Commission is against us, but all the others are in favour of us’. There is this feeling of being squeezed into a corner. (Interview 67)

Contrary to what some of the statements above claim, the MIP has not been fully ignored by politicians. But again, it has been an instrument for the minority. In an assessment of the parliamentary debate on the Semester, Maatsch shows that on multiple occasions left-wing opposition parties have used the CSRs as intellectual weight to support their agendas of boosting demand, and tackling precarious contracts and stagnant wages. Resolutions that called upon the government to be more ambitious in implementing the CSRs, however, were voted down. Instead, the government took a rather defensive line,
arguing that the surplus supported job creation abroad and should not be perceived so negatively (2017). The resolution that was adopted calls for procedural changes to the Semester and blames the Commission for being too political (Bundestag, 2015).

The question of effects thus provides a mixed picture: there has been some leveraging effect and a slow acceptance of the debate albeit not among all. The question of a hierarchical use of the MIP can be dismissed straight away. If the Commission were to take a tougher approach, the German administration would certainly have cried bloody murder. But as shown in the first part of this chapter, the underlying argumentation for a tough approach is also not strong enough. The more interesting question is why it has been so difficult for the Commission to build consensus around its argumentation? In the literature on the euro crisis, some have looked at the role of ideas and made the argument that German policy-makers speak an (ordoliberal) economic language that does not resonate with stimulus-based macroeconomic thinking (Matthijs, 2016a). The level of disagreement between the Commission and some German actors is indeed quite deep. There is political and intellectual opposition to the CSRs in other countries as well. But in Germany, the disagreement goes all the way to the question of whether there is a problem at all. Others have argued that the German administration has shielded its lack of ambition by a strategy of ‘normalise and apologise.’ The surplus is seen as a natural phenomenon that the Germans cannot do much about, because it is about market forces and because of the federal structure of the country (Jacoby, 2017). The interviews indeed in part confirm this logic, for example:

... often we still hear from German officials: “yes, we agree with your analysis, but there's not much that we can do about this.” And this is where we differ, this is where we say that in particular in the area of structural reforms you can do quite a lot, there is still quite a bit of room for improvement, as I mentioned: tax wedge on low incomes, disincentives for work for second earners, not much has changed there, public investment has been increasing nominally but not as a percentage of GDP, its stable. (Interview 62)

But this chapter has highlighted a number of other issues as well. First, it is important to distinguish between the discussion on whether more investment is good for Germany (and possibly demand in the euro area) and the discussion on whether the surplus is problematic for the euro area. This last discussion has been particularly tricky. While talking about the surplus has become more accepted, the nuanced message one can find in Country Reports is not the same as the one in the public debate. The public debate is much more about Germany distorting the EMU with its surplus and an attack on German
export strength. With pundits calling it a ‘Scheindiskussion’ (fake discussion) because Germany’s export strength ensures 5 million jobs throughout the EU (Süddeutsche Zeitung, 2017), and industry leaders repeating the argument of the surplus as a sign of competitiveness (Welt, 2017). And on the other side of the debate, you hear Commissioner Moscovici arguing that Germany’s surplus leads to ‘significant economical and political distortions for the whole Eurozone’ (EUObserver, 2017), and Macron, who argued during his election campaign that the surplus is ‘hurting’ the euro area (2017).

It is questionable how much of this is necessary when the real issue seems to be demand and investment weakness. The surplus is so open to multiple interpretations that it raises more confusion than that it adds to the argument of what is really necessary. Even those in the German administration who have welcomed the Commission’s criticism and calls for more investment did not really believe a stimulus would have a large effect on the surplus. Nor did they believe that it would have significant effects on euro area rebalancing. They were simply in favour of a better allocation of the surplus money and of stimulating demand and investment. Monitoring developments in the current account should give policymakers a descriptive picture of broad trends. The extreme level of Germany’s surplus should be treated as a curiosity, which invites discussion and investigation. But the current account position is not a very useful target for economic policy decisions and arguments about it being economically and politically distortive are not very convincing. In some ways, this is also still a learning process about what the German surplus really embodies. As one Commission official explains:

For the German imbalance, we have to go through the entire economy and look for answers everywhere. This process is still ongoing. Each year we try to focus on a different set of issues, try to take a different viewpoint. The economics of how to treat this imbalance is still taking shape. (Interview 70)

The difficulty of being precise about what the surplus means for the euro area should, of course, not justify complacency on the side of the Germans. But those who would have liked the Commission to be firmer against Germany have to take account of the ambiguity of the debate which prevents the Commission from being more convincing. There is an argument to be made for German investment and demand stimulus, which could also help the euro area. But there is no unequivocal evidence that a German stimulus is a crucial part of this euro area rebalancing process.
10.6 Conclusion

When the Commission first announced that it would start investigating Germany under the MIP, Daniel Gros of CEPS – a prominent Brussels commentator – predicted it would be much ado about nothing. ‘This might trigger strong political reactions and lead to an enormous debate in the media. But nothing of substance is likely to follow’ (Gros and Busse, 2013). Looking at the implementation of the CSRs alone indeed paints a gloomy picture. Gros has mostly been proven right. At the same time, it could be argued that in an environment that is very hostile to the argument there is more ground to be gained in cognitive terms. Most of the imbalances described in this thesis have already been firmly on the radar of national politicians, but in Germany there was more work to be done. Especially since authoritative domestic institutions such as the Council of Economic Experts or the Bundesbank remained unconvinced of the arguments.

This chapter has shown that we should read the influence of the MIP primarily as one of agenda setting and redefining the policy frame. Those who believe there is no investment problem and the surplus is something good have been put on the defensive. The MIP was never the only factor involved, but it demanded from German policymakers that they take a position and produce a compromise text. Both on the side of interviewees in the German administration and on the side of the Commission, there was a feeling that the debate has changed over the years. This has been specifically the case for the necessity to increase public investment. There is still a significant group in the German economic and political class that dismiss the MIP and the argumentation on the surplus. And while ground is gained on public investment a sustained upward trend has not yet followed.

To show why the MIP does not easily impress the Germans, this chapter carefully assessed the surplus phenomenon. In line with the Belgian case, the German case shows clearly that the MIP is not only confronted by political obstacles but also by genuine intellectual disagreement. This intetellectual uncertainty around the surplus also prevents the Commission from being more convincing. The surplus is prone to misinterpretation and the argument the Commission is trying to make is not an easy one to understand. There are a number of ways to think about the surplus and its relation to the EMU, but not all of the arguments are equally convincing. The primary question is whether the surplus is welfare-enhancing for Germany itself. The measures needed to redress the surplus are seen as good for the future of the German economy and could also potentially help the aggregate macroeconomic stance of the euro area. But these linkages to the rest of the euro area remain difficult to prove and do not always provide for a convincing political
Part II: In-Depth Case Studies

narrative. Arguments that redressing the surplus is crucial for euro area rebalancing or that the German surplus causes significant distortion for the EMU fall mostly flat. The case also shows how the influence of the MIP is conditioned by domestic factors, such as a change of government and key individuals taking up or rejecting the argument.

It remains difficult to convince a booming economy that, in fact, it has a growth problem for the future. We now know that a growing current account deficit in a booming economy could potentially be a signal of a concentration of risk: see the example of Spain before the crisis. But for a surplus this is not the same. The Commission is still working on their argumentation in this context. It remains an interesting case to follow from an intellectual perspective. But from a political perspective, the case is not yet convincing enough to build an epistemic consensus in Germany around the proposition that redressing the surplus should be an important target for economic policy.
Chapter 11

What we learn from the analysis

The case chapters have told country-specific narratives in relation to the MIP. In this chapter the findings from the cases are analysed on the basis of the conceptual framework to allow for systematic cross-case comparison and answering the research questions. The first section will try to answer the question of whether the MIP is hierarchical. The second section focuses on substantive effects, procedural effects and the channels and determinants of influence. In this section it should be remembered that the conceptual framework is used as a way of characterizing effects. There are no Chinese walls distinguishing these effects; many of them can be classified under multiple categories. The third section gives an overview of some of the other notable findings from the analysis. All the evidence that supports the analysis in this chapter can be found in the case study chapters. This chapter expands on them and compares them but does not introduce new material. It provides an overview of the findings so that the next chapter can conclude and reflect on what these findings mean for the debate on the MIP.

11.1 Is the MIP hierarchical?

The first question that needs answering is: is the MIP is hierarchical? Much of the early literature has discussed what mode of governance the MIP entails, primarily based on studying the MIP’s legal design (see chapter one). In this literature there is an underlying assumption about a move towards more hierarchical governing. And despite the increased flexibility that has been introduced in the post-crisis period, the idea that the euro and its governance are highly constraining is still very much alive. This thesis has argued that the hierarchical character should be determined empirically on the basis of how the MIP is applied in practice. Assessing the hierarchical character has been deemed important not only from a perspective of classifying what mode of governance the MIP is, but also because existing classifications of a constraining nature of European economic governance feed back into the public debate.
Chapter four has studied the design and governance of the MIP. It shows that MIP CSRs cannot be legally imposed with the sanction procedure. Member States remain in charge of the formulation of their policies. The MIP includes a number of procedural obligations, but compliance with the CSRs themselves is not obligatory in nature. However, the analysis also shows that the design of the corrective arm has the potential to be used coercively if the Commission would want to do so. In practice, it would have to build a very strong case. So far, the Commission has shied away from using the corrective arm, also because it has not seen a need to do so. The ambiguity of the concepts used in the MIP, the difficulty of defining spillover effects, and the potential political fall-out from a coercive use make it quite unlikely that the corrective arm will be used in any instances other than an extreme case.

Actors describe the corrective arm as a sign of the times. It was included so that actors would take the MIP seriously. Some see it as a deterrent. There are actors who wish to see the corrective arm being used more forcefully, but these arguments are also made for strategic reasons. Few could identify a case where they thought a financial sanction was justified. As one actor summed it up ‘officially there are sanctions, but nobody believes in sanctions.’ Finally, chapter three shows how the MIP has evolved over time by introducing more interactive elements and streamlining the CSRs. Many have praised this evolution as a way to enhance ownership. Others now see the Commission as too political. In any case, the evolution should be seen against the background of Member States’ protests against an overly rigid approach. This was not seen as appropriate or effective. The analysis shows that a legal interpretation of the MIP simply does not capture how the MIP actually works. While the MIP represents a de jure step towards hierarchical governance, there is no clear evidence that it represents a de facto step in this direction.

Chapter five shows that the Commission has interpreted its mandate within the MIP very widely. It placed many states under the MIP and linked the vast majority of CSRs to the MIP. In doing so, it has become unclear for actors why certain issues are linked to the MIP. By placing so many Member States under the MIP and up to six Member States in the excessive category, the rationale of ringing alarm bells because imbalances are widening has become somewhat diluted. This move has reduced the relative weight that MIP CSRs could have as opposed to normal Semester CSRs. Arguably a more selective or targeted use would make the MIP more distinctive.

The analysis of the opening chapters is largely supported by the findings in the case studies. The threat of sanctions has loomed during particular moments in the cases of
Italy and France. Actors argued in the Council for opening up the corrective arm. But neither Member State perceived this as a serious threat. Opening up the corrective arm would not have been seen as a credible, nor as a justified move and would certainly have led to a political backlash. Smaller steps, such as labelling them with ‘excessive imbalances’ without opening the corrective arm, have not made much of an impression on domestic actors either. In the case of France, it is questionable whether this assessment is justified at all. In the case of Italy the imbalance primarily concerns a stock issue that Italians have been living with for years, whereas the Commission and Council have supported the overall policy direction. The label was used to signal that reform effort was slowing. The additional monitoring that followed from this label is mostly seen as a way of being informed, rather than a coercive tool. Finally, the Commission signalled in both cases that it could open the EIP before the publication of the NRP by the Member State to create additional pressure. But these threats were not seen as very credible in either France or Italy.

The Dutch case is pretty straightforward: there is no evidence that the MIP has acted in a hierarchical manner. The CSR for the Netherlands has been quite prescriptive. This stands in contrast to Belgium and France where over the years CSRs have been formulated more openly to take away the perception that the Commission is insisting on a particular approach. But the prescriptiveness of the CSR in the Netherlands does not say much. If the Dutch were to solve the issue in a different way the Commission would be equally satisfied. In Germany it has also been clear that the MIP has not been hierarchical. What is interesting is that even if the Commission would want to take a tougher approach, it would be difficult for them to make the case intellectually. Not only does the MIP contain procedural safeguards against a hierarchical approach on surpluses, but there is significant and legitimate disagreement over the nature of the imbalance. The Commission is having difficulty proving in what way and to what extent the German surplus matters for the rest of the euro area.

The Belgian case displays elements that could be interpreted as hierarchical. Primarily the unofficial announcement that Belgium could end up re-entering the MIP if it did not make a serious effort on reforming its wage institutions. Some Belgian officials interpreted this as a strong signal of pressure. But it should be seen within the specific Belgian setting of a right-wing government that cherished its reputation of being a reformer, the credibility that the Commission has among policy elites, and the elusive linkages to decisions within the EDP. The EU institutions raised the cost of non-action, primarily through the threat of reputational damage. In Belgium this made an impression on government officials, but it is questionable whether it would have made a
similar impression on the government of a country like France. The fact that the decision to label France with excessive imbalances went by relatively unnoticed suggests it does not. These small instances of hierarchy seem contextual, and linked to the credibility and perceived legitimacy of the CSR and of the EU institutions. It is remarkable that this leverage approach was used in this case, given the fact that the previous government had fought off the CSR on intellectual grounds, supported by the analysis of respectable domestic institutions.

We can conclude that the MIP can heighten tension when issues are not addressed, but it is important to dispel the perception that it has so far acted as a rigid top-down compliance framework. The enforcement seems to lie rather in largely non-hierarchical mechanisms such as socialization and persuasive power and urging the Member States to stick to their own commitments rather than any type of technocratic dominance. Actors that work with the MIP describe it in terms of ‘an authority argument’ (Interview 17), ‘it creates a solid framework for a good discussion’ (Interview 5*), or ‘we use these types of instruments mainly to open up a dialogue’ (Interview 6*). Some have even gotten frustrated with the way the MIP has been characterised in parts of the critical literature:

_They overvalue the power of the EU administration very strongly, in my opinion. They give us way too much power. Maybe we would like to have so much power, but that is not the case. The best thing that we can have is that we are in agreement on the priorities of the reforms._ (Interview 51)

Of course it could be argued that there is a cyclical element to the conclusion that the MIP is not hierarchical. If the economies of the Member States turn sour and the Commission decides to use the instrument differently, it has the potential to be coercive. We have so far not seen the MIP in action where it concerns the rise of a current account deficit. However, this thesis has listed many practical, political and intellectual obstacles to a more hierarchical approach. This makes it unlikely that real hierarchy will be the case in any other situation but an extreme one. Hierarchy within the MIP is possible, but also problematic. So far hierarchical elements such as the threat of sanctions are not seen as very credible by insiders and are prone to misinterpretations by the public. This also means that the MIP is not an instrument that primarily acts in the shadow of hierarchy or operates on the basis of a logic of deterrence, as is sometimes claimed (Begg, 2013).

Does this conclusion automatically mean that the MIP should be considered as soft?
This conclusion would go too far into the other direction. The MIP has the features of a hybrid governance mechanism (Trubek and Trubek, 2007). The case studies have shown that the ‘hardness’ of pressure from the MIP is largely dependent on perception and usage of domestic actors. It can raise the political cost of non-action by reputational damaging, which can in certain circumstances exert real pressure. Similarly, chapter two has devoted some attention to the case of Slovenia where the MIP was used as an authoritative framework for government policy while the country was facing market stress. A similar situation arose in Italy at the start of the crisis as will be discussed in the sections below. The MIP increases transparency on the potential build up of imbalances: if imbalances start unwinding rapidly markets respond. As we have seen during the crisis, this market pressure can hardly be called ‘soft’. A strong market reaction can be a determinant that gives prominence to the implementation of CSRs.

11.2 Does the MIP have an effect on national policymaking?

11.2.1 Substantive effects

Policy changes

The conceptual framework of chapter two has defined three types of substantive effects: programmatic shifts, agenda shifts and ideational shifts. Before analysing these effects, it is important to first summarise which policy changes occurred. In all cases there has been a substantive change of policy at some point, although in varying degrees. The MID has been lowered in the Netherlands, although before and after the period under study. Belgium has changed its wage-setting institutions by reforming the law of 1996 and even before that it was taking smaller steps to address the same problem. In France there has been continuous reform of the labour market. Italy has taken multiple steps to further liberalise professional services, although it has also faced setbacks. And even in Germany, which has seen very meagre progress evaluations, the rate of public investment was put on an upward trend, a reform of fiscal federal relations was set in motion to allow for more public investment at municipal level and debt relief was provided to certain regions and municipalities to free up fiscal space for investment. Most of these changes were labelled as ‘some progress’, with the exception of Belgium and France. In these cases the reforms were eventually labelled as ‘substantial progress’, but on the basis of lower ambition. In France dualization trends were not significantly reversed and in Belgium only the part on automatic corrections was introduced whereas the initial CSR asked for
much more.

Agenda shifts

Perhaps the most pronounced effect of the MIP is its contribution to agenda shifts: a change in the salience of particular issues on the political agenda. In Germany we see that the MIP has contributed quite strongly to agenda setting. Before the MIP demanded position taking, the German administration did not attach salience to the issue, criticisms were largely dismissed and the surplus was rather seen as a sign of competitive strength. With the issue being placed under the MIP, Germany had a procedural obligation to come up with a response in its NRP. This required that Ministries with a different view on the matter had to come with a joint response, which led to the first official recognition that there is also something problematic about the surplus. The issue slowly became more prominent and domestic actors that were pushing an investment agenda used the MIP as cognitive leverage to give more salience to the issue. In the conceptual framework this is referred to as leveraging, using European norms, ideas or policy processes as a way to support one’s own agenda. The issue increased in salience, but its position on the agenda should not be exaggerated; there is a large group that remains unconvinced.

The agenda effect of the MIP can also be seen in the Belgian case where the practice of automatic wage indexation was long seen as a holy cow. The debate goes back to the 1970s and has been repeatedly held. But, despite minor changes, the general sense has long been that no political party should touch it. A serious reform was off the agenda. This changed in the last few years with political parties taking stronger positions on the issue and ending up supporting the Commission’s view on introducing automatic correction mechanisms. Even before this change occurred the fact that it was included in the MIP led to significant discussion and the issuing of a report from high-level institutions on competitiveness. Belgium needed to come up with the ways and means to convince the Commission that they take the issue seriously, despite not agreeing with its conclusion. As such, the issue gained salience on the political agenda. And with a new administration and their desire to broaden an EDP induced austerity package to also encompass structural reforms, the agenda effect translated to a programmatic shift. Insiders considered the MIP to be an important contributing factor to this shift.

In Italy, issue salience can equally be seen as the most important contribution of the MIP. The liberalisation of professional services is a reform with few political incentives. The
gains are diffuse and the opponents are concentrated and powerful. With the MIP, this reform is presented in a broader package to tackle structural impediments to growth. As part of a growth strategy it remains on the agenda. This reform is not something that endogenously gains sufficient traction within the Italian political system. The EU, with the MIP, lends weight to those domestic institutions, such as the Competition Authority, who do advocate this agenda. The content of the CSR and the precise working of the MIP might not be well-known outside a relatively small group within the administration, but for those working on the issue of liberalisation the voice of the EU weighs relatively heavy. When it comes to the implementation of reforms it does not weigh strong enough to overcome opposition in parliament, where interest groups have a tighter grip on affairs. Actors have referred to the MIP as a way of leveraging their agenda (creative appropriation), but with the legitimacy of EU institutions waning in domestic politics this has not been a very fruitful strategy in the public debate.

For France, you would not expect any agenda effects. Unemployment and the reform of the labour market have for a long time been at the top of the political agenda. The agenda effects in France should not be read as attaching salience to the issue, but rather as aligning various actors around a single set of priorities. Ideational shifts and agenda shifts go hand in hand in this case. For the Netherlands, the agenda effects are small, but nonetheless present. When the first CSR on the MID was issued, there had been at least a decade of divisive domestic debate around the issue. As a consequence, the CSR itself did not do much. It simply coincided with a reform momentum that was forged on the basis of domestic factors (and helped a bit by the EDP). This is what led to policy change. In the years after, it looked at first like the CSR played a negligible role. Politicians were quick to say that no further change would be needed as the housing market needed calm. The role of the MIP was to give an annual reminder to politicians that the issue had actually not been solved. As such, the issue could not be ignored and pro-reform forces found support in the MIP to pursue further reform. The Commission was far from the only one to say this, the voice of domestic institutions was louder, but it is the cumulative voice that matters most. Those working in the administration found the MIP useful:

*Despite the fact that these recommendations were often dismissed by the Minister, we made sure to continue to receive them and we used them in the discussions. They were used for issues that simply would not rise in salience on the political agenda, to make sure that at least we talk about them.* (Interview 73*)
Ideational shifts

The CSRs do not usually entail radically new ways of thinking about policy problems. Rather they contribute to mainstreaming particular economic views that can also be found in the domestic debate. For Italy, the reports draw on the information of the national Competition Authority. The MIP serves to amplify these voices. For the Netherlands, almost all technocratic institutions, domestic, IMF and OECD, follow a relatively similar line of argumentation and draw upon each others' work. In the Dutch case, a broader perspective away from the specifics of the MIP does show some ideational shifts. The statement from financial supervisors that they are increasingly confronted with a European way of thinking about financial stability is telling in this regard. But in general the arguments are well-known and no serious shifts in thinking have occurred.

The French case is a bit different. With near 10% unemployment French policymakers do not need an annual reminder that there are issues in their labour market. French policymakers are also not very impressed by the threat of sanctions or their position in the MIP. The real politics of French labour market reforms occurs between the administration and the social partners and not between France and the EU. And yet actors involved with labour market reforms do see additional value in the interaction within the framework of the MIP in terms of ideational shifts.

The ideational effects are subtle: labour market reforms are designed and evaluated in a context of Europeanization. Labour market reforms include a high level of strategic uncertainty so that deliberation and learning elements have a stronger role to play. Actors use the framework to advance their own knowledge about potential solutions to commonly identified problems. There is a high level of information exchange about the effects of reforms, both bilaterally and within the Council. This has been done in the context of the flexicurity debate, which has contributed to French thinking about labour market dynamics. The intellectual contestation in this debate is not between the Commission and France, but between various approaches to reform. The dynamics between the EU institutions and France are best described as collective puzzling rather than external pressure. The information exchange underlying the MIP analysis seemed more of interest to French officials than any procedural aspect of the MIP. Examples such as the German model of part-time work or the Jobs Act in Italy are prominently discussed in French policy circles. Such discussions do not always have the MIP as their basis so that it is better to speak of general Europeanisation dynamics of which the MIP is part.
The German case is a clear case of ideational shift. The first time the German surplus was criticised, it provoked an outcry among German officials. A taboo had to be broken. Developments in the current account and the associated risks are now constantly monitored and those who do not see a problem are continuously put on defence. The MIP is part of a larger debate, but it is no insignificant factor. It helped in redefining the issue away from the export champion narrative to a narrative of demand and investment shortage. Contrary to the wider economic debate the MIP constantly triggers an official reply from the German administration through the procedural obligation. The ideational shift is the most important outcome from placing Germany under the MIP. But building a strong epistemic consensus remains an uphill battle, as the Semester remains relatively marginal in Germany and little substantial programmatic shift has followed.

In Belgium, the MIP can be seen as a contributing factor to ideational shifts, but in a relatively modest way, other effects are more pronounced. The first CSR was heavily disputed on intellectual grounds. The Belgian administration did not agree with the analysis and the weight that was given to the wage element in the competitiveness debate. Domestic institutions were on the side of the Belgian administration, so that the effect from the MIP is more isolated, its voice in the debate has been significant. And through interaction, the perceptions of the problem have evolved over the years so that we can speak of an ideational shift. This evolution has happened on both sides; it was not just the Belgians who changed their view. It is difficult to talk of learning, because some of the apparent shift in thinking can also be attributed to strategic behaviour, but a degree of persuasion from both sides cannot be denied. The idea of introducing automatic corrections became more accepted over the years in Belgian circles, whereas the Commission toned down its criticism on wage indexation as such.

But perhaps the most important ideational shift that can be linked to the MIP is when we move away from the country-level analysis to a focus on the aggregate level. Those with a longer involvement in policy coordination within the Council argued that the most pronounced effect is the general change in the way of thinking about imbalances as such. The MIP can be seen as an extensive information infrastructure. It leads to mainstreaming particular economic ideas and insights. Those who view imbalances or solutions to imbalances in a radically different way are confronted with a European way of thinking. Many of the issues that used to be taboo, surpluses or wages, are now discussed more extensively at the European level. For example, Eurogroup meetings used to be characterised by quite legalistic discussions with a strong focus on fiscal rules. But according to Tomas Wieser (former EFC/EWG chair), and confirmed by other interviewees, these discussions have over the years changed in tone and have become
more macroeconomic in character (Interview 61).

Programmatic shifts (and the missing link)

If you have a Newtonian view of the world, a view based on clear cause and effect relations, X leads to Y, then the effects of the MIP are deeply depressing. In no case has the MIP been the key factor leading to policy change. Where Member States have complied with the CSRs and even when they have openly claimed that they have done so, the lines of causality have been delicate and mostly indirect. In none of the cases have Member States introduced policies that they did not intrinsically want to pursue themselves, only to comply with the MIP. And at no point during the research have I gotten the impression from actors that this has been significantly different had I picked different cases. National politics remains dominant, and from a legitimacy perspective this is probably a good thing. But the interpretation of effects in this thesis goes further than a Newtonian or mechanistic view of the world; indeed it goes mostly against it. It asks whether the MIP has contributed to this intrinsic belief of politicians to pursue the policies they have pursued, while being aware that it is never the only factor. These effects are substantive themselves.

In all cases there have been changes of policy, albeit sometimes small. In all cases there have been either ideational or agenda effects or both that can be linked to the MIP, albeit sometimes small and always in combination with other factors. The MIP affects the way policymakers think about domestic macroeconomic issues and the saliency they give to a particular problem or a particular solution. Actors use the MIP actively and attach value to it. In this sense, the analysis of this thesis nuances the depictions of the MIP as fairly useless in practice (Claeys, 2017) or the argument that if the MIP is not reformed it is open to the charge of irrelevance and might as well be discontinued (Begg, 2018). But despite these effects and despite the argument that the effects should not be viewed in a Newtonian way, the analysis in the cases also shows that overall we have to be relatively modest about the contribution that the MIP makes to programmatic shifts (new legislation being introduced).

Even on the basis of in-depth process-tracing and careful triangulation, where actors have been asked to be specific about the effect of the MIP on reforms, establishing a link between the MIP and programmatic shifts remains extremely difficult. Causality occurs in the interaction and determining how important of a factor it is cannot be established
with precision. We can roughly say that in the reform of the Law of 1996 in Belgium it has been quite important, as it raised the political cost of non-action. In Italy and France, it has contributed to the intrinsic commitment of the policymakers to introduce reforms (on the side of the government especially), in the Netherlands it has been one among many voices to add pressure, while in Germany the cognitive shift has not been strong enough to lead to a significant change of policy. But it remains somewhat of a judgement call. The ideational and agenda effects seem more pronounced.

These ideational and agenda effects occur primarily within the bureaucratic realm. The message disseminates through the administration and also affects the positions of politicians, but not in very obvious and visible ways. Whether policy ideas and the saliency that is given to these ideas translate into programmatic shifts depends also on whether politicians are able to build societal consensus around the issue and find political alliances to support it. The case studies provide evidence from interviews, which show that politicians do refer to the MIP in parliamentary debates. But in general, the MIP is relatively unknown among parliamentarians. The message of the MIP does not travel very far. An important reason for this is the complexity of the procedure and its content.

Those who have looked more systematically at parliamentary scrutiny notice an increased involvement of parliaments in the Semester, especially among non-euro Member States in Eastern Europe. But they also describe a general lack of ownership and ultimately remain unimpressed about the role of parliaments in the process (Kreilinger, 2016; Hallerberg, Marzinotta and Wolf, 2018). Vanheuverzwijn and Crespy aptly describe the Semester as contributing to the rise of a multi-level administrative space rather than an arena for political debates (2018). Contrary to these statements, media analysis shows that the concept of imbalances has featured significantly more often since the start of the crisis, but is waning again in later years (Pierluigi and Sonderman, 2018).

This thesis has not looked systematically at parliamentary debates or media appearance in the way that the authors above have. But the case studies and interviews do give some indication of why the MIP message does not travel very far. In Germany the complexity of the surplus argument is seen as a factor; the macroeconomic dimension does not really land. Maatsch notes that in parliament opposition parties have used the CSRs to call attention for increased support for demand, precarious contracts and wage stagnation, but the majority of parliament dismissed the CSRs in their resolutions. In Belgium, opposition parties have also used the CSRs to criticise the government in a more prominent way. And when a new government came in, the CSRs were all
literally cited in an important document of the coalition talks as the priorities for the government. In Belgium the awareness seems higher than in the larger Member States. In the Netherlands, the politicians have been receiving criticism from international organisations on the MID for at least 15 years, so that a new report from the Commission on the issue does not give a lot of political incentives to re-open the discussion, especially not in later Semester cycles. But when the MID is discussed, pro-reform politicians also refer to international pressure as a way of leverage. And international pressure was in the back of their minds when a new government decided to pursue further reform.

In France, interviewees considered parliamentary awareness of the MIP to be low. But politicians also deliberately refrain from referring to the influence of the EU on reforms, because it leads to misinterpretation and misuse by opposition forces more than it leads to support. During the 2016 El Khomri labour market reform opposition forces used EU influence as a way to argue against the reform. This is a more general point of concern from the perspective of gaining ownership. In the Dutch parliament both the left and the right-wing opposition referred to the CSRs as dictates from Brussels in the first Semester cycles. Such depictions never gained much traction, but in Italy the issue is more serious. Pro-reform forces deliberately stopped referring to the EU in debates because it was too easy for opponents to rally opposition by arguing that reforms were introduced to please Brussels. The idea that the euro is highly constraining has gained considerable traction in Italy. Opposition forces used the role of Brussels to argue against the reform of the Constitution. The traditional vincolo esterno (external constraint) by which political forces were able to circumvent opposition has worn off in usefulness and become a force to rally opposition.

On the issue of wider ownership beyond the bureaucratic realm, the MIP suffers from the same fate as the SGP. The analysis in this thesis is perhaps more optimistic, but on the whole largely confirms the view of Pisani-Ferry when it comes to ownership outside of the administration, especially in the larger Member States (I am more positive about results within the administration). Pisani-Ferry has described the issue as follows, and is worth quoting at length:

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In a personal capacity (and as a non-representative example) I can state that I was surprised by the level of engagement of Belgian parliamentarians when attending an expert meeting in 2017 about the Semester. There was a high attendance of the meeting and politicians seemed genuinely interested to hear what Belgium could learn from foreign experience. Having attended and watched a few dozen EU debates in the Dutch parliament over the years and having worked with the Parliament’s 2013 Semester rapporteur, my impression is that the Tweede Kamer was somewhat anxious about the Semester at the start and wanted to have a tight grip on the process. In later years the salience and attendance of debates decreased.

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... practitioners and outside observers concur that the EMU policy system has become excessively complex, and for this reason can only be mastered by a few technocrats and experts. Complexity results from the intricacy of the procedures, from the technical character of some of their provisions (as regards, for example, the measurement of structural deficits), and from their mutual entanglement. The result is that national policymakers and members of national parliaments have at best a very approximate notion of what this system exactly implies. They often perceive the EU framework as excessively procedure-driven. To use a comparison first made in the Sapir report (2004), the EU is widely seen as a policeman rather than as a facilitator. This situation contributes to a serious lack of ownership of the reformed EU framework in the national capitals. It contributes in some countries to the perception of EU discipline as an abstruse external straightjacket. (2015b: 14)

The question of whether parliamentary involvement and awareness is the right yardstick to measure the effects of the MIP is one for the concluding reflections in the next chapter. The effects of a change of thinking or the rise in salience of an issue automatically add pressure to introduce a reform. The MIP aims to harden commitments to reform, by enhancing issue salience and demanding responses through procedural obligations. Domestic actors also use this framework to advance their agendas. Domestic reforms are designed, implemented and evaluated in a context of Europeanisation. But overall, the linkages are not linear or very visible and thus appear not very strong. The influence runs primarily through the administration; awareness and engagement outside the administration is mostly limited and prone to misinterpretation whereby the EU is seen as a policeman. At least observers can rest assured that the lack of salience is equally distributed: it is not the case that the MIP is very strong in Italy and fully absent in Netherlands.

11.2.2 Procedural effects

A second set of effects that the conceptual framework has identified is procedural effects. These include: reinforced horizontal cooperation, improvements in steering and statistical capacity, enhanced vertical coordination, increased involvement of non-state actors and the development of new networks. It is safe to say that the MIP has indeed led to procedural effects, especially on the part of reinforced horizontal cooperation. Actors in various Member States were surprisingly positive about this. The MIP demands that the Member States have a credible and unified macroeconomic strategy, backed up by analysis and statistics. The Commission questions the approach in MIP missions and with questionnaires and
with their own counter-analysis. This demands from administrations a certain level of steering and cooperation between various units. Actors were quite clear that with the Semester and the MIP this process has gained significantly more prominence within administrations than under earlier coordination regimes.

In France, the Semester involves the highest-level officials: bilateral meetings with the Commission include top advisors from the cabinet of the Prime Minister and President, Ministers are involved in formulating answers to the Commission’s questions and the NRP is written by high-ranking officials. Despite low public awareness, within the administration the NRP is seen as the central document outlining the economic strategy. Because labour market issues fall under the MIP, the Ministry of Social Affairs has to work together with the Ministry of Finance, which indeed has led to reinforced horizontal cooperation. There is sometimes the fear among members of the EMCO that when issues are placed under the MIP (or when a country is placed under the EDP) this automatically strengthens the hand of the Finance Ministry internally. But in the case of France it seems to break down policy silos; officials argue they have ‘real dialogue’ between Ministries and ‘we have more impact if we work together’ (Interview 58).

Reinforced horizontal coordination is seen as equally important in Italy. Officials describe the role of the MIP for the internal working of the administration as ‘extremely important’ because it is a way to get everyone aligned and involved on the basis of a single agenda. This has been an important difference with the pre-crisis OMC, which gained less traction. Officials spend months preparing for the NRP and argue that it has strong value for the organisation. In here it contrasts a bit with the Netherlands where coalition agreements are detailed documents with a strong guiding role and the NRP is usually a copy of the year before, with some minor updates. In Belgium, the first Semester cycle led to a strong internal coordination effort steered from the Prime Ministers office. The administration wanted to open a constructive dialogue with the Commission on the issues and knew it had to come with sufficient evidence and a coordinated response based on clear and common mandates. Thematic sessions were organised, social partners were included, and the regions were given the opportunity to provide input (enhanced vertical coordination). One top official confirmed that ‘this was all pretty new’ (Interview 25). In later years this process became institutionalised. In Germany, it also helped to break policy silos by forcing two Ministries with a different view on the surplus to work together on a common response. But the role of the MIP as an enhancer of internal coordination is weaker in Germany than in France or Italy.
The reinforced horizontal cooperation is the most pronounced procedural effect. For the other effects that can be identified the MIP has mostly expanded upon earlier practice. The improvement in steering and statistical capacity, for example, is a more general and diffuse effect of the MIP. The MIP has statistical indicators, monitoring and evaluating policies at its heart. As such national practice is compared to European benchmarks and differences are discussed in Council committees, which sharpens the thinking on both sides. An interesting example of new monitoring systems being introduced and which can be traced back to interaction with the MIP is the example of the Italian Ministry of Justice. In response to comments made by the Commission, it developed its own monitoring procedures with clear timetables of what has been done and will still be done in terms of reform; all this information is now published on the website of the Ministry.

Similarly, on the increased involvement of non-state actors the MIP typically expands the existing involvement. Social partners are the most important in this context. In Belgium they meet with the cabinet of the Prime Minister to discuss the NRP and the CSRs and both sides use the Commission's documents as a support to advance their own agenda's (on different points). Trade union representatives even met directly with the desk officers from DG ECFIN to try to clear out their differences on wage policy. The introduction of the Semester officers has reinforced the involvement of stakeholders.

The Italian business union Confindustria uses the MIP framework to discuss the liberalisation of professional services with the government, and considers it a topic which otherwise would not receive sufficient traction within the Italian institutional constellation. The Commission also meets directly with the representatives of the professional orders in Italy. In Germany social partners are equally involved, but a business representative admitted that it is a relatively small circle that is working on Semester issues. This is a broader phenomenon: in general the Semester involves more actors within the administration than external stakeholders (see: Vanheuverzwijn and Crespy, 2018, for a mapping exercise).

The procedural effects are overlooked or taken for granted in some of the evaluations of the MIP that are discussed in chapter one, but are seen as important by the actors that work with the MIP. There is an argument to be made that these are general Semester effects and not related to the MIP specifically, but actors in France and Italy argued that the additional monitoring of the MIP has amplified these effects. At the same time, they express concerns that the extra monitoring should not lead to an overburdening of the administration. Excessive amounts of MIP missions or additional reporting obligations
under the Two-Pack regulation do not add much additional value. All in all, we can say that the procedural obligation to come with a solid annual macroeconomic strategy, which is questioned in light of foreign experience and in light of the MIP indicators and Country Report increases transparency and quality of governing. Furthermore, the necessity to come with a unified response backed up with a fact-based analysis in the MIP missions leads to reinforced horizontal coordination between different units and actors.

11.3 Unpacking causality: mechanisms and determinants

The conceptual framework has identified the following channels of influence: external pressure (reputational or material; horizontal or vertical), external support (financial, organizational, technical), creative appropriation, socialization, persuasion, deliberation and learning. This section will focus on external pressure; it will leave out external support (for which the cases did not provide any evidence) and will treat the final five channels as a package. The conceptual framework has left the definition of determinants open, but argued that it typically involves issues such as a change of government, the fiscal situation of a state, elite perceptions, etc.

11.3.1 The MIP as an instrument of external pressure

The MIP is not a hierarchical governance instrument. But, as discussed in chapter three, it was presented in 2011 as a significant hardening of the governance framework. The Council also continues to commit to the concept of peer pressure when they refer to the MIP in their conclusions. But as a researcher it has been surprisingly difficult to pinpoint and specify what external pressure or peer pressure means in practice. The case studies do provide some insights into how it works. First, it should be noted that the typology of Zeitlin could in the context of the MIP be further specified. External pressure as possible reputational damage can be further specified on the basis of what Schild calls ‘domestic audience costs’ and ‘European reputation costs’ (2018). The former relates to voter perception (and media coverage) and the later is described by Schild as the loss of power resources in EU negotiations and loss of immaterial leadership resources. Schild uses this second typology as a way to describe the pressure felt by President Macron in his attempt to ensure that the French budget deficit would drop to below 3% in 2018.

Secondly, it is important to see the channels of influence in the specific context of
contextual determinants. For external pressure, one determinant stands out: market pressure. This is visible in risk premia such as bond ratings or an increase of the spread on long-term sovereign debt yields, when there are signs of falling performance. In a context of market pressure, Member States will seek to avoid negative publicity on economic performance. The case studies do not provide evidence of whether markets immediately respond to Commission reports. But in a context of strong market pressure, the role of the MIP changes. Actors will seek to prevent damaging reports, but also use the framework to regain trust. This was the case in Slovenia as explained in chapter four, but a similar dynamic was at play in Italy at the start of the MIP.

Italy faced strong market pressure in the early crisis years. The Italian administration under Monti and Letta were well aware of what needed to be reformed, so that – broadly speaking - the CSRs and the ECB conditionality list did not add much additional pressure. Rather, they provided a framework to work with. Actors described that the Commission and the Monti government were fully aligned on the priorities to regain market trust. During the Letta administration, Letta himself described that he experienced strong pressure from the EU on the budget and on reforms in the form of domestic audience costs. A negative statement by a Commissioner or a report was considered as very damaging and would be picked up by domestic media and markets. In a context of decreasing market pressure and slowing of reform momentum the Commission raised material pressure, by stepping up the MIP. As a signal this was well understood by the Italians, but as a clear tool for pressure it never materialised, because shortly after reform momentum was picked up again under the Renzi government. The Renzi government took a deliberate strategy of downplaying the role of the EU, which also lowered the domestic audience cost from the EU as a pressure mechanism. But his strategy raised pressure in the form of European reputation cost as the administration was well aware that for the ECB to pursue its strategy of quantitative easing and for the Commission to introduce budgetary flexibility it needed to show results in terms of reform.

Pressure in the Belgian case has been discussed in the section on hierarchy above. There was a risk of being seen as an insufficient reformer if Belgium would be placed back into the MIP, which would lead to domestic audience costs. And there was (the perception of) a link with fiscal flexibility in the SGP, which could be classified as material pressure. In Italy and France the domestic audience costs of a negative signal from the MIP are low, there is less concern with domestic audience cost when the message comes from

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90 Interviewees that were asked about this had the impression that they did not - see also the French case study - but in general this link remains somewhat understudied.
the EU. But in Belgium a negative signal from the MIP is interpreted as an authority argument that things are heading in the wrong direction. The Michel government wanted to show its reform drive, since some of the parties had criticised the previous government precisely on lack of effort in this domain. It has to be noted here that the centre-left Di Rupo administration managed to take Belgium out of the EDP, whereas the centre-right Michel administration struggled to prevent the opening of a new EDP. The determinant for external pressure comes from the fiscal situation, but above all the perception of the EU among Belgian elites. The Commission is an authoritative actor in the domestic debate.

In the Netherlands, the influence of the MIP should be classified as persuasion more than pressure. But, if we take a small sidestep to the EDP, an interesting example unfolds. In 2012 there was a very strong motivation by Dutch politicians to comply with the requirements of the EDP. This led them to introduce a significant pro-cyclical austerity package. The Dutch politicians interpreted the EDP with rigour, but there was also a strong element of intrinsic motivation to comply. After the Rutte 1 government fell, the package was introduced within 48 hours, signed by coalition and opposition forces. The Netherlands was not under strong market pressure, yields only slightly increased, but only after significant drops since 2011. The downgrade from the AAA rating on bonds to AA+ by Standard & Poor’s arguably was a factor. Reputational costs were clear, since windfall gains from dropping yields due to the financial safe haven status have been significant. But, in hindsight, so have the costs of the austerity package. What this example shows above all is the interplay between various channels and determinants, domestic and European in how pressure works in practice. Was it the EDP that forced the Dutch to introduce austerity (as some politicians hold), or was it the perception of Dutch politicians about their role in the fiscal framework that forced it? Arguably it was the latter. And hence, what looks at face value like pressure from the EU actually turns out to be the significance that domestic actors attach to following European rules and procedures also to gain a credible reputation from the markets.

This mechanism works in the opposite way in France. France was labelled with excessive imbalances in 2015. Commissioner Moscovici argued in the European Parliament that he would not hesitate to open up the EIP if France would not come forth with a sufficiently strong NRP. French officials argued they knew they would never be put in the EIP and described the discussion in the Council on such a step as ‘very short’. France stepped up reform effort, but not as a response to escalation within the MIP. Pressure from the MIP in France should not be understood in terms of reputational damage, but rather from persuasion, socialisation and learning. Arguably, under the Macron administration
(which falls outside the scope of analysis) we can add the European reputation costs as an element in introducing further reform.

In the German case pressure should also be classified as one of the mechanisms. The MIP as such might not put strong pressure on Germany, but it is part of a process of peer pressure. It is clear to German politicians that France and Italy want them to do more on aggregate demand.

11.3.2 The MIP as an instrument of cognitive shift

External pressure is present in the MIP. But under normal circumstances - in the absence of severe market stress - the primary mechanisms driving the influence of the MIP resemble what we know from the OMC (Barcevicius et al., 2014); albeit with greater saliency attached to it. The mechanism of influence is a change in the preference formation of actors and a redefinition of the issue and its salience due to continuous engagement with the framework. The MIP operates essentially through various types of cognitive mechanisms: actors become convinced of ideas or increased salience (persuasion), adopt the language, frames and concepts in domestic discussions to support their own agenda (creative appropriation or leveraging), are influenced in their thinking in a more passive manner due to constant interaction (socialisation) or actively seek to advance their knowledge on issues (deliberation and learning). After having studied the MIP we can also add ‘procedural commitment’ to this conceptual framework of mechanisms of change, as will be discussed below.

The fact that agenda effects and ideational effects occur through cognitive mechanisms makes it difficult to measure and evaluate effects with high precision. Even with careful process-tracing it is not always possible to properly evaluate and disentangle cognitive mechanisms. But methodological difficulty in being precise does not change the fact that these are the most prominent mechanisms of change in the MIP. The MIP works primarily through the force of argument. What we see in the cases and horizontal

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91 There are, of course, alternative ways to examine cognitive effects. Process-tracing allows to expose choices and motives of actors. But leverage mechanisms can also be studied by asking actors how often they refer to the CSRs in a survey among policy-makers and other relevant actors. The ECA has done a survey among EPC members, but questions relate to perceptions of effectiveness, consistency and quality only (2018). Another way is to measure and evaluate parliamentary activity by studying transcripts of parliamentary debates, like Maatsch has done (2017). Such studies can give a clear indication of activity and complement the findings of process-tracing research.
analysis is that actors make use of the MIP framework. The usage of European frames, concepts and language is how effects are transposed.

Terms like persuasion or learning suggest that new arguments are brought to the table. This is not very often the case; most of the arguments are well-known. The MIP is a device to mainstream particular economic views, by way of attaching authority to it. The way in which this is transposed is that domestic actors start referring to MIP frames, concepts or language to leverage their agenda. The MIP stimulates evidence-based policy and policy evaluation. Within the framework of the MIP, actors largely speak the same language, on the basis of common definitions of issues and concepts. Differences are discussed, usually with supporting analysis by way of careful procedure. In this technocratic way economic ideas about imbalances and ways of dealing with them become accepted (or mainstream) views. This creates persuasive power in itself, but transposition requires building epistemic community for which usage of domestic actors is key.

In Germany, for example, domestic actors refer to the Commission's argumentation to support their own agenda for increased investment and to argue that the surplus is not wholly unproblematic. The CSR was used as an authority argument. Such leveraging was present both within the administration and in parliament. In all cases actors claimed to have referred to the CSRs in parliamentary debates (with mixed results as argued throughout this thesis). The strength of the leverage relies in part on the intellectual authority of the Commission. Interviewees in most of the Member States argued that over the years the Commission has build up such authority, there is a general sense that the Commission is very well-informed about the national political and economic situation in Member States. This has changed over the years: at the start of the MIP some had the feeling that CSRs came out of thin air. The monitoring missions and the interaction with stakeholders has contributed to this enhanced understanding. But this intellectual authority plays out in the realm of those who understand the underlying argumentations and thus occurs mostly within the administration.

The strength of the leverage effect also relies on whether the Commission is seen as a legitimate actor in the debate. Referring to the Commission's argument in a parliamentary debate in France does not carry the same weight as it does in Belgium. Elite perception and receptiveness is an important determinant. But it is not just about elite perception. What also carries weight is whether there is a EU or EMU rationale to the argument. The Commission is seen as a more legitimate actor on issues of financial stability than on employment protection legislation, where it is not directly clear why
the EU should have a say on this, certainly not in the eyes of the trade unions or (part of) the opposition. For actors who do not see the EU as a legitimate actor in the debate, the CSRs do not do much. The case of the German surplus shows that translating this EMU rationale to hard facts is incredibly difficult and can end up in technical discussions on models to measure spillover effects. Technical discussions do not always translate well to convincing political narratives that are useful. The Italian case also shows that leverage from the MIP can be stronger if the voice of domestic institutions on the issue is weaker.

For persuasion the indicators are useful, even if they are not used mechanically. This thesis has discussed how indicators such as ULC or the current account position hide a lot of important context, but they do create persuasive images and depict trends. If you are the outlier on a certain indicator, you have something to explain. The debates have evolved in all of the cases. The cases also show that persuasion is not a one-way street; the MIP has produced new material by domestic institutions to fight-off CSRs on intellectual grounds. The Dutch administration came with constant estimates of what different scenarios of reducing the MID would do to the stability of the housing markets. The Belgians produced new material to examine the cost-competitiveness issue in their economy. The Germans have disputed arguments of the Commission based on reports from the Bundesbank.

The concepts of deliberation and learning in policy coordination frameworks have been a bit controversial in academic circles. It can be interpreted as something very soft, or a-political, to others it can sound as if the EU were a teacher. If I were to claim that the MIP is a device for policy learning not everyone will be immediately convinced. And yet, learning is also part of the drivers of the effects described above. The literature on the effects of the OMC explains that it primarily concerns second-order learning, or reflexive learning (Zeitlin, 2009). This is not the type where actors adopt radically new ideas that they had not thought about themselves, or where the EU is some omniscient teacher. Instead, it means that actors reflect on their own performance in light of foreign experience. This can lead to cognitive shifts over time. Ideally, policy coordination is not about the Commission coming in with a checklist to see what has been done every now and then, but it is also about drawing the right lessons to get to better policies or a better understanding of macroeconomic phenomena.

On the element of learning and deliberation the results from this thesis are a bit mixed. There are elements of learning, such as discussing various approaches to conduct a spending review and Member States adopting the formats of others. The chapter on
France has also mentioned the missions being carried out to Italy and Spain by French officials to study labour market reforms in these countries. Not all of these learning elements are directly related to the MIP, but the MIP is part of this broader framework. The German case is also interesting in this context: it is a politically sensitive case, but it is also a case of learning. The thinking about current account surpluses is still taking shape from both sides. A lot of material has been published on the surplus in recent years and several debates have taken place in the Council Committees.

Learning is not always as active as in the case of discussing formats for spending reviews or spillovers, sometimes it simply means being repeatedly confronted by foreign experience. As this example on labour market reforms in France makes clear:

> When we defend a new law in the parliament very often we refer to European benchmarks, also to try to help the Minister to make up his mind. And that is the way that all European processes, not just that of the Commission, influences our work. We also refer to good examples elsewhere. (…) It is difficult to say whether we do something because of pressure from the European Commission. But we have the peer review in EMCO, we see the examples of other countries, others were very interested in the Compte Personelle d’Activité that we have in France. It is a way of exchanging views. (Interview 58 – French official)

To others, the learning element underlying the MIP is insufficiently developed in certain domains. Multiple interviewees argued that they were not so interested in all the procedural aspects of the MIP, but they did want to know more about what are good reforms. Take, for example, this Italian official:

> If you look at the public administration or the civil justice, where you need to go to very specific details, which are very idiosyncratic to a country, then it becomes really hard to put in place a framework to judge what is the right thing and whether it will be effective. So if there is a huge public administration reform and the government goes to the European Commission and says ‘you asked for this and we did this’. Then it is really hard for them to say whether it is good. So what they do instead is monitoring, so they have the list of all the legislation that needs to be implemented and then the government can say we have done 10 out of 15. (…) This checklist stuff they do it very well and the monitoring of the process also. But what is very hard to do is to be able to say what is useful or not, so drawing lessons. (Interview 43)
One mechanism that does not feature in Zeitlin’s framework but can be added to his list is procedural obligation. This includes: the constant monitoring of implementation, agreeing on time schedules, ensuring that actors come with a joint response, pushing actors to discuss the fact that a problem has not been solved on an annual basis, etc. By way of procedure the MIP creates moments. What this does is heightening tension and salience around issues and as such aiming to harden commitment to reform and raise the level of ambition. The obligation to respond within this procedure simply makes it harder to ignore issues. The MIP increases the political cost of non-compliance. And in cases where there are not a lot clear political incentives to take up a certain issue this can help. An example is the case of professional services liberalisation in Italy. Italian officials argued that having an agreed set of policy ambitions, common definitions of problems and a clear and common schedule for reform was very useful in overcoming obstacles; such as a lack of salience and political incentives, or organised interest. This is the mechanism that contributed to the agenda effects. Aligning actors around priorities creates commitment.

Or, take the Dutch case: the arguments are well-known, it was during the Rutte II government also known that no new change to the tax incentive would be introduced and still it was useful to keep reminding the Dutch administration that the issue was not solved. This forced the government to continue to come up with a response every year and forced parliament to continue talking about it. To some parliamentarians it felt like a ritual dance, but this ritual dance has a function; keeping the issue on the agenda. If the Commission and the IMF and domestic institutions all argue that the issue has not been solved, it becomes very difficult for politicians to deny this fact. At any given instance one might wonder what the purpose of the whole operation is when both the Commission and the administration know that no new reforms will be introduced. And yet, there is a purpose to it, as it raises the cost of non-action. The topic never disappeared from the agenda and in the end a new government decided to introduce further reform.

11.3.3 What are the key determinants of the MIP’s capacity to affect domestic policymaking?

Most of the key determinants have already featured in the text above: market pressure can be a determinant for the hierarchical character of the CSRs; the same goes for the EDP; elite perception is a determinant for how serious the MIP is taken (this links with authority of the Commission); the intellectual basis of the CSR is a determinant for persuasive power; the EMU dimension can also be a determinant of how strong the
voice of the Commission is on the issue; the perceived legitimacy of the process is a determinant for whether actors refer to the MIP in public or parliamentary debates and a change of government can be a determinant for whether pressure translates to change.

A number of other factors were clearly not determinants. The colour of the government coalition does not necessarily say anything about receptiveness for the argument of the MIP. In Belgium it was the left who opposed the Commission’s argumentation and the right who were more receptive. In France it was a bit of both. In Germany, Italy and the Netherlands it was primarily the left who endorsed the CSR and the right who were less receptive. Sometimes it was particular politicians and their personal stance that mattered more than ideological colour. Another determinant that did not really matter was the position of a state in the MIP; whether as labelled with excessive imbalances or not. The extra missions in Italy that follow from this have their purpose, but are also not a strong explanatory factor for policy change or other change.

For determinants the most important conclusion is that effects are transposed through domestic usage by actors. This means that the receptiveness of governing elites is overall the most important determinant of the MIP’s capacity to affect domestic policymaking. This finding is in line with earlier OMC research (Heidenreich and Zeitlin, 2009; Graziano et al., 2011). However, the literature sometimes describes this determinant in terms of elite attitude on the EU. This is certainly the case for the political extremes on the left and right. It is also the case for explaining why Belgian elites take the process very seriously. But most of the usage occurs within administrations and among centre parties. The pro- or anti-EU distinction easily falls flat. To give some (quite generalised) examples: Dutch governing elites are quite skeptic of further integration in the EMU, but do believe in mechanisms that promote structural reforms. Or take Renzi, who openly criticised economic governance, but worked with it at the same time. French elites are quite pro-EU, but this does not translate in accepting the role of the Commission in this domain in the way that it does in Belgium.

An interesting determinant is the one of intellectual contestation. Member States do not just ignore the CSRs that they do not agree with; they actively oppose them. In several cases the Member States have put in significant effort to try to convince the Commission to redefine the issue or to explain why they do not comply with the CSR; often on the basis of fact-based analysis. This is an aspect that is overlooked in the implementation literature, which just assumes that the CSRs represent good policy and the problem lies in domestic political obstacles to implementation.
11.4 What else do the case studies show?

One of the two secondary questions in this thesis is: what does the analysis tell us about whether the MIP has a neoliberal bias in its recommendations? This is a secondary question in the sense that the research design has been structured around the questions of hierarchy and effects. But in so far as I have studied the MIP, the argument that the CSRs promote a type of welfare retrenchment in any neoliberal form is at best not proven. Chapter five on the scope and content of the MIP has analysed the ideological direction of the MIP. It shows that where people have looked at it more systematically they have faced methodological difficulty and their results do not indicate a clear ideological line. Based on the evidence of the five cases that position seems confirmed.

In the Netherlands, the CSRs aims to dampen a tax incentive that primarily benefits wealthier households, other CSRs are focused on issues such as increasing investment, intergenerational fairness in the pension system and the problem of self-employed in the labour market (too much flexibility). In Germany, the CSR have had a clear focus on raising domestic demand. In Italy the CSR under study concerns services market liberalisation. On the one hand this is focused on easing restrictions to doing business and raising competitiveness, but it should also be seen in the broader context of socioeconomic structures that still rely to an extent on cronyism, traditional (family) structures and clientelistic distributions, where the odds are sometimes stacked against the young. It would be a bit easy to dismiss this reform as merely neoliberalism, despite the element of increased competition.

The French case shows the evolution of the social character in the MIP. It is still sometimes argued that a well-functioning euro area needs more flexible labour markets, in line with the OCA theory. You continue to find such references also in Commission documents. But when studying the French labour market CSR up close, it is clear that the Commission takes aim at precarious contracts and adopts a rather open stance in what the right balance between flexibility and security should be, as long as the problem of segmentation gets solved. The Commission has also been supportive of measures by France to introduce fiscal incentives in the reforms, despite France's position in the EDP. And the Commission has supported the security elements in the flexicurity approach of France. Trade unions representatives admitted in interviews that they look more favourably to the CSRs in later years, although criticisms on the part of labour costs and disincentives to work remain.
The Belgian case is more delicate, as discussed in the final parts of the Belgian chapter. The Commission took a rigid stance against an important pillar of the Belgian social system, the practice of wage indexation. Yet Belgium was able to fight off the CSR on intellectual grounds and the Commission somewhat nuanced its stance in later years and tried to substantiate their claim that Belgium was facing employment losses because of indexation. But admittedly the Belgian case is somewhat doubtful from the perspective of preserving social structures.

Another lesson that is worth underlining is that the case studies show no signs of dominance by Germany or the ECB in the process. In part of the literature on euro area governance these two actors are described as dominant players, but this logic does not hold as far as the MIP is concerned. The ECB is outspoken in the discussions in the Council and is seen by some as ‘the best informed’. But Council officials also argue that the ECB almost never gets its way when it comes to voting. The Commission is described as the most influential actor. Calls for a tougher approach within the MIP by Germany, the Netherlands or the ECB have not led to substantial changes in how the MIP is operated.

A third lesson concerns the linkages between the SGP and the MIP. On paper these are two stand-alone procedures, but in practice they are quite linked. Commission officials still hold that the only link between the two procedures is the one that is specifically explained in the 2015 flexibility communication. But the reform of wage indexation in Belgium, which would arguably not qualify in terms of the 2015 flexibility communication, was conducted in the context of the EDP. The MIP missions in Italy have numerous questions on Italy’s fiscal situation. And in France, the Commission is criticised for constantly mixing up the two procedures, which should be separate according to the French. Commission officials argued in interviews that many issues are simply relevant in both the SGP and the MIP context and that the distinction is somewhat trivial. It seems that there are no Chinese walls between the two procedures. The analysis shows that there are political links between the procedures, but it would go too far to depict the Semester as a quid-pro-quo exercise where you can negotiate fiscal space for reform effort.

Fourth, in general the MIP is highly technocratic, CSRs usually follow from fact-based analysis and procedure. In a survey among Council representatives, the European Court of Auditors finds that 89% of respondents consider the quality of the supporting analysis (the IDR) to be good (ECA, 2018). Member States also have the opportunity to comment on the supporting analysis and amend the CSRs if they do not follow logically from the analysis. But despite an overall technocratic character, the MIP also involves significant
Chapter 11: What we learn from the analysis

discretion. The horizontal chapters have shown that there is no way around discretionary choices, because the Commission is faced with dilemmas. The MIP is not an automated CSR machine. But the chapters also show that such choices face criticism on how the MIP is operated; as too political or as overextended, with too many issues linked to the procedure.

At the start of the MIP there were serious discussions in the Council over the problem of over-labelling or CSRs not following consistently from the In-Depth Reviews. Over the years most of these problems have been ironed out. But the case studies also provide evidence of continued overly discretionary use of the instrument. To name a few examples: the German case has reviewed the claim by Commissioner Moscovici that the German surplus leads to ‘significant economical and political distortions for the whole Eurozone’. The French case has critically reviewed the linkages between efforts on dualization in the labour market and productivity and labelling France with excessive imbalances. It has also showed how the CSR of 2015 all of a sudden focuses on working time arrangements, without any analytical backing. The domestic political environment allowed for opening up a discussion about the issue, so the Commission jumped in.

Finally, as discussed in chapter one, the literature from think tanks that looks at implementation scores has in general argued that implementation is slowing. Efstathiou and Wolff (2018), for example, conclude worryingly that implementation rates have deteriorated especially for countries facing excessive imbalances in the 2014-2016 period. While this thesis has not looked at all the CSRs for the countries under excessive imbalances, it is still worth noting that a close reading of the Country Reports and supporting interviews in France and Italy do not confirm this alarmist tone. In the 2014 In Depth Review Italy is criticised for the slow pace of reforms and asked to decisively step up its pace. But with the instalment of the Renzi government these critical notes mostly disappear and from the interviews a much more positive message about reform effort appears. The same can be said for France, which was put under the excessive category in 2015, but the tone of the Commission remains supportive of the reform effort (not on the fiscal effort) in 2015 and 2016 and tells France in early 2017 that it will be taken out of the excessive category. I do not dispute the statistical accuracy of the analysis on the basis of implementation scores made by Efstathiou and Wolff, but based on the analysis of the case studies the average drop in implementation scores provides a one-sided and inconclusive picture.
## 11.5 Schematic summary of effects (simplified)

<table>
<thead>
<tr>
<th>Case</th>
<th>Policy change</th>
<th>Substantial effects</th>
<th>Procedural effects</th>
<th>Mechanisms of change</th>
<th>Determinants Pos. (+) or Neg. (-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Recalibration of wage indexation but no decentralization</td>
<td>The MIP contributed to programmatic shift</td>
<td>Minor reinforced horizontal cooperation</td>
<td>- Domestic audience costs - Material pressure</td>
<td>- Belgian pro-EU stance (+) - Self-presentation of new centre-right government as pro-reform (+)</td>
</tr>
<tr>
<td>Italy</td>
<td>Legislation introduced twice, but watered down in parliament</td>
<td>Agenda keeping effects; a rise in salience</td>
<td>Reinforced horizontal cooperation</td>
<td>- Reputational damage - Some leveraging - Procedural obligation</td>
<td>- Market pressure (+) - Weak voice of domestic institutions (+) - Declining Italian Europhilia (-) - Strength of interest groups (-)</td>
</tr>
<tr>
<td>France</td>
<td>Continuous incremental reform on both security and flexibility</td>
<td>General Europeanization effects (a little bit of everything)</td>
<td>Reinforced horizontal cooperation</td>
<td>- Persuasion - Learning - Procedural obligation</td>
<td>- Lack of legitimacy of EU in the debate (-) - Sensitivity to EU criticism (-)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Two reforms of the mortgage interest deductibility and a decrease of the loan-to-value ratios</td>
<td>Primarily keeping the issue on the agenda. But one among many voices</td>
<td>No clear procedural effect found</td>
<td>- Some persuasion - Leveraging - Some procedural obligation</td>
<td>- Changing party coalitions (+) - Intellectual clarity (+)</td>
</tr>
<tr>
<td>Germany</td>
<td>No significant increase in public investment, some debt relief measures for municipalities</td>
<td>Agenda-setting effect and some ideational shift; breaking the taboo</td>
<td>No clear procedural effect found</td>
<td>- Persuasion - Leveraging - Peer-pressure</td>
<td>- Pro-investment agenda of SPD (+) - Intellectual uncertainty (-) - Sensitivity to EU criticism (-)</td>
</tr>
</tbody>
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12.1 General conclusions

During the crisis, we learned that having a currency union does not by itself lead to stability, nor does it automatically lead to growth. Markets still test the viability of the euro area and politicians’ commitment to it. The crisis also confirmed that economies are not self-stabilizing and need steering. We also learned that fiscal rules are not enough for steering in the euro area and policies in the socioeconomic sphere matter. The MIP was one of the novelties of the new economic governance framework that was meant to fill this void. Fiscal developments are intrinsically linked with developments in the wider economy and the new framework was designed to ensure that unsustainable policies do not put the stability of the EMU at risk. The introduction of the MIP is a significant step in the process of European integration because it expands the EU’s toolkit in areas that primarily belong to national competence: there is the possibility to escalate towards sanctions and there are linkages to the SGP.

The manner in which the MIP influences these areas of national competence is somewhat ambiguous. This has made the MIP an easy target for criticism. Scholars have both overestimated and underestimated its impact on domestic policies because the exact concentration of power in the MIP is not clear. With the crisis waning, much of the initial criticism on the MIP as a type of technocratic and neoliberal dominance has eased. Instead, its champions have become disappointed by a lack of effectiveness. Implementation rates of CSRs are seen as low and the MIP as having failed to gain sufficient traction among policymakers. However, there is no clear view in the debate of what we can realistically expect from the MIP and how we should assess its character, legitimacy, and effectiveness.

This thesis has taken a critical perspective on those who have assessed the MIP from an overly legalistic angle; on those who have assumed that the MIP works in a hierarchical
manner; on those who have assumed that the MIP concerns a specific and coherent policy message; and on those who have made strong claims on the MIP’s lacking effectiveness on the basis of studying annual implementation rates. Annual implementation rates may tell us something about reform effort in the Member States, but tell us little about whether this is due to the MIP. This thesis has studied the governance, content, and effects of the MIP. It has studied the everyday operation of the MIP and its usage by domestic actors. It has aimed to study both the economic logic and the domestic political context of CSRs and their implementation. This is based on the premise that before we can judge the effectiveness of the MIP, we need to study what kind of effects it has on domestic policy making and through which channels and determinants these effects are exerted. And before we can judge legitimacy aspects, we should study the governance of the MIP and consider whether it constitutes a hierarchical relation between the European and national level.

Chapter 11 has argued that the MIP operates mostly in non-hierarchical ways and has enumerated a range of effects and their channels and determinants. This chapter will draw general conclusions and reflect on what these findings mean for a number of debates that are more normative and political in nature, concerning legitimacy, effectiveness and reform directions for the MIP. The reflections are based on the findings in this thesis, but are presented after the conclusions since they include concepts that go beyond its methodological and conceptual framework.

Before turning to questions of legitimacy and effects, we can draw a number of general conclusions. First, the MIP should not be interpreted as a legalistic or mechanistic instrument. The thresholds in the scoreboard are not rules and non-implementation of CSRs does not automatically lead to the procedure being stepped up. With a few exceptions, the MIP acts as a technocratic, evidence-based procedure. But it addresses issues that are deeply political; this results in inherent tensions where the Commission sometimes has to walk a tightrope not to overstep its boundaries. In operating the MIP, the Commission is faced with inherent dilemmas. It has to make discretionary choices on how focused versus how encompassing the procedure should be and whether to take a stepped-back approach and focus on domestic ownership or be bold in the formulation of CSRs in order to gain traction. As such, there is a significant difference between the MIP *de jure* and *de facto*. Its character is determined by how it is operated in practice. Furthermore, the dichotomy between technocratic and political is not easily applied to the MIP: it is both an instrument of a political nature and possibly as technocratic as it can be.
Second, the Commission has interpreted its mandate within the MIP very widely. It has placed many Member States under the MIP and linked 81% of their CSRs to the MIP. Given this wide scope, the MIP has become strongly co-extensive with the Semester at large. Its rationale is almost indistinguishable. And while this wide scope is understandable - macroeconomic imbalances are simply multifaceted phenomena - this has diffused its political force. It is not only co-extensive with the Semester; in general, its rationale also does not deviate in very distinctive ways from the Semester at large. Most of the effects that are described in chapter 11 are not specifically linked to the procedural peculiarities of the MIP, such as escalation in the scale of imbalances or threatening with opening a corrective arm. Actors see added value in enhanced monitoring within the framework, but are mostly unimpressed by labels such as excessive imbalances. However, in periods of severe market stress, the signalling effect from procedural steps within the MIP can be much stronger, as Member States will seek to avoid negative publicity.

Third, the MIP (and the Semester more generally) has seen an evolution in its governance and content. In its first years, the Commission met pushback from the Member States and societal actors. Its approach was perceived as rigid; its CSRs were sometimes seen as simplistic. Member States were implementing reforms in these years. But when we take causality seriously, we cannot assume that this more rigid approach led to stronger effectiveness of the MIP. The more interactive approach that the Commission adopted over the years was widely appreciated among actors and is seen as having enhanced ownership. The Commission now seeks consensus on reform priorities; it has opened the procedure to allow for more input, and it has taken a more stepped-back approach on a number of politically sensitive topics. This was not purely a political decision, but something that has grown over the years based on learning from experience. It was based on a strategy of seeking ownership. Actors from various sides see great value in ‘agreeing on the facts’; as such the MIP enhances common understanding of issues and mainstreams particular definitions and interpretations of socioeconomic phenomena. What also follows from this evolution is the fact that the framework of the MIP should be seen as dynamic: the Commission, the Council, and the Member State interact and influence one another. The MIP should not be interpreted from simplistic principal-agent perspectives; the political reality of the EU does not operate in that way. Member States are not spineless recipients of EU commands.

This evolution is also visible when looking at the content of the CSRs. Chapter five shows that measuring content remains problematic, given the fact that it touches upon a wide array of policy issues, such as welfare arrangements, product and services markets, the quality of institutions and financial supervision. Therefore one should be careful in making
overly deterministic statements about the policy message of the MIP or its ideological stance. When labelling the CSRs, it shows that the share of the various policy categories in the total of MIP-CSRs has remained relatively constant over the years. However, when looking within policy fields, the progressive socialization of the Semester also has had an impact on the content of the MIP, which – due to its co-extensive nature – has evolved along the same lines. This is also visible in case studies on wage setting and labour market institutions where the Commission has adopted a more socially friendly tone. Overall, we should not judge the MIP as a static instrument, as it is conducive to changes in economic and political sentiment and should be understood within that context.

Fourth, despite the Commission’s search for ownership and agreement, there continues to be legitimate and genuine intellectual disagreement about appropriate policies; the pace of their implementation; the use and value of certain indicators; and whether there is an EU rationale to CSRs that some see as purely domestic issues. Even when the Commission is fully justified in pointing out certain problems, there is disagreement over whether it is the right actor to be saying so, since its involvement can be politically counterproductive to pro-reform forces. The narrative that the EU also wants a particular reform simply does not always sell in the domestic political context. Throughout the thesis, many opposing views and critical perspectives on decisions taken within the MIP were presented. All of this follows from the fact that the MIP concerns issues of a deeply political nature. This moves us away from an analysis of economic policy that somehow presumes that means and ends relationships are clear and that policy is a factor of competing interests and power resources. In other words, we cannot assume that the Commission has superior knowledge and implementation of CSRs is hindered only by classic political economy obstacles such as vested interests that somehow need to be bought out, persuaded or forced to comply. There is considerable strategic uncertainty involved in these issues. The Commission is often a well-informed actor, but national institutions often have considerably more research capacities and knowledge of the local situation. Discussions about the political role of the Commission should also be understood in this context: neutrality becomes a fairly elastic concept in a constellation of diverse interests and strategic uncertainty.

Fifth, the MIP is an enhanced and better-developed framework than pre-crisis policy coordination architectures. But when studying the underlying causal mechanisms and determinants, it essentially operates in the same way as the OMC. However, there are some differences as well. The underlying mechanisms may change in nature during periods of severe market stress when the salience of any step in the process is automatically enhanced. But in general, the introduction of new procedural formalities with the MIP has
Chapter 12: Conclusions and reflections

not represented a revolution in EU governance. The MIP has enhanced the saliency of the process; the notion that CSRs are fully ignored is too simplistic, as the case studies show. But the MIP has also further enhanced the Europeanisation of domestic bureaucracies. Procedural effects are important, but primarily impact the work of a relatively contained group of actors. For the MIP to attract salience outside of the bureaucratic realm, the perceived legitimacy of the actor and/or the argument are important determinants. In other words, either domestic elites automatically take the EU seriously even when they disagree with the argument (e.g. Belgium) or they use the authority of the Commission as an intellectual support for their own argumentation (e.g. minority in Germany).

How then should we characterise the MIP? Sanctions under the MIP are unlikely in any but an extreme case and therefore it is an instrument that operates in largely non-hierarchical ways. But this is an unsatisfactory depiction. We cannot refer to it as an instrument of soft law, because it is not really about rulemaking directly. Rather, the MIP is an instrument of second-order influence: it stimulates and informs domestic processes and policy making primarily through persuasion, much like the OMC (Armstrong, 2014; Vanhercke, 2015). It confronts domestic actors with a European way of thinking about policy issues and their external implications. The mode of integration is largely a cognitive one, not a legal one. The MIP is not fully soft either: the political cost of non-action can be serious, but whether this is the case depends on contextual circumstances. And similarly, the MIP interacts with other governance frameworks, most notably (but not exclusively) the Stability and Growth Pact.

All in all, the MIP is a governance framework that does multiple things and evolves in the way it works. It monitors imbalances (1); it shapes policy frames and defines them in a European context (2); and it aims to harden the commitment of domestic actors to reform (3). Whether this last aim is successful depends on its usage by domestic actors. As a mode of governance, it is best characterized as a hybrid governance framework, which operates mostly in a non-hierarchical manner. It operates on the basis of the authority of the institution (due to the careful procedure) and the legitimacy and strength of its arguments, but pressure can take more hierarchical forms under specific circumstances, such as severe market pressure.92

92 Alternatively, it would be an option to refer to the MIP as a commitment device. This is a term that is used by, amongst others, Weder di Mauro and Zettelmeyer (2017) to describe conditionality packages linked to IMF assistance, but might be more apt for the MIP than for the former.
12.2 Reflections: The MIP and euro area legitimacy

One of the key challenges of European integration has long been how to reconcile the need to accommodate diversity with the functionalist pressures of integration. In today’s EU, we see such tensions in the field of migration and refugee resettlement, with the rule of law and democratic backsliding and, of course, with the euro and economic governance. The entire euro project is understood by some as a project to deliberately weaken democracy by taking important tools out of the hands of policymakers and delegating them to technocrats, such as the central bank. The debate on the necessity of tying governments’ hands in exchange for a stable currency is still ongoing. Some believe these functionalist pressures act as a type of remorseless logic that inherently leads to more centralisation and thus requires also a form of EU political union. The MIP operates in the middle of this broader debate and field of tension.

The MIP has not taken tools out of the hands of policymakers, but increases political costs of non-action. With today’s economic governance framework, Member States can end up in a situation where they are arguing for months with EU institutions over individual measures, such as the proposal to introduce a tax cut on property in Italy in 2013, or more recently the Italian governments’ plan to reverse part of the pension reforms of the Monti government. Procedures like the MIP are the backbone of such discussions and serve as devices to escalate or de-escalate and as such heighten tension and raise salience. In the diverse political constellation that underpins the euro area, having such procedures is tremendously important; careful procedure builds authority, and it creates a temporal framework. The MIP should not only be understood from its economic function of supporting a stable currency but also from a political perspective of ensuring a degree of trust in one another and as such in the common currency. Monitoring and coordination serve a political purpose.

The MIP has significantly enhanced this possibility to escalate as opposed to the OMC and has, therefore, rightfully come under scrutiny from political scientists for fear of deepening the democratic deficit. There are basically two ways of thinking about this legitimacy discussion. One way is to say that because it is a technocratic process, it should not operate in overly hierarchical ways in order not to distort democratic processes. Another is that even when no reform has been introduced without parliamentary approval, there is still power in the knowledge that is concentrated in the MIP. Hence, either the mechanism is essentially undemocratic or, there should be better parliamentary control over the procedure. The question then becomes what the dividing
line is between when we would consider the MIP as an element of persuasive power like so many others in policy making; and when we would consider the pressure being exerted of such force that it entails a constitutive factor in policy making that requires accountability in its own right.

On the basis of the analysis of hierarchy, we know that the MIP is not of such a nature as to fundamentally disrupt the democratic accountability links between governments and their electorates. Rather, there is a strong argument to be made for asserting that the MIP acts as a complementary, rather than a rival form of accountability. Even when it exerts strong pressure, this is mostly in conjunction with market forces and domestic political forces in intertwined ways. In times of high tension, the MIP can be an important factor in policy making, but no cases were found in this thesis where it was the determinative factor. The obligatory nature lies in a procedural obligation to engage with the process, by reporting and responding to questions. And ultimately the MIP relies on usage by domestic political actors who remain accountable to their respective electorates.

The MIP can act as a complementary accountability mechanism in the sense that it holds each Member State to account for its policies, or lack thereof, on the basis of a different rationale and methodology. Governments are held accountable on the basis of indicators, an analysis of euro area-wide risks and are compared in light of foreign experience. They have to provide answers to questions from the Commission and other Member States on long-term sustainability trends and are asked to support their claims with analytical backing. And it is precisely the relative insulation from domestic electoral pressures that give these mechanisms added value to parliamentary control, as also discussed in the opening chapter. As such, the MIP sometimes duplicates what national parliament does, but this need not be the case. The question is not whether the MIP suppresses or dominates the work of national parliament, but whether national parliamentarians make sufficient use of the information available and use it to scrutinise the National Reform Programmes.

At the same time, while the MIP might not be a determinative factor in the process of reform, it certainly can be a cognitive force. Even when the Member State is responsible for implementation, it still matters *what* the Commission recommends. National policymakers have in some cases argued that they are increasingly confronted with ‘a European way of thinking’. In this context, the terminology used in chapter eleven on the MIP’s function of ‘mainstreaming particular economic views’ can be seen as a bit controversial. The guiding document on the general economic strategy – the Annual
Growth Survey – is discussed in the European Parliament, but the EP has little grip on how this translates into CSRs. It is questionable if it has the capability to do so, given the encompassing nature of the process and the fact that it is not really a process where policy decisions are made. But even if it did, organising forms of input legitimacy on the MIP would drastically change the nature of the instrument, which would not necessarily enhance its implementation at the national level. The MIP operates on the basis of analytical authority, not on the basis of ideological support.93

This does not insulate the process from questions of accountability but this accountability is not sought in parliamentary control but rather in the possibility to contest the CSRs in the Council. Discussions in the Council on amending the CSRs have a strong factual nature and are not about giving a political direction to the Commission. This argument does not hold up for every part of the process. One could imagine that for the future the European Parliament would be asked for input on other overarching documents that give guidance to the overall policy direction, such as the 2017 thematic discussion in the Eurogroup with the aim to define the concept of ‘economic resilience’.

There are other lessons to be learned for the future as well. The economic and political context may change and a future Commission may think differently about how to apply the MIP. Two key lessons from this thesis would be, first, to remain careful about increasing the automaticity or legality dimension of the MIP. The legitimacy discussion has moved a bit to the background because of the Commission’s non-hierarchical approach. But this causal link also works the other way around: the Commission has taken a less hierarchical approach because a more legalistic or automatic approach would run into serious legitimacy issues. The MIP, like the fiscal rules, can place external pressure on national democratic processes which can be useful to enforce breakthroughs in domestic decision making when faced with a difficult political balance. The case studies showed how this worked in the Netherlands, Belgium and in Italy. But one has to bear in mind that this strategy is not without its risk: when EU pressure is continuously used to circumvent opposition and overcome domestic hurdles, those forces will start targeting the EU itself. Ownership of the process by domestic politicians matters.

93 There are alternative ways to think about this: one could say that the MIP is essentially about political commitments to reform by Member States and that such commitments could be hardened when Member State representatives are also held accountable for them in front of the European Parliament. In this example the rationale would be enhancing visibility more than responding to a legitimacy gap. National parliaments would likely resist such steps and consider them as the EP stepping too far on their toes.
A related lesson would be to refrain from giving the EU a place in sensitive national debates where it cannot account for the consequences. Structural reforms involve vested interests who might stand to lose and the case studies have shown how easy it is to depict the EU as a foreign imposer even when this may not be true in reality. And structural reforms involve strategic uncertainty: reforms often do not fully go as planned and sometimes even fail. There can be a big difference between what the Commission recommends and what is implemented on the ground; if it plays an overly dominant role the accountability linkages become blurred and obscure democratic processes.

12.3 Reflections: Is the MIP effective?

Chapter eleven has described which effects the MIP has on domestic policy making and through what channels and determinants these are transposed. The question of whether this makes the MIP effective is more controversial. Some would say that the quantity of legislation, surveillance, and coordination that the Member States of the euro area are engaged in surpasses some federations (Schelkle, 2017). In Commission circles, one sometimes hears the argument that the Semester (and MIP) has actually been more successful than often proclaimed and that the Commission is quite happy with the result, but these results are poorly communicated. Discussions under the MIP are seen as having become more meaningful over the years because there is a larger consensus on concepts and definitions. But it can hardly be denied that the overall tone of the debate is one of disappointment. The MIP is depicted as ‘a talking shop’ or ‘a nice academic exercise for civil servants, but apart from them nobody cares’. The official line of the Council is that reform implementation is ‘uneven’ and that ‘decisive progress in implementing reforms’ is required (Council, 2018).

This thesis has argued that the underlying analysis of many claims on effectiveness – the annual implementation rates – is a simplistic way of looking at effectiveness. Reading Chapter eleven one may be forgiven for getting the impression that overall this thesis sketches a more optimistic picture about the effects of the MIP than found in much of the literature. Now obviously, when one deliberately sets out to find and analyse effects, one will also likely find them. With this research methodology one needs to be wary of self-affirmation. But this thesis has not fully discarded the argument of a lack of salience and traction; the arguments of the MIP do not always travel very far. The discussion of effectiveness goes one step further because any claim about effectiveness implicitly hides a yardstick by which to measure the concept. In discussing effectiveness one easily skates on thin ice, since it depends on underlying perceptions of what a currency
union needs in terms of coordination. The honest answer to this underlying question is that probably nobody really knows. Yet, with these caveats in mind, the question of effectiveness is important enough to attempt to answer or at least analyse.

This thesis has defined effects of the MIP in a broader sense than implementation rates alone. It presents a differentiated view of policy making where multiple factors lead to an effect and the MIP can be one of them. It also looks at the entire policy process from agenda setting to implementation. When looking at the cases in four out of five instances the CSR was about problematizing an issue. In the Netherlands, the CSR was meant to convince national politicians that the measures taken were insufficient to address the issue, contrary to what the government (officially) believed. In Germany, it was about breaking national policy myths of defining the current account surplus in terms of being an export champion and ways to address it as an attack on over-competitiveness. In Italy, it was about giving salience to an issue that would require political costs in the short term and yield diffuse benefits in the longer term. And in Belgium, it concerned a slow trend of deterioration of competitiveness. Only in France was the issue already firmly on the agenda, because it involved unemployment, which is a relatively obvious problem. But even there the Commission tried to draw attention to particular aspects such as the very short contracts.

These are all issues that do not immediately attract a lot of domestic political incentives to resolve, because they may be more abstract macro phenomena. The effects, as described in chapter eleven, were about redefining problems and their salience and increasing the political costs of non-action so that they cannot easily be ignored. It is nice for the EU if the arguments are attributed to the Commission or EU in national parliamentary debates, but this is not essential. Some politicians deliberately refrain from making any reference to the EU at all for domestic political reasons. This makes establishing causality more difficult for researchers but does not automatically mean that the issues are ignored. Politicians also do not always have an incentive to talk about the CSRs because these often do not contain new issues; the MIP is about anchoring particular policy frames in the debate with authority, this rules out the possibility to come with completely new things every year to make the evening news.

Also, the MIP should not be reduced to the CSRs; one of the novelties is its monitoring dimensions. A large part of the euro crisis was caused by panic; the overvaluation of risk by markets because of a lack of knowledge on developments in one another’s economy. For a long time, financial exuberance allowed policymakers and broader publics to
ignore and deny trends like those in Ireland and Spain. In the words of Martin Sandbu: “the most resilient societies are those that know the truth about themselves” (2017b). We should not be over-determinative about the indicators in the MIP, but arguably the entire procedure – including supporting analysis and interaction - has increased transparency about trends of macro-critical importance and of the sustainability of European growth models.

The MIP also has a role in shaping understanding of economic and financial phenomena; many of the issues that fall under the it represent learning exercises in ever-evolving debates. The MIP keeps minds focussed on a particular set of issues. For example, we now know a lot more about current account surpluses or the role of wage coordination in the euro area. Just a few years ago, the Commission was not even allowed to speak about such issues as they were declared taboo in the Council. These are ongoing processes that often take time to be recognised. One may remember the first furious responses by Ministers when the Commission started talking about new policy frames, such as the aggregate fiscal stance for the euro area. Also, building up policy expertise outside of the national administration has value in itself (think only of the disastrous first bailout package for Greece); the MIP thus represents a significant knowledge infrastructure. This knowledge infrastructure – especially in DG ECFIN – used to revolve primarily around fiscal issues but has broadened significantly. And finally, this thesis has described the procedural effects that are often ignored: the MIP has quite significant effects in some cases on enhanced horizontal coordination within administrations.

The argument that ‘now at least we talk about these issues’ can be deeply disappointing if one believes that developments in certain Member States represent the next fault line for the euro; or, if one believes that the euro area is only as strong as its weakest link and therefore control on domestic policies is essential; or, if one believes that a strong MIP is the only tool that would prevent the euro area needing a transfer union; or, perhaps most importantly, if one believes that reinforced convergence is economically and politically essential for the euro. On the basis of such yardsticks, there is indeed reason not to consider the MIP as very effective. There are simply inherent limits to what the MIP can do and it indeed does not gain much traction outside a relatively small group of insiders. It has not been the decisive factor in policy making at the domestic level. On the other hand, the Member States have mostly been willing to engage with the framework and recognise the need to tackle their imbalances.

From an economic viewpoint, there is reason for both optimism and pessimism. There
are clear signs that recent growth in the euro area has been based on a different model than the foreign debt-financed consumption boom of the pre-crisis period (Gros, 2018). With the MIP, there would likely be more attention paid if the old model were to re-emerge. At the same time, stock imbalances remain elevated and a hike in the interest rates or an exogenous shock could lead to serious sustainability issues (Zorell, 2017). The most prominent reason for being concerned by a lack of effectiveness of the MIP is the angle of convergence. Many economists see reinforced convergence as an essential necessity for the resilience of the euro area.

For example, ECB President Draghi – a key protagonist of a strong MIP – argues continuously that structural reforms are crucial to limit asymmetry in the euro area. The euro area would need coordination of structural reforms to prevent divergence in labour and product market developments and real exchange rate misalignments that would hamper an effective single monetary policy and would make these countries more vulnerable to shocks. A strong grip of the EU institutions on structural reforms in the Member States is, therefore, a legitimate interest of all in the euro area (e.g. Draghi, 2015). The lack of real convergence in the euro area since the crisis (Franks et al., 2018) is one of the key reasons why many champions of the MIP are disappointed in its effectiveness. The Commission – in official documents – concurs with this view and calls coordination under the Semester essential to foster further convergence and seeks ways to strengthen the mechanisms (EC, 2017). It is in light of this latter dimension that effectiveness should be further discussed. Arguing that the MIP is ineffective only as a wake-up call to politicians to take CSRs more seriously is a fair argument.

While the MIP undoubtedly has its value, one may question how essential a factor it is for the viability of the euro area. In other words, before moving on to the question of whether the MIP should be reformed and strengthened, one may ask how worried we should be about its (perceived) lack of effectiveness. This is where the ice becomes a bit thinner and the arguments more political. Convergence is a complex phenomenon, even between regions within states it is a difficult process which goes very slow. We do not know what precise mix of policies will lead various Member States to stable growth and

94 For some alternative perspectives on convergence and the euro area, see also Buti and Turrini (2015), who argue that pre-crisis convergence was based on unsustainable dynamics and the post-crisis euro area has the potential for structural convergence. Gros (2018b) shows that the distance between the richest and the poorest 12 original Member States of the euro area is today higher than when the euro was introduced, even taking into account the high growth period before the crisis. However, he also argues that the lack of convergence since the crisis between the North and the South of the euro area has roots other than the euro.
thus converge towards one another, nor what level of convergence is required for a viable monetary union to work. Convergence is a political goal of the entire EU (Art. 174 TFEU) and is supported by the EU budget. Here it concerns output convergence; levels of income and growth, etc. But the argument about convergence as a functional necessity for the euro area has its limitations, especially where it concerns input convergence (measured on the basis of policy indicators: tax burden, institutional quality, etc.). There will not be many pundits in the debate who will argue for a full harmonization of policies, but where does one draw the line?

It is clear that for monetary policy to be effective, it would be desirable to have some type of cohesion and cyclical convergence. If one Member State moves towards a debt-fuelled consumption boom, it does not have its own monetary policy options to slow this down. In this sense, there is a clear function for the MIP (and for macroprudential policy tools). But up to what point should the euro area facilitate legitimate diversity and when does difference become a problem? This is no easy question to answer. Will the euro be stronger if Belgium introduces slight corrections in the calculation of wage dispersions with neighbours; if France reduces the length of judicial proceedings in case of unfair dismissal; or, if Italy opens up the number of licenses for its notaries? And more importantly, should other Member States get angry if those measures are not implemented and threaten them with sanctions? None of this is to say that the Member States should not improve the structure of their economy or that the goals of the Semester are unimportant. As pointed out by Alcidi and Gros (2017), where the rationale is much weaker is the argument that this needs to occur in a coordinated manner and with an important role for the EU institutions.

It is understandable why many of the interviewees in this thesis did not really see strong linkages between the individual policies that fall under the CSRs and the euro area rationale. Even in the German case, it proved extremely difficult to determine what increased investment would do for the euro area. In 2014, the EFC already concluded that spillover effects are not a frequent feature of reforms (EFC, 2014). With banking supervision, a strong rationale emerged for common action under for the euro area and as a result a Banking Union was established. But for many issues that fall under the MIP,

\[95\] There are good reasons to believe that the EMU would actually benefit from institutional diversity (Schelkle, 2017; EEAG, 2018). Others believe that too much heterogeneity in areas like labour market institutions is eventually harmful for the EMU (e.g. Sapir, 2016).

\[96\] A recent Horizon2020 project came to similar conclusions: spillover effects from both fiscal and structural policies in the euro area are generally not very large (with some minor exceptions), although the nature of the spillover effects may change in times of crisis (Määttänen and Alcidi, 2018).
the Commission has a hard time explaining why it is a legitimate actor to be making these arguments. This also explains why the CSRs do not always gain a lot of traction outside a small circle of those who engage with this particular debate. This euro area rationale is not fully absent, but it remains a matter that requires a lot of convincing and discussion. This is difficult to reconcile with more rigid or legalistic approaches in the MIP or even moving from policy coordination to common institutions in this domain, such as Draghi urges (2015).

There are serious political drawbacks to the argument that the euro area requires a single growth model or more top-down meddling in socioeconomic policies. Already, many perceive of European integration as an unstoppable train, or what George Osborne has famously called a ‘remorseless logic’. One may or may not agree with such depictions of euro area integration, but it is a political dynamic that should not be ignored. There are sometimes tensions between the arguments for the euro’s economic viability and those for its political viability.

The counter-argument here is that in times of stress, markets lose trust in those countries with the least resilient structures first and all of a sudden spillover effects become more pronounced. The crisis showed how interdependent the euro area ultimately is. At the same time, a focus on the transmission mechanism of these spillovers might provide more fruitful avenues for further strengthening. In other words, there is a good argument to be made that for a more resilient euro a focus on the financial sector is more important than the MIP. A better organisation of the financial infrastructure in the euro area will also allow pundits to be less worried about the policy directions of individual Member States and demand the EU to take a tougher stance. What drives the need to make commitments to reform under the MIP harder in the first place is the enormous costs and difficulty to restructure debt (see also: Zettelmeyer, 2018).

The MIP is a mechanism to prevent and correct imbalances insofar as these arise from national policies, but there is also a strong financial element to imbalances that has dynamics of its own. At the same time, some of the proposals to introduce stabilizers in the financial sector lead to a renewed discussion on moral hazard and thus on the role of the MIP. This latter argument will be discussed in the next section.

97 Many proposals can be found for more resilient financial structures in the euro area (e.g. Bénassy-Quéré, 2018; Pisani-Ferry, 2018).
To sum up, the question of effectiveness cannot be answered in a yes or no manner. This thesis has shown that the MIP can have an effect on the policies of Member States. It has also shown that the MIP (in normal times) does not have great traction. There are inherent limits to what instruments like this can do. These limits also have a strong legitimacy dimension. Those who have become disappointed with the MIP often rely on particular views of what a currency union needs, especially in terms of convergence. Convergence is an important political goal of the entire EU. But the argument about convergence as a functional necessity for the euro area has drawbacks. The rationale that for a euro area to function the centre needs a tight grip on socioeconomic policies in the Member States is not particularly convincing. More resilient financial structures would further weaken this need for tighter control and would better allow non-hierarchical governance to be appreciated for what it is and what it can do. Ultimately political discussion about economic policies in the euro area should be guided and supported by procedure, not determined by it.

12.4 Reflections: The MIP and reforming the EMU

The last secondary research question is: what does the analysis tell us about the debate on reform of the MIP. The debate on reforming the architecture of the euro area is very much alive. New proposals for reform by academics or institutions are proposed almost every month. While the majority of proposals have a strong focus on fiscal and financial matters, there are often implications for the role of the CSRs and the MIP. Given the prominence of this debate, it is worth reflecting upon a number of policy options on the basis of the findings in this thesis. This section does not seek to propose a new governance structure, nor to give answers on the desirability of various options. The goal is to reflect upon various options from the angle of someone who has studied the dynamics between national politics and European frameworks in terms of hierarchy and effects. It builds on the reflections in the previous two sections.

12.4.1 Option 1: maintain the status quo

A first option to consider would be to maintain the status quo. There is often an activist bias in European policy making: things always have to change. The OMC has seen continuous change since its start and new elements are added to the Semester framework almost every year (Vanhercke, 2015). But when institutions are stable, actors know what to expect from them and they can become a point of reference. Building up
a type of jurisprudence from the MIP is much harder if the system changes constantly. When keeping the governance of the MIP stable, the institutions can work on the quality of the policy message that is produced through the process in order to make it more effective. One of the key conclusions of the thesis is that the underlying channel through which the MIP exerts effects is persuasive power. The Commission could work on the quality of its analysis and continue to build ownership by involving national institutions in the process. The MIP in this setting would be an instrument that is be more or less useful depending on the context: in times of severe market turbulence, it is there to be used by the EU institutions, while in normal times the effect depends on its usage by domestic actors.

12.4.2 Option 2: reorganise and reorient

A second option would be to reorganise the MIP and/or reorient its focus. This thesis showed that the MIP is quite overstretched. It involves many structural long-term growth issues for which there will always be a rationale, but for which the link with imbalances is questionable. This approach has diffused the MIP’s political force. It has become almost indistinguishable from the Semester at large and the procedural tools – such as escalation towards the label of excessive imbalances - have been used without strong analytical backing which has made them opaque. A reoriented MIP would focus on issues of macro-critical importance and would be used in a more focussed way so that escalation has a stronger signalling effect. A more precise mission statement for the MIP could be formulated and the number of headline indicators reduced; escalation within the procedure would occur strictly on the basis of higher values on flow indicators. Since the issues that are of macro-critical importance in the euro area are often financial in nature, the EU could consider incorporating macroprudential oversight mechanisms into the MIP (see also Bénassy-Quéré and Ragot, 2015; Efstathiou and Wolff 2018). In this set up the MIP would only be used scarcely.

Social policies, structural policies and any other policies related to growth would be linked to the Semester only, which could be further reoriented on the basis of the European Pillar of Social Rights. In the medium term, parts of the Semester could be further decentralised. For example, national fiscal councils could have larger roles in reviews of expenditure and taxation. The original idea of the national productivity boards could be reconsidered for wage coordination; in which case, a more prominent role for social partners should be envisioned in managing the system, such as in Belgium, in order to overcome opposition. All in all, in this scenario, the MIP would be an instrument
that would be only scarcely used. At the same time, so far it has proven very difficult in practice to isolate a number of key actions and key indicators for the Member States with deeper imbalances.

12.4.3 Option 3: conditionality-based procedures

The third option is widely discussed and requires more lengthy analysis. Ever since the start of the crisis, EU leaders have sought alternative governance mechanisms around CSR implementation. The opening chapter has already mentioned a number of these proposals. This section will look at two types of conditionality mechanisms: stronger links between CSR implementation and the EU budget; and CSR implementation as conditionality to access a new stabilisation tool.\(^98\) After an introduction, these proposals will be briefly discussed in light of the findings of this thesis.

One of the best-developed proposals is to establish closer links between structural reforms and the EU budget. In 2011, Merkel and Sarkozy already proposed stronger linkages and conditionality between structural reforms and the EU budget (2011b). And two years later, the Commission proposed Competitiveness and Convergence Instruments, which would have involved Member States’ signing reform contracts and receiving financial support for them (EC, 2013h). This proposal, based on Merkel’s idea of introducing contractual arrangements, was rejected firmly in the Council. The idea behind such initiatives has long been that linking financial support to the CSRs will give them a higher visibility among politicians and will help to surmount some of the initial costs and hurdles to reform. Instead, ex-ante conditionality and conditionality were introduced in the structural and investment funds. Examples of ex-ante conditionality include reforms related to energy efficiency and waste management, network infrastructures or administrative capacity (Berkowitz et al., 2017; for discussion see section 4.2.4). Suspension of the budget through macroeconomic conditionality has not occurred (apart from one instance with Hungary in 2012). Similarly, the 2015 flexibility document of the SGP further allowed for stronger deviations from fiscal targets in case the money were used to support a structural reform. In other words, some linkages already exist.

\(^98\) I will not discuss the desirability and necessity of a fiscal capacity for the euro area, which has already been discussed at length in the literature (see e.g. Feld, 2018 for a critical perspective).
More recently, more significant support has emerged in the Council for building on the ex-ante conditionality instruments in cohesion policy and expanding them to larger structural reforms. As such, the Commission came forward with a proposal for a reform delivery tool, linked to at least 25 billion euro over the next Multiannual Financial Framework (MFF). The reform delivery tool was announced with the ambitious aim of: ‘supporting those reforms that can contribute most to the resilience of domestic economies and have positive spill-over effects on other Member States’ (EC, 2018). The reforms would include labour and product markets, and taxation as well as other reforms to improve the business environment. The Commission would agree on commitment packages with the Member States, support them from the budget and monitor their implementation through the European Semester. In the reflection paper on the future of the EMU, the Commission also proposed to make the disbursement of the ESI Funds, or part of them, conditional on progress in implementing concrete reforms to foster convergence (EC, 2017l). This is in line with the position of the German government, which frames the ESI funds not only as a way to stimulate and support reforms but also as a way to enhance compliance with CSRs (Federal Government of Germany, 2017). The Dutch government even describes stronger conditionality as a substitute for needing any type of (fiscal) stabilisation for the euro area (Ministerie van Financiën, 2018).

The second widely discussed proposal is to link CSR implementation to a bigger carrot a stabilisation function for the euro area (see also discussion in section 1.3). The Five Presidents’ Report on the future of EMU proposes in this regard that in the medium term the Semester process should be formalised into commonly agreed standards of a legal nature. Significant progress of Member States on the basis of these standards would be a condition for members to benefit from the stabilisation tools (Juncker et al., 2015a). The set of binding standards could include measures to improve the quality of public spending; investment in education and training; embracing more open and more competitive products and services markets; creating fair and efficient tax and benefit systems; and implementing minimum social standards as defined under the European Pillar of Social Rights (EC, 2017l). The European Parliament has adopted (own initiative) reports that refer to the OMC as an insufficient basis for Europe’s economic strategy and argue for the need to introduce binding convergence codes instead (to be adopted under co-decision of the EP). These should imply strict conditionality related to both the EU budget and a fiscal capacity of whatever form (EP, 2016; 2017).

In academic circles, many similar proposals have been made. A prominent one is the report by 14 leading Franco-German economists. In their report, they refer to ex-ante conditionality to access a new fiscal capacity. But they go one step further: access
to a revamped ESM (which has the ability for earlier precautionary intervention) should be made conditional on a track record of ‘good policies’ (Bénassy-Quéré et al., 2018). Alternatively, there are proposals linking specific conditionality to specific stabilisation tools. For example, Boeri and Jimeno (2015) argue for linking access to a European Unemployment Insurance Scheme to substantial progress of Member States towards a better design of labour market institutions. This European top-up to national unemployment schemes should evolve towards a system of single European employment contracts (a proposal that is heavily criticised by trade unions, see chapter eight).

There are good reasons to argue that each of the proposals would change the nature of the CSRs and the underlying mechanisms of implementation. Even where the proposed conditionality is positive, such as with the links to the EU budget, it would still require further codification of reforms and their implementation. Of course, there are reforms for which this is not such a big problem: for example, an ICT project to upgrade administrative capacities could be co-sponsored by the EU budget. Such reforms are closely in line with the current rationale of the ESI funds. Even in the labour market, there are already particular initiatives that link EU funds to particular policy ideas, such as the Youth Guarantee Scheme. Further strengthening links could help the effectiveness of the budget on the margin. But when expanding the scope in this area more widely – as the documents indicate – a grey area emerges where things have the potential to get very complicated. For many of the CSRs, it is difficult to measure implementation with precision. Should the Commission be the judge as to when national political and societal compromises falls sufficiently in line with requirements before distributing money? Should this be an ex-ante or ex-post judgement by the Commission? Alcidi and Gros (2017) rightly argue in this context that reforms will have to be ‘priced’, which is an impossible task that the EU should not engage in.

There is an argument to be made that reforms can be introduced more smoothly when

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99 Their report does not explicitly state that such a policy record would be based on the MIP, but they do refer to compliance with the CSRs of the Semester in addition to the fiscal rules. Other writings by individuals in the group make the reference to adherence to the MIP explicit (e.g. Enderlein and Guttenberg, 2018; Zettelmeyer, 2018).

100 As an alternative, Dijsselbloem puts this argument the other way around. He argues that expenditure related to structural reforms should be finance through cheaper credit from the precautionary instruments of the ESM (2017).

101 Further diffusion of priorities and reporting obligations under the ESI funds should be seen against the background of the current entry barriers to attain funds, which are already considered high. The ECA notes in their latest audit of the EU budget that the funds currently see the biggest spending backlogs ever recorded (2018a).
combined with a soft landing ground for those groups who might stand to lose (e.g. IMF, 2015). But should the EU be the actor to be footing (part of) the bill? Should the EU also be the one to buy out vested interests even when their demands are unreasonable? And who should decide this? The process of introducing structural reforms may sometimes be painstakingly slow, this is annoying, but it is doubtful whether a stronger role for the EU in the process is the answer. What can seem inefficient from an economic perspective can be the necessary ownership building from a political perspective. With negative conditionality, we know that it does not enhance ownership of reforms. Reforms undertaken without national ownership are both less successful and subject to reversal once the pressure is lifted (Turrini, 2017). But one may question whether codification and binding convergence codes do not lead to much the same problems, even when linked to positive conditionality mechanisms. This should not be read as an appeal against political processes towards upward convergence but as a fundamental questioning of building legalistic structures around this goal.

We may also ask ourselves whether financial resources really form the biggest obstacles to introduce structural reforms. A good reform is self-financing in the medium term (and is allowed to be deducted from fiscal targets). Positive conditionality would further blur the role of the EU in reforms and the accountability linkages between administrations and their electorates. National politicians can be voted out if the reforms are seen as not having achieved results, the EU cannot. It should be clear that the EU recommends policies, but does not dictate what should happen. The perception that it does the latter can be damaging for building ownership and in the long run also for EU support. Reforms in taxation, labour markets, product and services markets, and wage-setting institutions are often controversial and involve groups with strategic interests. As we have learned, the role of the EU is prone to misinterpretation; the ‘Europe asked for it’-argument has not been particularly strong in some cases; it is relatively easy to organise opposition against any EU involvement. The Commission has shown itself conscious of precarious socioeconomic balances and complexities in the Member States while operating the MIP and that is for good reasons.

But the problem with a stronger role for the EU in driving national structural reforms is not only political but also cognitive. This is where the lessons from the thesis come in: reforms are about more than political economy obstacles that should be bought off; they involve significant strategic uncertainty and sometimes fail. Since the problems at issue are complex and context-sensitive, there are no optimal solutions, and no reason to think that the EU institutions have superior knowledge even if they can often make a valuable contribution to the broader policy debate.
Most of these arguments are equally valid for the discussion on a conditionality-based fiscal capacity. The EU has a history of setting conditions for entering into new structures that involve common resources: the common market, Schengen, and the euro. This has not been without success. And yet, one may question how far this model can be pushed. In the framework of Bénassy-Quéré et al. Member States have to be compliant with the MIP or lose access to the revamped ESM or the stabilisation function. But what does it mean to be compliant with the MIP if there is no clear definition of what a balanced economy looks like? Was France only compliant with the MIP when it introduced the heavily protested El-Khomri law? Is surplus Germany compliant with the MIP? The debate on further risk-sharing in the euro area would benefit from further operationalization of the proposals that are made in this domain and a better demarcation of how far harmonisation of policies is required and what governance mechanisms would enforce this.

Policymakers and academics should consider the extent to which reform proposals crowd out politics rather than open up space for it. As Schelkle (2017:322) argues, academics have ‘a duty of reflexivity’ on what incentives new integrationist initiatives create at the Member State level. One of the key lessons I draw from working on this thesis is that there can be rather large differences between what EU institutions intend and how this is interpreted and translated at Member State level. Whoever wants to study European integration, should include - wherever possible - the angle of national politics.
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### European Semester: a partnership EU-Member States

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| Member States present their National Reform Programmes (economic policies) and Stability or Convergence Programmes (on budgetary policies) | | | | | | | | | | | |

| European Parliament | | | | | | | | | | | |
| Dialogue on economic priorities | | | | | | | | | | | |

**GLOSSARY:** AGS: Annual Growth Survey / AMR: Alert Mechanism Report / CSR: Country-Specific Recommendations / EDP: Excessive Deficit Procedure

#### Internal Imbalances

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<th>Accumulated 10-Year Net Capital Inflows as % of GDP</th>
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<th>PPI Year-on-Year Change</th>
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(source: European Commission, values for 2013)
Annex 3: Coding methodology

For the coding exercise we (author + research assistant Robin Verheij) coded all the CSRs between 2012 and 2017 on the basis of the Council documents. The recommendations in the documents are divided into recommendations concerning the Macroeconomic Imbalance Procedure (MIP), marked in the document as ‘No 1176/2011’, and non-MIP recommendations. The MIP-related recommendations were later coded under one of our eight categories, while all non-MIP recommendations were coded as ‘non-MIP’.

For both the MIP and non-MIP related recommendations, we discerned separate actions. In most cases, actions were guided by an active verb. In some other cases, actions were not guided by an active verb, but still recognizable as separate actions. We did not count specifications of actions as separate recommendations, for instance when they are guided by ‘especially’ or ‘in order to’. An example of this is the fifth (MIP-related) recommendation for Portugal in 2016: ‘By the end of 2016, improve and accelerate administrative and licensing procedures, accelerate tax litigations and reduce regulatory barriers, especially in business services’. According to our coding logic, this sentence contains three separate actions and one specification; the specification is not counted. Another example to clarify our coding logic is Finland in 2013: ‘Take further steps to increase the employment rate of older workers (…), increasing the effective retirement age or pension benefits to changes in life expectancy’. In this case, the second recommendation is not guided by an active verb (increasing), yet it is considered a separate recommendation because it involves a different action. On the other hand, as mentioned above, not all active verbs are considered as separate actions. For example, the fifth recommendation for Italy in 2014 ends with ‘and assess the need for additional action’. Since this is not an individual action, we code this part of the sentence together with the preceding action.

Frequently, the first country-specific recommendation contains two recommendations: one about the direct budgetary position of a country, and one standard recommendation about structural adjustment like compliance to the Medium-Term Objective (MTO). These two recommendations are coded together as one recommendation in all cases in our research. Yet, recommendations in the first CSR regarding the Public Spending Review are coded separately as one recommendation because they concern a different expedience. An example wherein the budgetary position and compliance to the MTO are coded as one action can be found in the document of Cyprus in the year 2012: ‘Take additional measures to achieve a durable correction of the excessive deficit in 2012. Rigorously implement the budgetary strategy, supported by sufficiently specified measures, for the year 2013.”
and beyond to ensure the achievement of the MTO by 2014 and compliance with the expenditure benchmark and ensure sufficient progress with the debt reduction benchmark’. Even though this recommendation can be read as including multiple actions they all amount to the goal of bringing the budget in line with requirements under the SGP.

We have made a distinction between goals and actions of CSRs while coding. Since goals are not separate actions in the sense that they can merely be understood as something a country has to pursue by following certain actions, a goal and a corresponding action are coded as one recommendation. If a goal is followed by multiple actions, we coded the goal and the first action together as one, and the following actions as separate ones. For example, the second recommendation for Belgium in 2014 is: ‘Improve the balance and fairness of the overall tax system and prepare a comprehensive tax reform that will allow shifting taxes away from labour towards more growth friendly bases, (…)’. In this sentence, ‘improve the balance and fairness of the overall tax system’ is considered a goal, and ‘prepare a comprehensive tax reform’ as an action. Therefore, this sentence is coded as one single recommendation.

A second challenge is labelling the sub-CSRs under the correct policy category. All sub-CSRs have been coded by one coder and checked by the other coder to ensure sufficient inter-coder reliability. Borderline cases were always discussed between the coders. An example of such a borderline case is the fourth recommendation for Romania in 2015: ‘Adopt the law on reforming corporate governance of state-owned enterprises.’ Even though this recommendation covers corporate governance, which should be coded as F3 (Corporate Governance), the code D1 (State owned enterprises & privatisation) is the most appropriate because ‘state-owned enterprises’ is the main topic of the recommendation.
List of abbreviations

AGS  Annual Growth Survey
ALMP  Active Labour Market Policies
AMR  Alert Mechanism Report
AWG  Ageing Working Group
BErg  Broad Economic Policy Guidelines
BMWi  Bundesministerium für Wirtschaft und Energie
CAP  Corrective Action Plan
CBS  Centraal Bureau voor de Statistiek
CCE/CRB  Conseil Central de l’Economie/Centrale Raad voor het Bedrijfsleven
CD&V  Christen-Democratisch en Vlaams
CDA  Christen-Democratisch Appèl
CDU/CSU  Christlich-Demokratische Union/Christlich-Soziale Union
CEPS  Centre for European Policy Studies
COREPER  Committee of Permanent Representatives
CPI  Consumer Price Index
CR  Country Report
CSR  Country-Specific Recommendations
D66  Democraten ‘66
DG  Directorate-General
DG ECFIN  Directorate-General for Economic and Financial Affairs
DG EMPL  Directorate-General for Employment, Social Affairs and Inclusion
DG TAXUD  Directorate-General for Taxation and Customs Union
DNB  De Nederlandsche Bank
EAP  Economic Adjustment Programme
EC  European Commission
ECA  European Court of Auditors
ECB  European Central Bank
ECJ  European Court of Justice
ECOFIN  Economic and Financial Affairs Council
EDP  Excessive Deficit Procedure
EES  European Employment Strategy
EFC  Economic and Financial Committee
EFSF  European Financial Stability Facility
EIP  Excessive Imbalance Procedure
EMCO  Employment Committee
EMU  Economic and Monetary Union
EP  European Parliament
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
</tr>
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<tbody>
<tr>
<td>REER</td>
<td>Real Effective Exchange Rate</td>
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<tr>
<td>RLI</td>
<td>Raad voor de Leefomgeving en Infrastructuur</td>
</tr>
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<td>RQMV</td>
<td>Reverse Qualified Majority Voting</td>
</tr>
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<td>S&amp;D</td>
<td>Socialists and Democrats</td>
</tr>
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<td>SDG</td>
<td>Studiegroep Duurzame Groei</td>
</tr>
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<td>SECGEN</td>
<td>Secretariat-General</td>
</tr>
<tr>
<td>SER</td>
<td>Sociaal-economische Raad</td>
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<td>SGP</td>
<td>Stability and Growth Pact</td>
</tr>
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<td>SPC</td>
<td>Social Protection Committee</td>
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<td>SPD</td>
<td>Sozialdemokratische Partei Deutschlands</td>
</tr>
<tr>
<td>SPC</td>
<td>Social Protection Committee</td>
</tr>
<tr>
<td>SWD</td>
<td>Staff Working Document</td>
</tr>
<tr>
<td>TARGET-2</td>
<td>Second generation Trans-European Automated Real-time Gross Settlement Express Transfer system</td>
</tr>
<tr>
<td>TFEU</td>
<td>Treaty on the Functioning of the European Union</td>
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<td>TFP</td>
<td>Total Factor Productivity</td>
</tr>
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<td>TSCG</td>
<td>Treaty on Stability, Coordination and Governance</td>
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<tr>
<td>ULC</td>
<td>Unit Labour Cost</td>
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<td>VAT</td>
<td>Value-Added Tax</td>
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<td>VVD</td>
<td>Volkspartij voor Vrijheid en Democratie</td>
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<tr>
<td>WRR</td>
<td>Wetenschappelijke Raad voor het Regeringsbeleid</td>
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</table>
List of interviews

1. 25-08-2015
2. 26-08-2015
3. 04-09-2015
4. 04-09-2015
5. 02-07-2015
6. 04-03-2016
7. 18-03-2016
8. 03-05-2016
9. 29-04-2016
10. 24-03-2016
11. 24-03-2016
12. 31-03-2016
13. 23-03-2016
14. 25-04-2016
15. 29-04-2016
16. 11-05-2016
17. 11-05-2016
18. 12-05-2016
19. 18-05-2016
20. 18-05-2016
21. 19-05-2016
22. 26-05-2016
23. 26-05-2016
24. 26-05-2016
25. 28-06-2016
26. 01-09-2016
27. 06-10-2016
28. 06-10-2016
29. 20-10-2016
30. 20-10-2016
31. 20-10-2016
32. 26-10-2016
33. 27-10-2016
34. 02-11-2016
35. 04-11-2016
36. 07-11-2016
37. 08-11-2016
38. 08-11-2016
39. 09-11-2016
40. 14-11-2016
41. 17-11-2016
42. 17-11-2016
43. 21-11-2016
44. 21-11-2016
45. 23-11-2016
46. 01-12-2016
47. 16-01-2017
48. 03-04-2017
49. 11-04-2017
50. 11-04-2017
51. 11-04-2017
52. 11-04-2017
53. 12-04-2017
54. 18-04-2017
55. 25-04-2017
56. 26-04-2017
57. 26-04-2017
58. 17-05-2017
59. 18-05-2017
60. 27-06-2017
61. 18-07-2017
62. 29-09-2017
63. 02-10-2017
64. 02-10-2017
65. 17-10-2017
66. 19-10-2017
67. 24-10-2017
68. 24-10-2017
69. 06-12-2017
70. 22-01-2018
71. 01-02-2018
72. 19-02-2018
73. 21-02-2018
74. 14-03-2018
75. 19-03-2018
76. 20-03-2018
Summary

The topic

Since the euro crisis that erupted in full force in 2010, politicians in the euro area have become considerably more concerned with other Member States’ economic policies. The Italian government's announcement to withdraw a pension reform can lead to furious debates in the Dutch parliament. Italian politicians criticize Germany’s lack of stimulating fiscal policy, while German politicians closely follow labour market reforms in France. The crisis showed that what happens in our neighbours’ economies can spill over to ours. In this thesis, I examine how the EU governs these interdependences.

The pre-crisis framework to govern the euro was relatively simple. Its main elements were: rules for public debt (maximum 60% of GDP), deficits (maximum 3% of GDP), and the ‘no bailout rule’. This rule ensures that ultimately every country bears sole responsibility for their public debt and will not receive financial assistance in case of trouble. It was believed that markets would discipline states for unsustainable policies. The crisis showed that this framework was far too simplistic and that interdependence runs much deeper than was previously thought. Markets did not correct the fallout from unsustainable policies, but deepened them. Similarly, the idea that every country has sole responsibility for public debt turned out to be naïve. Greece, Cyprus, Spain, Portugal, and Ireland all received financial assistance, while the European Central Bank had to intervene to prevent further escalation. And – most importantly for this thesis – policymakers learned that countries can run into trouble despite having following the rules on public debt and deficits, because developments elsewhere in the economy spiral out of control. Economic growth in some states turned out to be based on weak fundamentals and macroeconomic imbalances, such as high private debt, lacking demand, eroding competitiveness, etc.. When unaddressed, such imbalances can lead to a loss of market trust and an explosion of public debt as a result. The euro area did not have an effective mechanism to deal with macroeconomic imbalances.

The framework that governs the euro today has been heavily expanded and looks completely different. One of the main new instruments that has been introduced is the Macroeconomic Imbalance Procedure (MIP). We can think of the MIP as a ‘health check' for
Member States' economies. The Commission makes a yearly scan to check for possible macroeconomic imbalances and if it finds these, the Commission issues Country-Specific Recommendations (CSRs) in which it recommends policy reforms to address them. The MIP is part of the overarching European Semester for fiscal and economic policy coordination. With the MIP, the Commission may recommend structural reforms in tax policies, pension systems, labour market institutions or product and services markets. On paper, the MIP works like an escalation ladder: the more severe the imbalances, the stricter the MIP becomes. Insufficient action on excessive imbalances could potentially lead to financial sanctions for Member States.

The puzzle

The euro is the only significant currency without a state backing it. Rather than a single political centre, the euro area is governed by a much more diffuse power structure where technocratic procedures such as the MIP play a stronger role. The euro is also a relatively young currency and how to govern it effectively is an unresolved question: market participants test its viability, academics question its institutions and policymakers continue to look for the right instruments to stabilise it. The effectiveness of the mechanisms that govern the euro is also unclear. Some believe a viable euro needs more policy discipline of Member States and stronger enforcement mechanisms. Others argue that national sovereignty should be protected and believe that the euro threatens democratic decision-making. The debate on the MIP brings out these considerations very clearly, as it touches upon sensitive policy domains that go to the heart of national decision making. From a legitimacy point of view it would be problematic if the EU started imposing policies on Member States in these domains. At the same time, many champions of the MIP are disappointed in its effectiveness and look for ways to strengthen the procedure.

In this thesis, I analyse this debate and argue that often claims about the MIP's legitimacy, effectiveness and policy content suffer from a lack of empirical backing. Hence in the thesis I aim to fill this empirical deficit underlying the debate on the MIP by studying how this instrument works in practice. For example, claims about the MIP's effectiveness are often based on assessments of annual implementation rates of CSRs. But, implementation rates do not tell us much about the MIPs' effects, as it is not clear whether Member States implemented the policies in response to the CSRs or independently of them. Such assessments can therefore not be taken at face value. This thesis takes as a premise that we should first assess the MIP's effects on domestic policies.
and the channels and mechanisms through which it operates before making normative claims about (a lack of) effectiveness -- not least because we do not have a clear notion of what to realistically expect from the MIP in terms of results.

The approach

As the MIP may contribute to crisis prevention, it is crucial to investigate its (potential) effects. But, because of the above considerations, we should also analyse the mechanisms through which the MIP affects Member States. We want to know to what extent the way the MIP affects national democratic decision-making is hierarchical. And finally we should be concerned with the MIP's substantive content. In other words, what kind of policies does the MIP recommend?

To fill the debate's empirical deficit, this thesis presents an assessment of the first five years of operation of the MIP. The analysis consists of two parts. First, I present an analysis of the origin and evolution of the MIP (chapter 3); a broad analysis of its governance and institutional environment (chapter 4); and an analysis of the scope of issues that fall under the MIP and its policy content (chapter 5). The second part is based on qualitative, contextualised process tracing. It looks at the practical operation of the MIP by tracing the implementation process of five MIP CSRs:

» Wage indexation in Belgium (chapter 6);
» Professional services liberalisation in Italy (chapter 7);
» Labour market segmentation in France (chapter 8);
» The Dutch housing market (chapter 9);
» The German current account surplus (chapter 10).

In all cases I have traced the implementation process over the years to assess whether and how the MIP has affected the domestic reform process. I have examined the MIP's effects by studying the economic, intellectual and political context of each individual CSR, and how this has changed over time. This part of the research draws on extensive documentary analysis and is supported by 76 in-depth interviews with actors who played key roles in the process.

The findings

Most commentators who have analysed the effects of the MIP have looked primarily at its
impact on policy change. When doing so it is easy to become disappointed by the MIP's results. This thesis brings some nuance to these analyses but does not fundamentally challenge the notion that the MIP's ability to affect policy change directly is quite limited. There are cases to be found where its effect on policy change is clear, but mostly in conjunction with market and domestic political forces. The MIP can be a factor in domestic policymaking, but is not the determinative factor. The analysis also shows that the effects of the procedure primarily emerge within the bureaucratic realm. For national parliaments, it is easier to ignore CSRs as often they do not bring new information and the rationale for EU involvement on domestic policy issues is not always seen as very strong, especially when a country is not in crisis. In the case studies, the effect of the MIP was most pronounced in Belgium where actors claimed that the procedure was a serious factor influencing a reform of their wage indexation mechanism. This was also due to the authority that the European Commission has in the Belgian debate and especially for the Michel government that prided itself on being reformist.

When taking a broader view of the ways in which the MIP affects policymaking more effects emerge. While domestic political factors are mostly decisive for whether a reform gets introduced, the MIP can have an effect on the preceding process: the way the problem is framed and the salience that is given to the issue. When looking at the cases, in four out of five instances the CSR was about problematizing an issue. In the Netherlands, the CSR was meant to convince national politicians that the measures taken were insufficient to address the issue, whereas the government continued to state that it had been dealt with and calm in the housing market was now required. In Germany, it was about breaking national policy myths of defining the current account surplus in terms of being an export champion and ways to address it as an attack on German over-competitiveness. Such domestic policy views can be deeply engrained, as in Belgium where wage indexation is part of the social structure. In Italy, the CSR was about giving salience to an issue that would require political costs in the short term and yield diffuse benefits in the longer term. This meant there were not a lot of incentives for Italian politicians to pick up this issue of liberalisation of professional services. The MIP helped to ensure that they could also not ignore it. Only in France was the issue of labour market reform already firmly on the agenda, because it involved unemployment, which is a relatively obvious problem. But even there the Commission tried to draw attention to particular aspects such as the very short contracts.

The effects of the MIP can therefore also be cognitive: it can help frame policy issues and disseminate a certain reform logic. The fact that the Commission makes a certain analysis, on the basis of a careful procedure and backed up by majority support of all Member
States gives authority to the argument. The MIP therefore is about mainstreaming particular policy views. Member States get confronted with a European way of thinking about policy issues. Take Germany: when looking only at the implementation rates, the MIP does not seem to have had much of an effect. Yet over the years, the debate on the current account surplus has changed quite a bit, both in Europe and in Germany. The MIP forced German actors with opposing views to come to a consensus position and engage with the arguments of the Commission. Even when not everyone in Germany agrees with the Commission's arguments and even when the CSRs do not always gain a lot of traction in parliament, almost all interviewees agreed that slowly the policy frame was shifting. Whether cognitive effects translate into a change of policy is dependent on domestic political factors whereby the MIP can be conducive to change when domestic actors actively use it to leverage their agendas. But, in this thesis I argue that cognitive effects are substantive effects in themselves.

Secondly, the analysis of hierarchy shows that the MIP does not fundamentally disrupt the democratic accountability links between governments and their electorates. The MIP does not force action and the role of the sanction procedure is not very credible. What the MIP does is to increase the political costs of inaction. It sends a signal that issues should be addressed, but to what extent this is felt as serious pressure depends mostly on domestic political context and market sentiment. Simply put, for some governments a negative judgement from the Commission hurts more than for others and if a country is facing market stress, then any critical comment from an institution with authority is best avoided. But the MIP primarily operates through the ‘force of argument’. Procedural aspects such as escalating from ‘imbalance’ to ‘excessive imbalances’ do not seem to make much of an impression on domestic actors. The MIP does not operate in a fundamentally different way in Italy as it does in Germany, despite their different positions on the escalation ladder of the MIP.

The non-hierarchical character of the MIP has been shaped by the Commission's deliberate decision to focus on ensuring domestic ownership and making the MIP more interactive. This thesis shows how this decision was also due to forces in the Council that started to push back against a perceived rigid approach at the start. Another key choice that shaped the MIP's character was the Commission's decision to place many Member States under the MIP and to link 81% (own calculations) of their CSRs to the MIP. Because of this wide scope, the MIP has become strongly co-extensive with the Semester at large; their rationale is almost indistinguishable. In theory, a MIP CSR should trigger extra concern amongst Member States as opposed to a normal Semester CSR, but the procedure's political force is diminished if everyone and everything falls under it. Had
the Commission chosen to only link a few issues and a few Member States to the MIP, its political force – and hierarchical character – would in all likelihood have been greater.

Third, because the MIP is so extensive in scope, it is very difficult to make judgements on its overall policy content. The MIP does not seem to be driven by a clearly identifiable economic logic. The formulation of CSRs is often dependent on domestic political context and the terminology used in them does not have a univocal meaning. One may identify overarching frames such as the flexicurity frame for labour market CSRs and a trend towards ‘socialisation’ can be witnessed over the years. But in general, scholars should be careful in making overly deterministic statements about the MIP’s overall ideology, such as classifying the procedure as neoliberal.

**Reflections**

The effects, content and hierarchical character of the MIP differ depending on domestic factors. While the MIP is essentially technocratic, the Commission is constantly faced with political contexts in operating the procedure. Similarly, the thesis shows that there continues to be legitimate and genuine intellectual disagreement about appropriate policies; the pace of their implementation; the use and value of certain indicators; assessments of how much progress has been achieved; and whether there is an EU dimension to issues that some consider purely domestic. Even when the Commission is fully justified in pointing out certain problems, there can be disagreement over whether it is the right actor to be doing so, since its involvement can be politically counterproductive to pro-reform forces. Politicians and other pro-reform forces often deliberately downplay the role of the EU in public debates as it is an easy target for opposition forces or vested interests. The image of ‘the policeman’ or ‘foreign imposer’ can be a powerful one.

This does not necessarily speak against the MIP altogether, but should warn against introducing more hierarchy in the procedure. We cannot assume that more pressure automatically leads to greater effects. We can also not assume that the Commission has superior knowledge relative to Member States and that implementation of CSRs is only hindered by classic political economy obstacles, such as vested interests that somehow need to be bought out, persuaded or forced to comply. There is significant strategic uncertainty involved. This thesis not only shows how the MIP is not very hierarchical but also how hierarchy in the procedure can be problematic. This argument is important to
bear in mind when discussing effectiveness. Those who argue that the MIP is ineffective often rely on particular views of what a currency union needs in terms of steering on socioeconomic policies. But further tightening of procedures easily runs the risk of leading to legitimacy problems that can in turn weaken effectiveness. The final chapter of the thesis argues that it is anything but clear that a tighter grip on socioeconomic policies in the Member States from the centre is essential. There are other ways of strengthening the Economic and Monetary Union, which also allow for accepting the MIP’s inherent limits. If the MIP primarily works through the force of argument than strengthening the force of the latter is perhaps the best way forward.
Samenvatting

Het onderwerp

Sinds de eurocrisis in 2010 is losgebarsten, zijn politici van de landen in de eurozone een stuk ongeruster dan voorheen over het economisch beleid in mede-lidstaten. Een plan van de Italiaanse regering om de pensioenhervorming terug te draaien, leidt tot boze reacties in het Nederlandse parlement. Italiaanse politici op hun beurt bekritiseren de Duitsers vanwege gebrek aan stimulerend begrotingsbeleid. En Duitse politici volgen arbeidsmarkthervormingen in Frankrijk op de voet. De crisis liet zien dat wat er in de economie van onze buren gebeurt, gevolgen kan hebben voor de eigen economie. In dit onderzoek analyseer ik het bestuurlijk systeem waarmee de eurozone invulling geeft aan deze wederzijdse afhankelijkheid.

Het bestuur van de eurozone was vóór de crisis relatief eenvoudig. De belangrijkste elementen waren: regels voor publieke schuld (maximaal 60% van het BNP), voor begrotingstekorten (maximaal 3% van het BNP) en tevens de ‘no bailout’ regel. De ‘no bailout’ regel garandeert dat elk land uiteindelijk zelf verantwoordelijk is voor de publieke schuld en andere landen niet financieel te hulp zullen schieten. Verder geloofde men destijds dat de markten landen zouden disciplineren als zij geen gezond economisch beleid zouden voeren.

De crisis liet zien dat dit bestuur veel te simplistisch was en dat de wederzijdse afhankelijkheid van landen in de eurozone veel dieper gaat dan gedacht. Tevens is gebleken dat de markten landen niet disciplineren bij ongezond beleid, maar juist de problemen verergeren. En de regel dat elk land zelf verantwoordelijk is voor de eigen schulden bleek uiteindelijk naief. Griekenland, Cyprus, Spanje, Portugal en Ierland kregen financiële hulp en de Europese Centrale Bank moest vergaande stappen nemen om verdere escalatie te voorkomen. De voor dit onderzoek meest relevante conclusie die getrokken werd, was dat landen in de problemen kunnen raken ondanks gezonde begrotingen en overheidsschuld, doordat problemen elders in de economie uit de hand lopen. De economische groei in sommige lidstaten bleek gestoeld op zwakke fundamenten en macro-economische onevenwichtigheden, zoals te hoge private schuld of verslechterende concurrentiekracht. Als deze niet worden aangepakt,
leiden ze tot een verlies aan marktvertrouwen en een explosie van publieke schuld als resultaat. De eurozone had echter geen enkel effectief mechanisme opgetuigd om deze onevenwichtigheden te monitoren en aan te pakken.

Het huidige bestuur van de eurozone is sterk uitgebreid en ziet er totaal anders uit. Er werden tal van nieuwe instrumenten opgetuigd in de crisis, met als een van de kerninnovaties de *macro-economisch onevenwichtighedenprocedure* (MEOP). De MEOP kan gezien worden als een gezondheidscheck voor economieën. Deze bestaat uit een jaarlijkse cyclus waarbij de Europese Commissie onderzoek doet naar macro-economische onevenwichtigheden in de economieën van de lidstaten en, indien nodig, hier gepast beleid bij aanbeveelt via zogeheten landenspecifieke aanbevelingen. De MEOP is onderdeel van het overkoepelende Europees Semester voor de coördinatie van economisch en begrotingsbeleid in de EU. Met de MEOP kan de Commissie landen aanbevelingen doen om hervormingen door te voeren in het belastingssysteem, het pensioenstelsel, de regels op de arbeidsmarkt of om de product- en dienstenmarkten te liberaliseren. Op papier werkt de MEOP als een escalatieladder, hoe ernstiger de onevenwichtigheden hoe dwingender de aanbevelingen. En als er buitensporige onevenwichtigheden bij een land worden vastgesteld en het reageert niet afdoende op de aanbevelingen, riskeert het land een boete.

**De puzzel**

De euro is de enige wereldmunt zonder een centrale staat. In plaats vanuit één machtscentrum wordt de euro bestuurd door een diffuse machtsstructuur waarbij technocratische procedures zoals de MEOP een belangrijke rol vervullen. De euro is ook een relatief jonge munt, waarbij markten haar bestaansrecht en eenheid nog testen. Er is continue debat in politieke en academische kring over nut en noodzaak van de euro en welke institutionele structuur vereist is voor een robuuste muntunie. De effectiviteit van de huidige instrumenten is onzeker. Sommigen geloven dat een stabiele munt veel meer beleidsdiscipline nodig heeft onder lidstaten en strenge mechanismen om dit te controleren. Anderen zien de euro en haar bestuur juist als een aanval op de nationale soevereiniteit en als fundamenteel ondemocratisch. Het debat over de MEOP brengt deze verscheidenheid aan opvattingen goed naar voren aangezien de aanbevelingen raken aan de kerncompetenties van de individuele lidstaten, zoals belastingbeleid. Voor de legitimiteit zou het problematisch zijn indien blijkt dat de EU beleid opdringt aan lidstaten op deze terreinen. Tegelijkertijd zijn er tal van voorstanders die juist wijzen op het gebrek aan effect dat de MEOP op landen heeft. Zij zoeken juist naar mogelijkheden
om de MEOP te versterken.

In dit onderzoek analyseer ik dit debat en beargumenteer ik dat veel stellingen over de effectiviteit, legitimiteit en beleidsinhoud van de MEOP gestoeld zijn op een gebrek aan empirische onderbouwing. Daarbij probeer ik invulling te geven aan dit empirisch tekort door te bestuderen hoe de MEOP in de praktijk werkt. De argumenten inzake het gebrek aan effectiviteit van de MEOP zijn bijvoorbeeld vaak gestoeld op de jaarlijkse implementatiescores die weergeven in welke mate landen opvolging geven aan de aanbevelingen. Echter, deze scores vertellen in feite niet veel over de effectiviteit van de MEOP, aangezien ze niets zeggen over de vraag of landen hun beleid aanpassen in reactie op de MEOP of onafhankelijk daarvan. Met andere woorden, implementatiescores laten niet zien of er een causaal verband is tussen de aanbeveling en de verandering van beleid in lidstaten. Hierdoor kunnen deze scores niet zomaar klakkeloos worden overgenomen als basis voor uitspraken over effectiviteit. Dit onderzoek stelt dat je eerst moet onderzoeken tot welke effecten de MEOP kan leiden, via welke kanalen en onder welke voorwaarden de effecten zich openbaren, voordat er iets gezegd kan worden over de normatieve vraag of de MEOP effectief is. Immers, er zijn ook helemaal geen maatstaven in het debat om te bepalen wat realistisch is als verwachting van een dergelijk instrument.

De aanpak

Aangezien de MEOP kan helpen om een volgende eurocrisis te voorkomen, is het van belang om de effecten van het instrument te onderzoeken. Echter, gezien alle bedenkingen die hierboven zijn besproken, zal men ook moeten kijken naar de wijze waarop de MEOP invloed uitoefent op lidstaten. Ik wil weten of deze uitoefening van druk op lidstaten hierarchisch is en dus mogelijk problematisch vanuit de optiek van legitimiteit. En tot slot is het ook van belang te onderzoeken wat de inhoud is van de beleidsaanbevelingen. Met andere woorden, tot welk soort hervormingen roept de MEOP eigenlijk op?

Om dit te onderzoeken heb ik de eerste vijf jaar van de werking van de MEOP bestudeerd. Deze analyse bestaat uit twee onderdelen: ten eerste een brede analyse van de achtergrond en ontwikkeling van de MEOP (hoofdstuk 3), een analyse hoe de MEOP op papier werkt en welke instituties en actoren verbonden zijn aan de MEOP (hoofdstuk 4) en een analyse van de reikwijdte van de MEOP en de ideologische richting van de aanbevelingen.
Het tweede deel bestaat uit vijf casussen waarbij de implementatie van aanbevelingen in lidstaten wordt onderzocht op basis van kwalitatieve procesanalyse. Deze casussen zijn:

- Loonindexatie in België (hoofdstuk 6);
- Liberalisatie van gereguleerde beroepen in Italië (hoofdstuk 7);
- Segregatie op de arbeidsmarkt in Frankrijk (hoofdstuk 8);
- De huizenmarkt in Nederland (hoofdstuk 9);
- Het lopende rekening overschot in Duitsland (hoofdstuk 10).

In alle casussen heb ik het implementatieproces door de jaren heen gevolgd om te onderzoeken of en op welke wijze de MEOP invloed uitoefent op het beleid van de lidstaten. Elke aanbeveling is onderzocht binnen de economische en politieke context van het land en geanalyseerd tegen de achtergrond van het intellectuele debat over dit beleidsonderwerp. Dit deel van het onderzoek is gebaseerd op grondige documentanalyse en 76 diepte-interviews met de meest direct betrokken beleidsmakers.

**Het resultaat**

De meeste critici van de MEOP hebben vooral gekeken naar het *directe effect* dat het instrument uitoefent op verandering in beleid. Als men dit als basisuitgangspunt neemt, is het begrijpelijk waarom velen teleurgesteld zijn over het effect dat de MEOP op landen heeft. Dit onderzoek brengt enige nuance aan op deze stelling, maar ondersteunt het argument dat de capaciteiten voor directe beleidsbeïnvloeding redelijk beperkt zijn. Er zijn voorbeelden waarbij sprake is van beleidsaanpassingen, maar de invloed van de MEOP is dan wel afhankelijk van andere factoren, zoals marktdruk of binnenlandse politiek. De MEOP kan een factor van betekenis zijn bij hervormingen, maar is over het algemeen niet de meest bepalende factor. De analyse laat zien dat effecten zich vooral openbaren binnen het ambtelijke domein. Voor nationale parlementen is het vrij eenvoudig om de aanbevelingen te negeren. Immers, de aanbevelingen geven vaak geen aanleiding tot debat, omdat ze algemeen zijn en geen nieuwe informatie bevatten. Tevens is niet altijd duidelijk waarom de EU op deze beleidsterreinen een relevante actor zou zijn.

In het geval van België zijn de directe effecten van de MEOP nog het meest zichtbaar. Beleidsmakers in België stelden dat de aanbevelingen een serieuze factor van betekenis waren bij de uiteindelijke hervorming van het systeem voor loonindexatie. De verklaring hiervoor is onder meer dat de Europese Commissie in België in hoog aanzien staat,
haar autoriteit wordt gerespecteerd, met name door de regering van Michel die graag hervormingsgezindheid wilde uitstralen.

Vanuit een breder perspectief dan alleen het kijken naar het directe effect worden de beïnvloedingsmogelijkheden van de MEOP prominent. Binnenlandse politieke factoren zijn doorslaggevender voor het uiteindelijke doorvoeren van een hervorming, maar in het proces dat daaraan vooraf gaat, kan de MEOP van invloed zijn. Bijvoorbeeld daar waar het gaat om de perceptie van het probleem en het belang dat aan het oplossen van het probleem wordt gehecht. In vier van de vijf casussen gaat het in de kern over het problematiseren van een onderwerp. In Nederland was de rol van de aanbeveling om erop te wijzen dat de reeds genomen maatregelen inzake de hypotheekmarkt onvoldoende waren. Dit terwijl de Nederlandse regering beargumenteerde voldoende ingegrepen te hebben en dat de huizenmarkt nu vooral rust nodig had. In Duitsland ging het om het doorbreken van het beeld dat het overschot op de lopende rekening vooral een reflectie is van Duitslands' sterke positie op de exportmarkt en manieren om het op te lossen als aanval op Duitslands' concurrentiekracht.

Dit soort nationale denkbeelden kunnen diep geworteld zijn, zoals in België waar het loonindexatiesysteem wordt gezien als één van de pijlers van het sociale stelsel waar beleidsmakers vooral vanaf moet blijven. In Italië was het van belang om te blijven hameren op verdere hervorming van de gereguleerde beroepsmarkt. Een dergelijke hervorming brengt politiek nadeel met zich mee voor politici en slechts diffuse voordelen op de langere termijn. Kortom, niet een heel aanlokkelijk perspectief voor politici. Alleen in Frankrijk ging de aanbeveling niet over het problematiseren van een onderwerp, aangezien segregatie op de arbeidsmarkt een voor de hand liggend en algemeen geaccepteerd probleem is. Tegelijkertijd probeerde de Commissie ook in deze casus één onderbelicht element te problematiseren, namelijk het probleem van de extreem korte contracten.

De effecten van de MEOP blijken veelal cognitief in plaats van direct: de MEOP helpt in het vormen van een beleidsframe. Het feit dat de Commissie haar analyse presenteert op basis van grondige procedurele waarborgen en gesteund wordt door een grote meerderheid van lidstaten geeft autoriteit aan de argumenten. De MEOP is een middel om bepaalde economische denkbeelden over beleid mainstream te maken. Lidstaten worden geconfronteerd met een Europese manier van denken over beleidsonderwerpen. Neem de Duitse casus: als er alleen naar de implementatie van aanbevelingen gekeken wordt, lijkt de MEOP niet tot veel effecten te leiden. Echter, door de jaren heen is de manier
waarop over het probleem van lopende rekeningoverschotten wordt gesproken stevig veranderd, zowel in de Europese beleidswereld als in de Duitse. De MEOP dwong tevens de Duitse beleidsmakers om hun stellingen goed te onderbouwen. Deze beleidsmakers waren het vaak niet eens over de precieze analyse en moesten binnen het raamwerk van de MEOP tot een gemeenschappelijke visie komen. Ondanks het feit dat niet iedereen in Duitsland overtuigd was van de argumenten van de Commissie en ondanks het feit dat de aanbeveling niet altijd uitvoerig in het parlement werd besproken, werd in alle interviews die ik Duitsland heb gehouden, beaamd dat de discussie sterk veranderd is. Of de verandering in het beleidsframe zich ook vertaalt in daadwerkelijke aanpassing van het beleid is afhankelijk van binnenlands politieke factoren.

De analyse ten aanzien van de onderzoeksvraag over hiërarchie laat zien dat de MEOP niet dermate dwingend is dat zij leidt tot een verstoring in de verhoudingen van het democratisch stelsel tussen regering en volk. De MEOP dwingt landen geen beleid op en de rol van sancties is niet erg geloofwaardig. Wat de MEOP wel doet, is het verhogen van de politieke kosten bij een gebrek aan actie. De MEOP geeft een signaal af dat zaken aangepakt moeten worden. Maar of dit signaal gevoeld wordt als het onder druk zetten van landen is afhankelijk van het binnenlandse politieke sentiment en van de rol van de markt. Voor sommige regeringen kan een signaal vanuit Brussel dat het niet goed gaat met hervormingen behoorlijk vervelend zijn, voor anderen maakt het weinig uit. Als markten bezorgd zijn over een land willen politici negatieve signalen uit Brussel voorkomen omdat deze tot oplopende rentes kunnen leiden. Echter, over het algemeen werkt de MEOP vooral via de kracht van het argument. Bureaucratische stappen, zoals escalatie binnen de procedure, maken over het algemeen weinig indruk op nationale beleidsmakers. De MEOP werkt niet op fundamenteel andere wijze in Italië als in Duitsland, ondanks het feit dat Italië dichter bij de sanctieprocedure zit, gegeven de buitensporige onevenwichtigheden in het land.

Het non-hiërarchische karakter van de MEOP heeft zich door de jaren gevormd als gevolg van bewust gemaakte keuzes door de Europese Commissie. Bijvoorbeeld de keuze om te focussen op betrokkenheid van en interactie met lidstaten. Dit onderzoek laat zien dat dergelijke keuzes niet volledig vanuit de Commissie zelf kwamen. Leden van de Raad protesteerden tegen de rigide houding die de Commissie aanvankelijk innam en claimden meer ruimte en flexibiliteit. Een andere keuze die het karakter van de MEOP vorm heeft gegeven is het feit dat de Commissie zo veel lidstaten onder de procedure heeft geplaatst en 81% (eigen berekening) van de totale aanbevelingen onder de procedure heeft geschaard. Omdat hierdoor de reikwijdte van de MEOP zo groot is geworden zien actoren geen daadwerkelijk verschil meer tussen een MEOP aanbeveling
en een algemene Semester aanbeveling. In theorie zou een aanbeveling gekoppeld aan de MEOP meer gewicht in de schaal moeten leggen dan een gewone Semester aanbeveling. Dit politieke gewicht is minder als vrijwel alles en iedereen onder de procedure valt. Als de Commissie ervoor had gekozen om slechts enkele landen en slechts een paar thema's onder de MEOP te laten vallen, dan was het signaal dat hiervan uitging een stuk krachtiger geweest en was de procedure ook meer hiërarchisch van karakter.

Gezien dit zeer brede karakter van de MEOP is het erg lastig om een oordeel te vellen over de beleidsinhoud van het instrument. De MEOP wordt niet bestuurd op basis van een duidelijk afgebakende economische logica. De formulering van de aanbevelingen is – wederom – afhankelijk van binnenlands politieke factoren en de gebruikte terminologie heeft hierdoor geen eenduidige betekenis, omdat deze per land kan verschillen. In sommige beleidsvelden kan men een overkoepelend beleidsframe identificeren, zoals het flexisecurity frame bij aanbevelingen op de arbeidsmarkt. Men kan ook een trend waarnemen waarbij een steeds groter aandeel van de aanbevelingen een sociaal karakter heeft. Maar verdergaande kwalificaties blijken moeilijk te staven met gedegen empirisch bewijs. Er is dus ook geen grond voor het bestempelen van de MEOP als neoliberaal instrument.

Reflecties

De effecten, de beleidsinhoud en het non-hiërarchische karakter van de MEOP verschillen dus per politieke context. Alhoewel het een zeer technocratische procedure betreft, moet de Commissie in de uitvoering constant rekening houden met politieke factoren. Het onderzoek laat ook zien dat er een reêel en legitiem verschil van inzicht bestaat tussen Europese en nationale actoren over nut en noodzaak van een aanbeveling, het tempo van implementatie, het gebruik van indicatoren in de analyse, oordelen over de mate van vooruitgang die er is geboekt, en of dit überhaupt een thema is waarbij een Europese dimensie aanwezig is en de EU dus een legitieme actor in het debat. Zelfs als de Commissie volledig gelijk heeft in het wijzen op bepaalde zaken, wordt er verschillend over gedacht of ze dit wel moet doen, omdat haar betrokkenheid in gevoelige debatten contraproductief kan werken voor diegenen die graag een hervorming door willen voeren. Deze hervormers verzuigen vaak bewust de rol van de Commissie in het publieke debat, aangezien de EU een makkelijk doelwit is voor belangengroepen of oppositiepartijen. Het beeld van Europa als ‘de politieman’ of als ‘buitenlandse inmenging’ kan zeer overtuigend zijn.
Het voorgaande argument betekent niet dat we maar moeten stoppen met de MEOP, maar het waarschuwt wel voor het introduceren van meer hiërarchische elementen in de MEOP. We kunnen niet zomaar aannemen dat het opvoeren van de druk op landen via de MEOP ook gaat leiden tot meer resultaat. Verder kunnen we er niet zomaar vanuit gaan dat de kennis van de Commissie superieur is aan die van de lidstaat en dat de implementatie van hervormingen slechts gehinderd wordt door klassiek politiek-economische obstakels, zoals belangengroepen die overtuigd, gedwongen of gekocht moeten worden. Vaak gaan hervormingen gepaard met grote strategische onzekerheid. Dit onderzoek laat niet alleen zien dat de MEOP niet zo hiërarchisch is, maar ook dat hiërarchie in de MEOP problematisch kan zijn aangezien het zich slecht verhoudt tot strategische onzekerheid op nationaal niveau. Dit is een belangrijk argument als we het over de effectiviteit van de MEOP hebben. Zij die in het debat beargumenteren dat de MEOP ineffectief is, doen dit vaak met in het achterhoofd bepaalde ideeën over wat een muntunie nodig heeft aan sturing op sociaaleconomisch terrein. Hierarchisch sturen vanuit de EU kan leiden tot legitimiteitsproblemen die uiteindelijk weer terugslaan op de effectiviteit.

Het laatste hoofdstuk in het onderzoek beargumenteert dat het niet op voorhand duidelijk is dat een sterkere grip op nationaal beleid door de EU essentieel is voor een stabiele muntunie. Er zijn andere methoden om de muntunie te verstevigen die het ook toestaan om simpelweg de grenzen te accepteren van wat een instrument als de MEOP uiteindelijk kan bereiken. Als we kunnen vaststellen dat de MEOP vooral werkt via de kracht van het argument, dan moeten we precies dat element verstevigen om te komen tot een effectievere procedure.
How can the euro area protect itself from future economic crisis? The framework governing the euro has been significantly expanded in recent years. Among the key innovations is the Macroeconomic Imbalance Procedure (MIP), whereby the EU monitors economic vulnerabilities among Member States and issues policy recommendations to address them. In this thesis, David Bokhorst traces the implementation process of different recommendations in Belgium, Italy, France, the Netherlands, and Germany. He presents a holistic assessment of how the MIP works in practice and analyses the effects it has on policymaking in the Member States.

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