EU POLICY NETWORK

PROMOTING IDEAS IN EUROPEAN AFFAIRS

European economic governance: towards a conceptual framework and the way ahead

Demosthenes Ioannou and Arne Niemann

Since the first stage of European Economic and Monetary Union (EMU) in 1990, the framework for the coordination of Member States' economic policies has developed considerably, both on paper and in practice. Instead of creating a fully fledged European economic government, as some had proposed when the Maastricht Treaty was being drafted, the process of integration has resulted in a *sui generis*, and rather extensive, system of EU economic governance that uses a variety of instruments to make and execute policy, some of which are considerably 'softer' than the classic Community method. In this article, we provide a framework for conceptualising this system and some thoughts about where it may be heading.

Towards a conceptual framework of EU policy coordination

Table 1 provides a list of the main EU policy coordination *procedures (I)*.[1] These procedures cover a large number of *policy domains (II)* of a typical economy.[2] One can conceptualise coordination, broadly defined, as 'the engagement among separate actors to take, and comply with, joint decisions',[3] by considering the *legal and/or institutional basis (III)* and the 'harder' and 'softer' *means (IV)* that are being used in order to ensure coordination of the policies of EU member states. In turn, these two parameters (III and IV) determine the relative *degree (V)* of coordination.

More specifically, on the parameters determining the degree of coordination, the legal/institutional basis (e.g. Treaty based rules) is an important parameter that distinguishes different procedures because it reflects, among other things, the level of commitment by member states to coordinate their policies. The level of commitment has implications on the extent to which member states may comply with decisions (e.g. EU Council recommendations) taken at the EU level. The level of commitment is also reflected in the degree to which the supranational

[1] In this article, we focus on so-called vertical coordination, as opposed to horizontal coordination. Vertical coordination refers to the coordination of member states' policies at the EU level. By contrast, horizontal coordination refers to coordination between different policy domains at the EU level.

[2] For the sake of simplicity, at this point we use 'economic' to refer broadly to quite distinct policy domains such as budgetary, fiscal, structural, employment and wage policies. However, as explained in the article, these different policy domains are treated (very) differently when it comes to coordination at the European level.

[3] See Padoa-Schioppa T. (1999). 'Europe's new economic policy constitution', Will EMU lead to European economic government?, Centre for European Reform, p. 16.

institutions enjoy competencies when member states coordinate their policies. Supranational competence determines the degree to which non-national actors can exert pressure on member states both in a direct (e.g. initiative to reprimand) and an indirect manner (e.g. through assessments) to comply with the rules and/or agreements.

The second parameter that determines the degree of coordination is the means that are used in each procedure. They include the significance of the implications of failure to abide by commonly agreed rules (e.g. sanctions), and the 'depth' of policy-goal setting (e.g. guidelines), monitoring and assessment. This depth is signalled by the frequency and level of decision makers' meetings, the format in which the exchange of information takes place, and the extent of information sharing. In view of its political repercussions, benchmarking can also influence decision-makers' efforts to comply with commonly agreed objectives.

In addition, benchmarking can be used to exert peer pressure, which is an important means of coordination inherent in virtually all of these procedures. The feasible degree to which peer pressure can be exerted in applying the rules and/or joint agreements that member states have entered into depends in practical terms on the level of commitment to coordination.

Within this conceptual framework, and beyond the single policy format where a single institution is responsible for policy (e.g. monetary policy), the most binding procedures in the system of EU economic policy coordination are the Excessive Deficit Procedure (EDP) and the Stability and Growth Pact (SGP) which govern member states' budgetary and fiscal policies.[4]

Table 1 - Conceptualising European economic governance

The EDP and SGP entail detailed reporting, monitoring and assessment on a regular basis through bi-annual fiscal notifications and yearly updates of the Stability and Convergence Programmes. Failure to comply with the rules (e.g. emergence of excessive deficit), which is determined through a process initiated by the Commission, is linked to sanctions both in the form of direct fines and in the form of preventing additional debt issuing or European Investment Bank (EIB) lending. Thus, the institutional and legal basis and the means of coordination result in a degree of coordination which is very high, compared to other EU economic governance procedures.

Beyond the specific provisions relating to fiscal and budgetary surveillance, the Broad Economic Policy Guidelines (BEPG) are the strongest form of economic policy coordination. The wording of the Treaty, which requires member states to 'regard their economic policies as a matter of common concern' (Article 99), means that the guidelines deal, both at Community and country specific level, with a great variety of issues including, for example, short term budgetary policy, long term fiscal sustainability, structural reforms in labour and product markets, and making the productive structure of the economy more competitive. The Commission plays an important role as it provides the recommendation for the BEPG, which is adopted by the Council and endorsed by the European Council. Reporting, monitoring and assessment is extensive with the main findings of other surveillance procedures (see Cardiff process below) also feeding into the BEPG. Peer pressure can be significant, while recommendations to specific member states can be made by the Council, deciding by qualified majority voting, when failure to comply with the guidelines is detected.

[4] *The EDP is based on Article 104 EC Treaty. The SGP consists of three elements, namely, the Resolution of the European Council on the SGP of 17 June 1997 (OJ C 236, 2.8.1997), and two Regulations linked to Articles 99 and 104 EC Treaty: (i) Council Regulation on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ C 209, 2.8.1997), and (ii) Council Regulation on speeding up and clarifying the implementation of the excessive deficit procedure (OJ C 209, 2.8.1997).*

In a similar fashion to the BEPG, the Employment Guidelines (EG) are Treaty based and are also issued under the Community method paradigm, with the Commission proposing to the Council the guidelines to be adopted. They are synchronised with the BEPG (tri-annual adoption and annual update) and are required to be consistent with them. Again, regular reporting, monitoring and assessment takes place. The Employment Guidelines arguably enjoy additional legitimacy due to the consultative role of the European Parliament.[5] Furthermore, the Employment Guidelines are linked to pecuniary incentives regarding the European Social Fund (ESF). In this respect, they could be considered as a 'stronger' form of coordination than the BEPG. The Treaty, however, does not require employment policies to be regarded 'as a matter of common concern'. Instead, the Treaty uses softer wording and requests member states to 'work towards developing a coordinated strategy for employment' (Article 125). Such difference in wording also shows that, of course, the degree of coordination may vary even if procedures share a common legal basis.

Moving further down the ladder of coordination, the parameters determining the degree of coordination become gradually weaker. The Cardiff and Luxembourg processes on structural reform in product, capital and labour markets are not Treaty based but rather the outcome of conclusions by the European Council.[6] They feed into the BEPG and EG respectively and are based on member state reporting, monitoring, assessment which entails peer pressure also in the context of annual country-by-country reviews. The procedures cannot lead to sanctions and one would be hard pushed to imagine how this could be done, even if it were deemed desirable to ensure the implementation of policy recommendations through such means. Nevertheless, recommendations to member states are issued indirectly through the BEPG and EG.

In addition to these procedures, the Lisbon European Council of March 2000 introduced a new open method of coordination (OMC), which was intended to support the implementation of the Lisbon strategy and its objectives. As to where the open method fits into the conceptual framework outlined above, this would depend on the view one adopts as to what exactly the OMC is, since the literature is often imprecise on the very concept of the open method. Some observers suggest that most of the above procedures, including the BEPG and EG, are 'new modes of EU governance' (Héritier 2001) and variations of the open method of coordination as they entail a number of the elements that are included in the definition of the open method in the Lisbon European Council conclusions (e.g. guidelines, common objectives, qualitative and quantitative targets).[7]

So far, however, the open method has been used on an ad-hoc basis to tackle issues in specific policy areas, such as the reform of pension systems. The outcome of this coordination exercise, which has basically come in the form of an exchange of information, has fed into the BEPG in connection with the fiscal sustainability of public finances. Therefore, on the basis of the above conceptual framework, it would appear that the OMC, as defined in and implemented since Lisbon, is yet another form of coordination, at least in practical terms, and arguably weaker than the Cardiff or Luxembourg processes, let alone the BEPG or EG.[8] Hence, OMC in pensions was included as an example at the bottom of Table 1.

[5] *The European Economic and Social Committee and the Committee of the Regions* are also consulted.

[6] Cardiff European Council conclusions, June 1998; Luxembourg European Council conclusions, November 1997.

[7] See, for example, Hodson and Maher 2001 and Trubek and Mosher 2001.

[8] For an elaboration of this argument see Ioannou and Niemann 2003.

The way ahead?

The overall picture that emerges from the above analysis suggests that although they do indeed share common traits, the various coordination procedures can be differentiated, in some cases substantially, on the basis of a number of criteria. There are several reasons for the emergence of these differences and for the shape that the framework has taken. We now turn to these reasons in order to help us judge how the framework may develop in the future.

The sets of factors underlying the development of EU economic governance can be summarised under the three general headings of economic, political and institutional. These factors have intertwined over time and have created the basis for the varying degrees of coordination.

With regard to the economic factors that have contributed to the shape of the present framework, and without going into detail, there is a certain, well documented economic rationale why there should be more EU coordination in some areas (e.g. budgetary policies) and not in others (e.g. employment policies). With member states sharing 'club goods' such as the single market and the single currency, there is a need to ensure that, at the very least, free rider behaviour is avoided (von Hagen and Mundschenk 2001). The main reason for this is the necessity to deal with policy spillovers. For example, excessive deficits and high debts in one member state could lead to higher borrowing costs in another. This speaks in favour of closely coordinated budgetary policies. At the same time, member states need to pursue, for example, adjustments to the structures of their economies in order to increase their growth potential but also to cope with asymmetric shocks. This has required to go towards 'managing' collectively reform in labour and product markets and tackling constantly evolving common problems on a more regular basis. Structural reform has not, however, been regarded as an area where a high degree of coordination is necessary in order to pursue the desired common goals.

> **"Member states need to pursue, for example, adjustments to the structures of their economies in order to increase their growth potential but also to cope with asymmetric shocks."**

As for the political factors that have contributed to the form of the present coordination framework, here the question is not so much about the necessity or ability of member states to act collectively, but rather their (un)willingness to concede more competencies to the EU. While member states' reluctance to concede more powers is often linked to economic reasoning, it is also the outcome of political considerations. Coordination in the area of employment, for example, is difficult in view of the (very) diverse labour market institutions of the member states. Even if one could support the argument that extensive coordination at the EU level is desirable in this policy domain from an economic point of view in order, for example, to promote the free movement of labour within the single market, member states would still remain reluctant to concede powers to the EU, given the central political significance of employment rules for each member state. An additional dilemma in this context is the controversial question of how much political legitimacy would be necessary in order to transfer further competencies to the Union.

This brings us to the third set of factors that have determined the evolution of the present coordination framework, namely, the EU institutional framework itself. As policy making is to a very large extent determined by the institutional framework within which policy is conducted, the policy coordination framework is bound by the limitations of the broader EU institutional framework. This is perhaps also an explanation of why softer modes of governance have emerged at the European level. While policy makers have sought to pursue common goals, they have refrained from engaging in the traditional Community method, given both the institutional constraints and also member states' unwillingness to concede further powers to the EU. However, as illustrated above, the more 'open' the mode of EU governance, the more limited the impact is likely to be in practical terms when it comes to the conduct of policy makers at national level. A significant strengthening of policy coordination would require a shift in the distribution of powers between the national and supranational levels of governance and a parallel reorganisation of the legitimacy and accountability requirements. Thus, from an institutional point of view, the possible degree of policy coordination depends on the allocation of powers and the legitimacy and accountability mechanisms that are present in the broader EU institutional framework. Without considerable adjustment to the present EU institutional framework, major changes in policy coordination are therefore not feasible.[9]

The text of the new Constitution currently being finalised has put its stamp of approval on the present coordination framework by adopting, *grosso modo*, most of its parameters. While this has been broadly welcomed, critics of the present framework argue that the Constitution has not gone far enough. Among other things, they point to its inefficiency and the rather cumbersome nature of the multiple procedures. In particular, it has been argued that the present system contains an imbalance between strong rules which seek to halt free rider behaviour by national governments, and weak arrangements that do not entail the means by which policy makers can effectively engage in directing economic policy where and when appropriate.

In conceptual terms, one should point out that the differences between the EU policy coordination framework and a national one are not significant. In other words, EU economic governance already encompasses a broad mixture of mechanisms that reflect many of the functions of a typical national policy-making framework. This process is also a mixture of 'constitutional' rules, the adoption of secondary legislation, and the implementation of legislation which calls for day-to-day management and requires the equivalent at national level of what has been described in the recent literature as 'soft' governance at the European level.

Nevertheless, compared to domestic-level policy coordination, policy coordination at the European level relies to a much greater extent on rules. This is a reflection of the very much 'rules based' institutional framework of the EU. Thus, in contrast to the conceptual similarities, practical differences in the institutional set-ups underlying EU and national policy coordination also give rise to important differences on how policy coordination is actually conducted.

Conclusion

Given the role of the above factors in determining the evolution of the policy coordination framework until now, the way ahead is likely to be one of incremental change rather than significant shift. Economic rationale, political imperatives and institutional limitations all point in this direction. So do the suggestions that have been put forward by various observers which generally call for a relatively limited adaptation of the present system.[10]

It is not unlikely that political imperatives and institutional adaptation may in the future allow for progress in making the EU policy coordination system more efficient and less cumbersome. This can already be achieved through incremental changes that do not require Treaty revisions. Moreover, if one assigns great importance to the ability of institutional arrangements to improve economic performance, well designed

[9] *For a similar argument concerning possible reforms of the decision making process for adopting the EU budget, see Enderlein and Lindner 2004.*

[10] *See, for example, the suggestions put forward in the so-called 'Sapir report' (Sapir et al. 2003).*

adjustments to the present framework could perhaps also help to improve the economic performance of the EU. As for the economic rationale underlying the development of the coordination framework, this would not change *per se*, but it would adapt to the changing political imperatives and institutional limitations by which it is always bound. In this sense, deeper political integration may hold the key to improved EU policy coordination and better economic performance.

REFERENCES

Enderlein H. and J. Lindner (2004). 'The EU budgetary procedure in the Constitutional debate', Paper prepared for the 2004 Conference of Europeanists, 11-13 March, Chicago.

Héritier, A. (2001). *New Modes of Governance in Europe: Policy-Making without legislating?*, Rienner Institut, Paper given at the University of Vienna, 10 December.

Hodson, D. and I. Maher (2001). The Open Method as a New Mode of Governance: The Case of Soft Economic Policy Co-ordination, *Journal of Common Market Studies*, 39 (4), 719-746.

Ioannou D. and A. Niemann (2003). 'Taking stock of the open method of coordination: nature, modus operandi and theoretical perspectives', *Dresdner Arbeitspapiere Internationale Beziehungen*, Nr. 8.

Sapir, A., P. Aghion, G. Bertola, M. Hellwig, J. Pisani-Ferry, D. Rosati, J. Viñals and H. Wallace (2003). 'An Agenda for a Growing Europe: Making the EU Economic System Deliver', Report of an Independent High-Level Study Group Established on the Initiative of the President of the European Commission, July.

Trubek, D. and J. Mosher (2001). 'New Governance, EU Employment Policy, and the European Social Model', New York University of Law, *Jean Monnet Working Paper* 15/01.

von Hagen J. and S. Mundschenk (2001). 'The functioning of economic policy coordination', *ZEI Working Paper*, B 08.