EUROPEAN PARLIAMENT

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT B
STRUCTURAL AND COHESION POLICIES

Agriculture and Rural Development

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Transport and Tourism

EUROPEAN ECONOMIC GOVERNANCE AND COHESION POLICY

STUDY

EN DE FR

2014

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT B: STRUCTURAL AND COHESION POLICIES

REGIONAL DEVELOPMENT

EUROPEAN ECONOMIC GOVERNANCE AND COHESION POLICY

STUDY

This document was requested by the European Parliament's Committee on Regional Development.

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LINGUISTIC VERSIONS

Original: EN.
Translation: DE, FR.

ABOUT THE PUBLISHER

To contact the Policy Department or to subscribe to its monthly newsletter please write to:
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Manuscript completed in January 2014.
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This document is available on the Internet at:
http://www.europarl.europa.eu/studies

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Abstract

This study analyses the interactions between the wide-ranging economic governance reforms undertaken since 2008 and Cohesion Policy. It details the main changes and analyses how the aims of Cohesion Policy are likely to be affected. It also highlights the challenges of assuring legitimacy and of suitable formulation of Cohesion Policy as especially salient issues for the European Parliament, not least because of the expanded roles in economic governance of the European Commission and the European Central Bank.

IP/B/REGI/IC/2013-086 2014

PE 513.999 EN

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LIST OF ABBREVIATIONS

CCI Convergence and Competitivess Instrument

CF Cohesion Fund

CSF Common Strategic Framework

DG ECFIN Directorate General for Economic and Financial Affairs

DG REGIO Directorate General for Regional and Urban Policy

EAFRD European Agricultural Fund for Rural Development

EC European Commission

ECB European Central Bank

ECB European Central Bank

EDP Excessive Deficit Procedure

EFSF European Financial Stability Facility

EFSM European Financial Stabilisation Mechanism

EIB European Investment Bank

EIB European Investment Bank

EMU Economic and Monetary Union

EP European Parliament

ERDF European Regional Development Fund

ESA European Supervisory Authorities

ESF European Social Fund

ESFS European System of Financial Supervisors

ESI European Structural and Investment Funds

ESM European Stability Mechanism

ESMA European Securites Markets Agency

ESRB European Systemic Risk Board

ETC European Territorial Cooperation

EU European Union

FI Flagship Initiative (Europe 2020)

GDP Gross domestic product

GEMU	Genuine Economic and Monetary Union
ICT	Information and Communication Technology
IMF	International Monetary Fund
LTRO	Long-term Refinancing Operations
MA(s)	Managing Authority
MAP	Macroeconomic adjustment programme
MEP(s)	Member(s) of European Parliament
MC	Monitoring Committee
MIP	Macroeconomic imbalances procedure
MLG	Multi-Level Governance
MoU	Memorandum of Understanding
NEET	Not in Employment, Education or Training
NGO	Non-Governmental Organisations
NSRF	National Strategic Reference Framework
OMT	Outright Monetary Transactions
OP(s)	Operational Programme(s)
PA(s)	Partnership Agreement(s)
RAL	Reste à liquider (committed funding still to be spent)
RCE	Regional Competitiveness and Employment (richer regions)
RTDI	Research, Technology Development and Innovation
SF	Structural Funds
SGP	Stability and Growth Pact
SME	Small and medium sized enterprise
SMP	Securities Market Programme
SSM	Single Supervisory Mechanism
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance

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EXECUTIVE SUMMARY

This study investigates the likely consequences of the many economic governance reforms adopted in the European Union since 2008 and their implications for Cohesion Policy. Its aim is to provide the European Parliament and, specifically, its Regional Development Committee, with insights into the future conduct of Cohesion Policy.

Reforms of economic governance

Four distinct sorts of reforms have been undertaken, transforming the basis for economic policy-making, including on how to promote economic, social and territorial cohesion.

A first set of changes has been in monetary policy, involving greater emphasis on financial stability and underlying economic performance, including new instruments to underpin the finances of Member States and the funding of the banking system.

Second, there have been extensive reforms of the governance of fiscal policy and, more generally, of the sustainability of macroeconomic policies, with new or strengthened mechanisms for surveillance of Member State policies.

Regulatory reforms constitute the third area, notably those affecting the financial sector, with the primary responsibility for prudential supervision shifting from the Member State to the EU level.

Significant political and institutional changes are a fourth axis. New responsibilities have been conferred on the ECB and the Commission, while the European Council has assumed a more explicit leadership role, raising issues of legitimacy and accountability of relevance for the European Parliament.

In parallel, a substantially revised framework for Cohesion Policy has been agreed. Difficult negotiations around ‘measures linked to sound economic governance’ resulted in some concessions to the EP, but greater macroeconomic conditionality has been imposed on Member States.

Major political challenges include the ramifications of implicitly preferring policies that favour stability over other objectives and the consequences of a more rule-based governance system. With further reforms in the pipeline, well-conceived political responses will be needed.

Consequences for Cohesion Policy

These changes will affect economic development and the nature of Cohesion Policy. If they succeed, the reforms will contribute to a sustainable macroeconomic environment, which should provide a favourable economic climate for investment. Over time, changes to financial regulation at EU level could reverse the recent fragmentation in banking/financial services across the EU and promote more uniform financing conditions for SMEs.

In the short term, however, fiscal consolidation will put pressure on public finances and Cohesion Policy, especially in the most troubled economies. Both public and private investment are facing serious constraints across the EU.

As the EU's primary investment policy, Cohesion Policy will continue to contribute to macroeconomic governance objectives in the 2014-20 period. Enhanced macroeconomic conditionality could result either in revisions to strategies or the imposition of financial suspensions for non-compliance with economic governance rules. A crucial question is how any suspensions will be applied, although there are safeguards to take into account the economic and social circumstances of the Member States.

Inter-institutional relations in economic governance are in flux and the impact on Cohesion Policy is unclear. The European Parliament has been and is likely to continue to be the junior partner.

Scenarios

The extent to which the different components of genuine economic and monetary union (GEMU) will progress is uncertain. Two steps towards banking union now agreed are the establishment of a single supervisory mechanism (SSM) and a single resolution mechanism (SRM). But the aim of breaking the 'doom-loop' between banks and sovereigns is far from being achieved, and several Member States could face continuing problems in sustaining financial stability.

Plans for an additional fiscal capacity or even the relatively modest proposal to establish a Convergence and Competitiveness Instrument (CCI) are faltering. CCI could complement existing policy instruments to promote cohesion, but it could also be a source of confusion about their respective functions in the governance system. Difficult issues include eligibility and the nature of any conditionality.

A 'Limited GEMU' scenario would not have major implications for Cohesion Policy beyond the changes introduced since the crisis and in the 2013 reform of Cohesion Policy. This assumes that relatively few of the proposals are adopted or that they are adopted in only a limited form that makes no substantial difference.

Nevertheless, the combination of top-down constraints, conditionality and an increased resort to contracts between Member States and the EU level have implications for co-financing and the interactions between Cohesion Policy and other EU policies and processes.

A 'comprehensive GEMU' scenario could mean a greater focus on the EU's spending priorities. This would imply a shift of policy responsibilities to the European level, with Cohesion Policy being financially downgraded in favour of a separate fiscal capacity or being run as a 'top-down' contribution to EU-wide goals with less territorial emphasis. More intrusive oversight would intensify all of the financial and governance challenges: stricter conditionality; more automatic sanctions and strategy revisions; and associated financial, administrative and political tensions.

Comprehensive GEMU without new instruments would enhance the need for Cohesion Policy to cope with stabilisation pressures, probably leading to increased sectoralisation and pressure to modify the budget model. The implications of a GEMU with new instruments would depend on the funding involved. A small budget would not significantly affect Cohesion Policy. A larger budget could usurp the current stabilisation function of Cohesion Policy and might require a narrower thematic focus. There may be benefits for the policy in terms of freeing it from a stabilisation function and allowing a greater focus on the disadvantaged parts of the EU.

Evolving governance roles

The changing governance arrangements reconfigure the channels through which Member States and regions are affected by EU-level decisions and actions. Some of these changes support cohesion objectives, but others restrict the room for manoeuvre of the national and sub-national tiers of government.

The ECB's role in macroeconomic surveillance programmes is generally 'low profile', although it is more visible in 'Troika' missions. The ECB is also involved in the governance of the ESM and will have a prominent role in bank supervision and in the single resolution mechanism. In addition, through its liquidity support operations, the ECB can affect the interest burden on heavily-indebted Member States. In this sense, the ECB has become an actor shaping cohesion outcomes, even if this is an unintended consequence.

The Commission will, in future exercise greater powers over Member State policies and budgets, and it will have a pivotal role in imposing disciplinary measures. These could impinge on Cohesion Policy, especially where conditionality is applied.

Implications for the European Parliament

The role of the European Parliament will not change markedly as a result of governance changes already introduced or in a limited GEMU. However, economic governance themes are bound to be more prominent, as well as their interactions and repercussions for Cohesion Policy, matters of concern for the REGI Committee in particular. An important issue for the Parliament in the inter-institutional negotiations on Cohesion Policy was macroeconomic conditionality. Contrary to one of its demands, the EP will not have a formal legislative role in the macro-conditionality decision-making process, but will be kept informed of developments through a 'dialogue' with the Commission. Nevertheless, the EP does have the right to call the Commission and Member States to account on these issues to increase the public transparency and accountability of the process.

There are four main implications for the European Parliament of a more comprehensive GEMU. First, there should be a stronger EP role in GEMU measures, given the need for greater accountability and legitimation. Second, there is a need for more scrutiny of the Commission and Member States by EP committees, including the REGI Committee when processes such as the Semester are scrutinised. Third, the EP requires better insights on how GEMU measures are affecting Member States. Last, there is a need for stronger inter-committee coordination and dialogue within the Parliament.

1. OBJECTIVES AND CONTEXT OF THE STUDY

This study investigates the likely consequences of the wide-ranging economic governance reforms taking place in response to the series of crises that have affected the European Union (EU), especially the euro area, since 2008 and their implications for Cohesion Policy. It seeks, first, to identify and assess the significance of the many different sorts of governance reform and to appraise how they will affect the planning and implementation of economic development initiatives.

A second aim of the study is to link the current reform of Cohesion Policy to the wider reform of economic governance. Some of these changes are already agreed and being implemented, while others are still at the proposal stage or only partly settled and, thus, subject to greater uncertainty. This distinction is reflected in how the findings are presented.

Based on these analyses, the third aim of the study is to provide the European Parliament and its Regional Development (REGI) Committee with insights into some of the issues likely to be especially salient over the coming years in the conduct of Cohesion Policy. Specifically, the objectives of the study are to explain how future European Economic Governance will influence the implementation of Cohesion Policy, notably:

- how it can influence the capacity of Member States to use Structural and Investment Funds?
- how it can influence the achievement of the objectives of Cohesion Policy in future?

The terms of reference provide a clear outline of the detailed questions that the proposed study is intended to answer. Box 1 lists these questions and indicates how they have been interpreted by the research team in carrying out the study.

Box 1: Questions to be investigated and their interpretation

Terms of reference questions	Research team interpretation of work required
What are the current proposals for EU legislation related to European Economic Governance and which of their elements potentially influence Cohesion Policy?	Identify legislation already confirmed and establish how it might affect Cohesion Policy.
What are the other important documents (e.g. studies, communications, important discussions) in the Member States related to European Economic Governance and what are their elements related to Cohesion Policy?	Focused literature review picking out material from official sources, think-tanks and academic studies.
What are the other EU documents (e.g. communications or important studies) related to European Economic Governance and what are their elements that if implemented could influence Cohesion Policy What impact will a genuine EMU, currently under construction, have on Cohesion Policy?	Enumerate additional proposals in the pipeline and anticipate their likely effect on Cohesion Policy as a more comprehensive 'genuine' economic and monetary union is taken forward.

Terms of reference questions	Research team interpretation of work required
What are the potential links and interactions between the development of European Economic Governance and the implementation of the future EU Cohesion Policy? What are the potential negative effects of the development of European Economic Governance for the implementation of the future EU Cohesion Policy?	Analytic work to clarify the mechanisms through which economic governance will affect Cohesion Policy. Explanation of the risks and opportunities arising from the governance changes.
What is the potential role of the future EU Cohesion Policy in the implementation of the future European Economic Governance?	Investigations of the means by which Cohesion Policy can shape the outcomes of the governance reforms and what they imply for the focus of Cohesion Policy.
What should be the role of the European Parliament in shaping and implementing European Economic Governance?	Bringing the analysis together to clarify how the conjunction of governance reforms, concerns about accountability and legitimacy, and changing pressures on Cohesion Policy bears on the role of the European Parliament

1.1 The broad thrust of the governance reforms

Since 2009, there have been extensive and rapid reforms of economic governance, embracing several domains of economic policy-making. These have included changes in practice as well as significant legislation, some applying to all Member States, some only to the euro area and some to other groupings of countries. Four different categories of governance reform can be distinguished from an analytic perspective, though there are evident areas of overlap which mean that in practice the borders between the categories of reforms are imprecise.

First, the **conduct of monetary policy** has evolved, embracing not just the unconventional measures deployed by the ECB and other leading central banks, especially in providing large amounts of liquidity, but also a reconfiguration of objectives to take more account of financial stability as well as price stability. In the process, as explained in more detail in section 2.1, the ECB has arguably stretched its treaty mandate. To the extent that some of the measures adopted by the ECB have affected public borrowing and what it costs governments, the boundary between monetary and fiscal policy has become fuzzier.

Much of the reform activity is aimed at improving fiscal discipline and, more generally, macroeconomic stability by forestalling the sorts of macroeconomic imbalances which afflicted Member States during the crisis. This second axis embraces a range of **governance innovations** which have been taken forward by a variety of legislative acts, notably the Six-Pack, Two-Pack and the Fiscal Compact component of the Treaty on Stability, Coordination and Governance (TSCG) - see section 2.2. These reforms enshrine a commitment to prevent public deficits and reduce the stock of public debt, but also reinforce surveillance of economies intended to curb unsustainable macroeconomic developments. While the rationale for many of the reforms is to improve policy-making in individual Member States, they are also motivated by a concern to avoid damaging spillover effects between Member States.

The establishment of the European Stability Mechanism (ESM), which can offer loans to Member States facing problems in funding, constituted a further piece of the budgetary policy jigsaw. The ESM built on the two temporary funds set up in May 2010 – the European Financial Stabilisation Mechanism (supported by the then EU27 and backstopped by the EU budget, but now being wound-up) and the much larger European Financial Stability Facility (EFSF - limited to the euro area). Crucially, the ESM has conditionality written into its terms of operation.

A third main area of reform is regulatory with the adoption, notably, of strengthened **rules for financial regulation** and prudential supervision, together with the integrated reform approach of the Europe 2020 strategy. The ECB has also taken on significant new tasks, in relation to financial supervision. These are covered in section 2.3.

Institutional and political developments constitute the fourth element. The period since the start of the euro crisis has seen a substantial recalibration of the institutions involved in the governance of economic and monetary union. Some of the changes occurring reflect shifts in political commitments and in the exercise of power, even if the changes observed are not necessarily the direct result of legislative acts or formally announced decisions. The Commission, in its coordinating and oversight roles, has new responsibilities, while the ECB has acquired new tasks in crisis management as part of the Troika (see section 2.4). The European Council, as an illustration of the political shifts, has met more often and taken on a leadership role in the annual cycle of economic policy making, as well as in setting priorities for specific themes, as explained in section 2.4. The European Parliament has also been a central player in the debate about responses to the economic crisis, and in asserting its role in the emerging architecture of economic governance, albeit with variable success.

Collectively, these reforms are intended to be transformative in correcting the shortcomings in EU economic governance exposed by the crisis, leading to a much more effective Economic and Monetary Union. These reforms will have a wide range of effects on the conduct of economic policies, including those aimed at economic development, and will have a number of direct outcomes which shape the policy environment. One is that the surveillance of Member States is being significantly strengthened, notably through the introduction of the European Semester (aimed at closer coordination and oversight of Member State policies and budgetary choices). Another is that there has been a shift in the balance between rules and discretion, with more insistence on the former, through the Six-Pack and the Two-Pack of measures aimed at improving fiscal and macroeconomic discipline, and the Fiscal Compact.

The combination of rules designed to prevent fiscal imbalances and more credible sanctions to deter governments tempted to flout the rules will discipline public finances more effectively. In particular, they widen the scope of surveillance by identifying threats to stability from sources other than public finances, including asset bubbles. At the same time, constraints on the discretion that Member States have in policy raise issues of legitimacy which are already proving to be contentious.

A further effect of the changes will be to accentuate the variability of the geometry of economic governance, but not only between the euro area and the non-participating Member States. Thus, the TSCG is only binding on Eurozone countries, but other signatories are bound by it once they adopt the euro or earlier, if they wish (in which case they may select the provisions that apply). These rules reinforce commitments to fiscal discipline, but also provides for closer economic policy coordination among the 25 signatories, as well as new governance approaches. A key issue in this regard – given that Cohesion Policy applies to all 28 Member States – is how governance changes that apply

exclusively to the euro area or to the larger number of signatories of the TSCG can be reconciled with regulations and process applicable to all 28 Member States.

1.2 Overview of likely consequences for Cohesion Policy

The economic governance changes already introduced will have to be taken into account in the formulation and implementation of Cohesion Policy. The likely effects on Cohesion Policy are not always obvious and their implications for the 2014-20 programme period uncertain, but a number of broad orientations can be identified.

- First, the severity of the economic crisis which triggered the reforms will have an enduring impact. Over the medium-term, most Member States will be subject to much more severe constraints on public finances than in the years leading up to the crisis, with the more intense pressures on fiscal discipline limiting room for manoeuvre and posing challenges for the co-financing of Cohesion Policy in the most troubled economies. At the same time, policy-makers have woken up to the extent of cross-border spillovers in an economy as integrated as the EU/euro area. The risk is of contagion from what should have been relatively manageable events, but which cannot be contained inside one Member State. As a result, existing macro-conditionality requirements on the Cohesion Fund were used for the first time, through an early-warning to Hungary for repeated breaches of EU fiscal rules, and have been reinforced for all ESI Funds in the new regulatory framework for 2014-20.
- Second, the reforms are shifting the balance of decision-making powers in ways that are, so far, incompletely understood. While changes such as the involvement of the ECB and the Commission in the Troika overseeing programmes in countries in difficulty are highly visible, others such as the emergence of the European Council at the pinnacle of economic governance has happened almost by default, rather than design. Other Community institutions have acquired new governance roles that are more permanent. It remains to be seen quite how significant innovations which give the Commission a more prescriptive role over Member State policies will be for Cohesion Policy and whether performance reviews in the Council of Ministers will affect the use of the Funds.
- Third, there has been a proliferation of new initiatives, agencies and fora for economic management, adding up to a more complete framework for the management of economic and monetary union, but also creating scope for confusion and uncertainty. The issue of how Cohesion Policy feeds into the governance structure is likely to become more complex, not least because of the emphasis being given to structural reform in adjustment programmes. Cohesion Policy has become ever more closely linked to these policies since it emerged as the EU level instrument for advancing the Lisbon strategy (Mendez, 2011; Begg, 2010). Yet, although structural reforms have notionally been centre-stage since the launch of the Lisbon Strategy in 2000, with the bulk of the Europe 2020 strategy being about changing the supply-side of the economy, they had become less prominent in the policy discourse in the last two years. Instead, both the Commission and Member States appear to be paying greater attention to the annual economic cycle, notably the Country Specific Recommendations. This shift arose because of the advent of the European Semester as a key governance reform and the obligation on Member States, in their Stability and Convergence Programmes (SCP) to specify a medium-term budgetary objective. As a result, Member State National Reform Programmes on structural issues and measures to boost growth and jobs are now assessed as part of the wider analysis of fiscal, macroeconomic and structural policies in arriving at recommendations which are discussed and adopted by the Council.

1.3 Next steps

Further reforms are in the pipeline as part of the push to create the 'genuine' economic and monetary union (GEMU) foreseen in the European Council's Four President's Report (European Council, 2012) and the blueprint for GEMU published by the European Commission (2012). In parallel, the agreement of the Multi-annual Financial Framework for 2014-20 and the recent agreement on the regulations for Cohesion Policy are intended to align the policy with EU economic governance, notably through the influence of Country-Specific Recommendations (CSR) on the content of Partnership Agreements and the application of macroeconomic conditionality.

The GEMU proposals fall under four headings which can be summed up as banking union, fiscal union, closer coordination, and political union, some of the options for which were fleshed out in the Commission blueprint. The latter distinguishes between proposals which can be taken forward in the short, medium and long terms, and makes clear that some of the medium and longer term changes are likely to require treaty change. Among the short-term initiatives to have made most progress are parts of banking union which was advanced substantially with the agreement in December 2013 of a single resolution mechanism, and the proposal to introduce a new Competitiveness and Convergence Instrument (CCI). The latter has objectives that have some common ground with Cohesion Policy through financial incentives associated with structural reforms. The possible social ramifications of the some of the current and prospective governance reforms have been addressed in a further Commission (2013a) communication which puts forward proposals for the social dimension of GEMU.

In parallel, considerable progress has been made in the negotiation of the Cohesion Policy regulations, with the main regulatory framework agreed between the institutions in November 2013, although associated secondary legislation and various guidance documents to inform programming are still to be finalised. One of the last blocks in the legislative framework to be agreed was the contentious issue of macroeconomic conditionality now referred to in the final version of the framework regulation (Chapter IV) as 'measures linked to sound economic governance'. In relation to this, the European Parliament sought until the end to have a greater influence on how these measures would be applied in practice.

Programming of Partnership Agreements (PAs) and Operational Programmes (OPs) in the Member States has been underway for more than a year, with almost all countries having submitted at least informal drafts of PAs to the Commission. In a briefing to the Informal Ministers' Meeting in Vilnius (26 November 2013), the Commission estimated that at least half of the Member States were ready for formal submission of their PAs, but that the preparatory process was slow in a significant number of countries. At time of writing (January 2013), it seems unlikely that the Commission target of adopting all Operational Programmes by the time of the European Parliament elections in May 2014 will be achieved. Delays in launching the 2007-13 OPs have knock-on effects, so that there is urgency to dealing with this.

2. INVENTORY OF GOVERNANCE REFORM MEASURES

The economic governance reforms outlined in section 1.2 have been extensive and will have far-reaching effects on the overall management of Member State economies and the EU as a whole. This section elaborates on their content and likely significance.

2.1 Main governance reforms affecting the ECB's monetary role

Before the occurrence of the 2007 crisis, and the ensuing sovereign debt crisis in 2010, the role of the European Central Bank (ECB) focused essentially on price stability, as set down in Article 127(1) of the Treaty on the Functioning of the EU (TFEU). A quantitative definition of price stability further identifies a level of inflation for the euro area as a whole at *'below but close to 2 percent […] over the medium-term'* as clarified by a Governing Council statement in May 2003.

Although the ECB and the national central banks – collectively the Eurosystem – are also expected to contribute (Article 127.1) to 'support the general economic policies in the Union', it is without prejudice to price stability. This mandate is widely interpreted to mean that the ECB has a hierarchy of objectives in which price stability has to come first, unlike that of the US Federal Reserve which has the dual aim of price stability and preventing unemployment. Like all central banks, the ECB also has implicit responsibilities for financial stability and for the operation of the financial system, although as former ECB President, Jean-Claude Trichet, observed:

> 'central banks often have an explicit mandate in the area of financial stability. But typically this mandate is formulated in very general terms, and it would have been written before growing recognition of the key role of macro-prudential oversight'.[1]

With the Lisbon Treaty in January 2009, the ECB mandate to focus *'clearly and unambiguously'* on maintaining price stability was confirmed and even reinforced by the elevation of this primary objective of the ECB as an objective of the EU as a whole (Gloggnitzer 2008).

To address the shortcoming of the institutional setup of the EMU with regard to fiscal and macroeconomic policies, a number of **long-term reforms** – involving, directly or indirectly, the ECB – have been implemented or are currently in the making. Following the intensification of the euro area crisis in 2010, important reforms of the ECB's contribution to euro area governance have taken place. In particular, starting from the recognition that there was no formal structural framework to monitor macroeconomic and financial imbalances (i.e. the Lisbon strategy focused on policy implementation at the structural level, rather than looking at imbalances themselves; see ECB, 2011c), the ECB mandate has been considerably stretched, both at its own initiative, and partly by legislation adopted by EU Member States.

As a response to the crisis, the ECB adopted a wide range of non-standard measures targeted mainly at the banking sector, owing to its importance in the transmission of monetary policy and financing of the economy. However, those measures exploited the flexibility of the existing framework – remaining fully consistent with the ECB mandate of maintaining price stability. Importantly, those measures were temporary in nature, not representing reforms of the existing governance framework.

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[1] Keynote address at the European Banking Congress, Frankfurt am Main, 19 November 2010.

The legal framework for ECB interventions outside a strict quantitative goal of price stability can be found already under Art. 127(1) TFEU stating that *'[w]ithout prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119.'* Those principles include, *inter alia*, *'balanced economic growth and […] a highly competitive social market economy, aiming at full employment and social progress […]'* (Art. 3(3) TEU) together with *'sound public finances and monetary conditions and a sustainable balance of payments'* (Art. 119 TFEU).

2.1.1 Liquidity operations

At the height of the sovereign debt crisis in 2010, the ECB launched a bond-purchasing programme intended both to stabilise the banking system and to calm the sovereign bond market. These were in addition to successive episodes of Long-term Refinancing Operations (LTROs) to provide liquidity to the banking system. The underlying aim was to reduce the cost of issuing debt by Member States under pressure by increasing demand for the bonds, thereby lowering the interest rate[2]. The **Securities Market Programme** (SMP), launched in May 2010, through which the ECB purchased bonds of Member States on the secondary market (i.e. not directly from the Member States, which would have been incompatible with the Treaty). In particular, the SMP aimed at addressing tensions in the sovereign debt market that hampered the monetary policy transmission mechanism. Under the SMP, public and private debt securities were eligible for purchase on the secondary market. Furthermore, the Eurosystem (the national central banks and the ECB) re-absorbed the liquidity provided through the SMP by means of weekly liquidity-absorbing operations so as to ensure that money supply was left unaffected.

Following the much publicised speech by Mario Draghi in London on 26th July 2012, when he undertook to do whatever it takes to safeguard the euro, the ECB announced **Outright Monetary Transactions** (OMT), in September 2012. Under the latter scheme, the ECB would again intervene in bond markets, provided that the Member State in question agreed to structural reforms. Although OMT has, so far, not been requested, the mere announcement had a dramatic effect in lowering the interest rate on bonds in vulnerable Member States. The last SMP purchases took place in February 2012 and the programme was terminated with the phasing-in of OMTs in September 2012.

The SMP and OMT were designed to comply with Article 123 TFEU, or the Treaty's 'no monetary financing' clause, prohibiting the grant of *'overdraft or other types of credit facilities'* by the ECB to any EU institutions or Member States, as well as *'the purchase directly of government bonds by the ECB or national central banks.'* As for the SMP, the objectives of OMTs are to *'safeguard an appropriate monetary policy transmission mechanism and to preserve the singleness of the monetary policy across the euro area by providing a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro area'*.[3] Similarly to its predecessor, the OMTs assume ECB interventions are not automatic.

[2] The way this works is that when the price of a bond, which carries a fixed interest rate based on the nominal value of the bond, rises, the interest rate as a proportion of the price of the bond goes down. Thus, if a bond nominally worth 100 euros at an interest rate of 2% falls to a nominal value of 50 euros, the interest rate doubles to an effective 4% and the issuer of the bond can only then sell additional bonds by offering a higher interest rate.

[3] Source: http://www.ecb.europa.eu/ecb/educational/facts/monpol/html/mp_011.en.html

Importantly, and in contrast to the SMP, a necessary condition for the Monetary Transactions is strict and effective conditionality attached to an appropriate EFSF/ESM programme, in compliance with a full or precautionary macroeconomic adjustment programme (Enhanced Conditions Credit Line) by either the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM). This criterion, introducing for the first time the concept of 'monetary policy with conditionality', also serves to ensure that governments retain the right incentives to implement required fiscal adjustments and structural reforms. As Draghi put it in another speech (3rd June 2013): 'They can either reform *without* OMTs and retain economic sovereignty, or they can reform *with* OMTs but give up some of their economic sovereignty'.

Another important difference with respect to the SMP is that OMTs are *ex ante* unlimited and would take place in secondary government bond markets with maturities up to three years (leaving financial markets to set the price of government bonds at longer maturities). As was the case with the SMP, the liquidity created through OMTs is fully 'sterilised', a process which is supposed to ensure that it is not inflationary.

The ECB was criticised for overstepping its role with such operations, for example many observers underlined how ECB targeted purchases of bond issued by highly indebted countries were likely to create a rolling over of credit risk from less virtuous countries to more virtuous ones (Belke 2010), creating room for moral hazard. Equally, by making it possible for governments facing adverse market conditions to borrow on more reasonable terms, it can be argued that these monetary policy actions have a pro-cohesion effect. Although questionable as a task for monetary policy, narrowly interpreted, the Treaty clearly empowered the ECB to do so in Protocol (No. 18) on the Statute of the European System of Central Banks and of the European Central Bank (1992), which says that '*[i]n order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may: — operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in Community or in non-Community currencies, as well as precious metals; — conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral* '.

Government bonds are indeed marketable instruments, which the ECB is entitled to trade. The only reasonable question is whether in doing so the ECB would undermine the achievement of the 'primary objective' of price stability (European Parliament, 2013). As concerns moral hazard, however, conditionality implicit in the OMTs, together with the idea of intervening only at shorter maturities, can in principle prevent (or at least mitigate) any such concerns.

2.1.2 Rescue funds

The SMP was first put in place when the **European Financial Stabilization Mechanism** (EFSM) and a **European Financial Stability Facility** (EFSF) were created, in May 2010. The EFSF, which is understood as a temporary arrangement to tackle the urgent need to finance governments which had effectively lost access to market financing, has been recently complemented by the creation of a **European Stability Mechanism** (ESM) – starting from October 2012.[4] The ESM is conceived as a permanent crisis management tool to safeguard financial stability in the euro area.

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4 While the ESM was conceived to become effective only starting from 2012, its creation followed a European Council's decision already in October 2010.

The general principles characterizing the functioning of the EFSF, first, and the ESM, later, are consistent with the 'no bail-out clause' contained in Article 125 TFEU. Under this clause, no EU institutions, including the ECB, can assume liability for the debt of any national government, whereas no Member State can assume liability for the debt of another. These provisions, coupled with those set out under Article 123 TFEU, preclude transfers and monetization of government debt, stressing the idea that the responsibility for repaying debt remains national.

To fulfil its mission, the EFSF (which formally has the status of a private company under Luxembourg law) issued bonds or other debt instruments on the capital markets. The proceeds of these issues were then extended temporarily to government as loans subject to strict conditionality. The EFSF was also allowed to intervene in the primary and secondary bond markets, act on the basis of a precautionary programme and finance recapitalisations of financial institutions through loans to governments.

Similarly to the EFSF, the purpose of the ESM management framework is that of giving euro area countries in distress the time necessary to implement measures to restore fiscal sustainability, competitiveness and financial stability. However, it is also linked to the closer surveillance of euro area economies under the 'Two-Pack'. As for the EFSF, ESM interventions can focus on purchases of bonds of a beneficiary euro area country in both the primary and secondary markets.

The ESM provides financial assistance which is expected to serve as a liquidity bridge until the country under scrutiny regains market access. Financial assistance is granted on non-concessional terms (i.e. at unattractive conditions, about three percent above the German bund)[5] to ensure that the country will return to market financing as soon as possible. From July 2013, the ESM became the main instrument to finance new programmes. In fact, the ESM is understood to provide the euro area with a permanent rescue fund with credible back-stop capacity,[6] superseding the temporary solutions provided by the EFSM and the EFSF.[7]

In the course of 2013, the ESM provided financial assistance to Spain for the recapitalisation of its financial institutions, a programme from which Spain successfully exited in December 2013 and financial assistance to Cyprus under a macroeconomic adjustment programme. In parallel to the ESM, the EFSF continues with the ongoing programmes for Greece, Portugal and has also lent to Ireland (which formally exited its programme in December 2013), and it is expected to remain in place until all its outstanding claims are repaid in full. In addition, rescue funding for non-euro Member States has been provided under the balance of payments facility, for example for Hungary and for Romania. These funds have been used in conjunction with IMF adjustment programmes. The balance of payments facility is enshrined in regulation 332/2002 of 18 February 2002, 'establishing a facility providing medium-term financial assistance for Member States' balances of payments'. It derives from Article 143, TFEU, which relates to non-euro Member States experiencing serious threats to its balance of payments. The balance of payments facility is not available to euro area countries.

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[5] ESM loans provide a charge of 200 basis points plus an additional surcharge of 100 basis points for amounts still outstanding after three years.

[6] The ESM's maximum lending capacity is €500 billion, of which €391 billion is still available (see EFSF's website http://www.efsf.europa.eu/about/index.htm).

[7] The EFSM allows the Commission to raise up to €60 billion on behalf of the EU for lending to EU Member States, subject to strong conditionality in the context of EU-IMF programmes.

Future ESM financial assistance is to be activated upon receipt by the Eurogroup (the body comprising the euro area finance ministers) and ECOFIN Presidents of a request from a euro area country. Following this request, the European Commission, in liaison with the ECB, and where possible the IMF, assess whether there is a risk to the financial stability of the euro area as a whole and analyses the sustainability of the public debt of the requesting country. If, on the basis of this analysis, it is concluded that a macroeconomic adjustment programme should be put in place, the Commission, again in liaison with the ECB, and where possible the IMF, is expected to assess the actual financing needs of the country requesting assistance. On the basis of this assessment, the Board of Governors of the ESM mandates the Commission, together with the IMF and in liaison with the ECB, to negotiate a macroeconomic adjustment programme (MAP), the details of which will be laid down in a Memorandum of Understanding (MoU).[8]

The Commission, in liaison with the ECB, and the IMF, is further expected to monitor compliance with such a MAP, reporting to the ECOFIN Council and the Board of Directors of the ESM. On the basis of this report, the Board of Directors can decide, by mutual agreement, on the disbursement of further tranches of the loan.

While the ECB's role in such a macroeconomic surveillance procedure is 'low profile' (Darvas and Merler, 2013), the ECB is involved in the ESM governance directly in two other respects. First, the ESM can only lend to euro area Member States, as was the case for the EFSF. However, as established during the euro area summit on June 2012,[9] upon constituting an effective supervisory mechanism (SSM) involving the ECB (discussed in section 2.3, below), the ESM could have the possibility to recapitalise banks directly, after consultation with the ECB/SSM. Second, there is a strict interconnection between the ESM's primary market intervention and the ECB's Outright Monetary Transactions. As announced by ECB President, Mario Draghi, on 6th September 2012, ECB's OMTs – which are anyway limited to the secondary market – will be considered for future cases of ESM macroeconomic adjustment programmes or precautionary programmes, provided that they include the possibility of ESM primary market purchases.[10] Also, in cases where the ESM intervenes in secondary government bond markets, the ECB will act as the agent for the ESM (as laid down in Article 18 of the Treaty Establishing the European Stability Mechanism).[11] In this respect, the ECB accepts the same treatment as private or other creditors for all of its government bond holdings (include OMTs); differently from the ESM which is instead granted preferred creditor status.[12]

2.2 Reforms of the governance of economic policy

Dealing with the flaws in the governance of the 'Economic' in Economic and Monetary Union (EMU) has been a central thrust of many of the reforms undertaken since 2010. Fiscal discipline has been enhanced in several ways.

- The revisions to the two regulations that make-up the Stability and Growth Pact (1466 and 1467 which set out the preventative and corrective arms of the Pact and comprise two components of the Six-Pack) amend it in three key ways. First, public

[8] As laid down in Art. 13(2) and 13(3) of the Treaty Establishing the European Stability Mechanism.

[9] Communication from the Commission to the European Parliament and the Council. A roadmap towards a Banking Union. Brussels 12.9.12.

[10] OMT may also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access.

[11] See Frequently Asked Questions on the ESM; available at http://www.esm.europa.eu/pdf/FAQ%20ESM%2001072013.pdf.

[12] At the same time, it is also recognized the preferred creditor status of IMF claims over ESM claims (see ECB, 2011 – Box 1).

debt (still part of the convergence criteria for accession to the euro area, but not hitherto part of the SGP) has become a facet of public finances which will be formally assessed. Second, sanctions will become more graduated, but also more automatic; and third, the adoption of 'reverse majority voting' makes it harder for the Council to countermand a Commission proposal to initiate proceedings against Member States.

- The obligation to adopt domestic rules that ensure fiscal sustainability (also from the Six-Pack) is expected to put pressure on Member States to reduce debt levels.
- Scrutiny of planned budgets of euro area countries by the Commission in the autumn (Two-Pack), before they return for final decision by national parliaments will introduce a new constraint on what these budgets contain.
- The Fiscal Compact places these obligations on a stronger legal basis, albeit one outside the EU Treaty framework for now.

The likely implications of these measures include not just the general pressure on governments to curb deficits and to take greater account of the quality of public finances, but also to be more attuned to debt, a shift which is bound to have more ramifications for the more heavily indebted. It may also affect the approach governments take to incurring debt in order to finance public investment. Advocates of a 'golden-rule' argue that public debt is justified where it is used to support investment projects which yield a rate of return high enough to finance the debt incurred. But once rules deter debt for any purpose, the logic breaks down. Insofar as Cohesion Policy aims to boost public investment and requires national co-financing, the national (or regional) public sector will be less able to use debt to co-finance projects supported by the Structural and Investment Funds.

Macroeconomic surveillance has also become more intense as a result of the establishment of the Macroeconomic Imbalances Procedure (MIP – two more elements of the Six-Pack), based on two new regulations (1176/2011, covering prevention; and 1174/2011, covering enforcement). Surveillance in the shape of the Broad Economic Policy Guidelines, derived from Article 121 TFEU, has long been in place but is widely regarded as having been toothless as a governance mechanism. The MIP with its scoreboards and scope for in-depth review of Member States considered to be at risk will be a more rigorous approach to identifying imbalances caused by reasons other than fiscal indiscipline. However, the original aim to look at surplus as well as deficit countries was watered-down. It is, though, expected that a number of social indicators will be added to the scorecard from 2014, following the proposals in the Commission (2013a) communication on the social dimension of the economic and monetary union. This could easily give rise to tensions in working out how an indicator such as the percentage of the age cohort not in employment, education and training (NEETs) is reconciled with standard macroeconomic indicators when assessing a country's overall position under the macroeconomic imbalances procedure.

Several other extensions of economic governance have also been adopted since the onset of the crisis. These include:

- The Europe 2020 strategy with its integrated guidelines, headline targets and range of Flagship Initiatives, launched in 2010. In principle, it is the medium and longer term governance process which connects most directly with Cohesion Policy, following on from the link made with its predecessor, the Lisbon strategy, for the 2007-13 programme period.
- The policy cycle around the European Semester, which appears to have overtaken the Europe 2020 strategy since 2012 in the degree to which it commands the attention of the relevant actors. The cycle comprises the Annual Growth Survey - Country-Specific Recommendations - amendments to national reform strategies.
- The Euro Plus Pact, adopted in March 2011 by 23 Member States (the euro area, with the 'plus' consisting of voluntary participation by Bulgaria, Romania, Poland,

Latvia (now part of the euro area as of 1st January 2014), Lithuania and Denmark, which has a range of measures intended to boost competitiveness and to promote supply-side reform, although it seems to have faded from view.
- Crisis management via the Troika and the task forces.
- The agreement in June 2012 of the Compact for Growth and Jobs.

Under the Two-Pack, which applies only to the euro area, two further regulations provide for closer monitoring of budgets and economic plans. Regulation 877/2013 covers Member States subject to an excessive deficit procedure (EDP), setting out the strategy proposed to deal with the deficit. Regulation 473/2013 refers to the budget monitoring procedure under the Two-Pack. Article 6 requires the submission of the draft budget by October 15th in the annual cycle.

The first round of budget assessments, undertaken in autumn 2013, covered 13 of the euro area members, because the procedure did not apply to the four Member States (Cyprus, Greece, Ireland and Portugal) subject to macroeconomic adjustment programmes – yet another variation of the geometry. The Commission verdicts[13] are in four categories:

- compliant with the SGP provisions: Estonia and Germany;
- compliant, but with no margin for possible slippage: France, the Netherlands and Slovenia, all of which are enjoined to implement the budget rigorously;
- broadly compliant with a trajectory to correct their excessive deficits, but at risk of deviating from their medium-term objectives: Belgium, Austria and Slovakia; and
- at risk of non-compliance: Spain, Italy, Luxembourg, Malta and Finland.

In rather cautiously worded terms, the Commission invited the Member States in the latter two groups to take steps to improve compliance and to address the risks identified. The assessment noted that for the euro area as a whole the headline budget deficit should fall below three percent of GDP. The report recalled that the Commission is entitled to request the re-submission of any draft budget found to be seriously non-compliant, but that although there were reasons for concern, none was severe enough to warrant a demand for resubmission. However, Member States were criticised for adopting inappropriate approaches to fiscal consolidation, notably decreases in public investment and not enough reduction of public consumption. The text referred to the need to adopt growth-friendly structural measures.

2.3 Regulatory changes

In response to the financial instability which characterised the early phases of the crisis, a new framework for prudential supervision was introduced, with two new bodies at its core: the **European Systemic Risk Board** (ESRB), with a mandate to assure macro-prudential stability; and the **European System of Financial Supervisors** (ESFS – not to be confused with the EFSF, the emergency fund created in May 2010 to provide bailout loans). New bodies with somewhat more powers than their predecessors were created in 2010 to oversee supervision of, respectively, the banking, insurance and securities markets sectors. ESMA, the new securities markets agency, has an additional mandate to regulate credit ratings agencies.

[13] Commission (2013) '2014 draft budgetary plans of the euro area: overall assessment of the budgetary situation and prospects' COM(2013) 900 final, 15.11.2013.

The ECB was assigned a central role in macro-prudential supervision by becoming a key participant in the ESRB, created at the end of 2010. The ESRB represents the macro-prudential pillar at the European level, going hand-in-hand with three new European Supervisory Authorities (ESAs) to cover micro-prudential supervision; representing the second pillar. The three ESAs were not created *ex novo* but resulted from upgrading the -'level 3' Lamfalussy Committees of European Financial Supervisors, respectively covering the banking, insurance and securities industries, and transforming them into authorities with legal personality and enhanced competencies.

This new financial supervision system was established following a European Commission proposal, on the back of the results contained in the De Larosière report (2009), supporting a new European supervisory structure.

The ESRB, according to its mandate, *'shall be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability [...] that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress'* (ESRB legislation).

The ESRB was not given any legally binding authority, but it has the power to issue warnings and recommendations, including both admonitions calling for the attention of the addressees to identified systemic risks, or recommendations advising on policy actions to be taken to mitigate the identified risks. Addressees of the ESRB's warnings and recommendations can be the European Union, individual EU Member States and the three ESAs, as well as national supervisory authorities in the EU or the European Commission (the latter, mainly as concerns the relevant EU legislation).

Given the ESRB's General Board composition, the process leading to the adoption of warnings and recommendations and their communication involves mutual consideration by a set of important bodies and institutions, including the President and Vice-President of the ECB, which makes it difficult for the addressees to simply ignore them.[14] Moreover, the addressees are subject to an 'act or explain' mechanism, implying that addressees have to report to the ESRB on the actions taken to comply with the recommendations, or to explain why, if no action is taken, (Dierick *et al.* 2012). The ESRB's Board composition and its functioning thus constitute a potent 'peer-pressure' mechanism on the addressees, even if no sanctions can be formally applied. These supervisory changes were largely a response to the financial crisis triggered by the collapse in September 2008 of Lehman Brothers and the wider weaknesses revealed in the banking sector. What had not been anticipated was that the links between national banks and national governments would emerge as a separate and potentially much more damaging problem. As the euro crisis deepened, this plainly had to be addressed and what is now known as banking union began to take shape. Its subsequent evolution is described in chapter 5.

Since the Maastricht Treaty, there has been an enabling clause (Article 127.6, TFEU) providing for the ECB to be assigned additional tasks in the supervision of credit institutions (though the same clause excludes a role in supervising insurance companies). As part of the moves towards banking union, a direction given added momentum by the problems that arose early in 2013 in Cyprus, the single supervisory mechanism (SSM) was created and will become fully operational towards the end of 2014. It establishes a new 'quasi-

[14] The ESRB board brings together the central bank governors and high-level representatives of the financial supervisory authorities from all 28 EU Member States, as well as the President and Vice-President of the ECB, a member of the European Commission and the chairs of three ESAs.

federal' system in which the banks deemed to be systemically most important will be directly supervised by the ECB, while national supervisors will oversee other banks within their jurisdictions. To pave the way, the ECB has announced an asset quality review which will examine the soundness of banks. There is much speculation about the extent of non-performing loans amid differences among Member States in how these are counted.

The SSM will be composed of the ECB and national supervisory authorities. The initial proposal – put forward by the European Commission in September 2012 and the European Council agreement of December 2012 – assume a supervisory authority to become effective by March 2014, or anyway 12 months after the legislation enters into force, subject to operational needs.

In fact, after extensive negotiations between various stakeholders, on 12 September 2013 the European Parliament gave its final 'go-ahead' for the ECB to be fully entrusted with responsibility for the supervision of banks in the framework of SSM.[15] The SSM final legislation consists of:

- Regulation No. 7776/1/13, adopted on 19 March 2013, conferring specific tasks (Art 4 of the same Regulation) on the ECB concerning policies relating to the prudential supervision of credit institutions;[16] and
- Regulation No. 7775/13 amending Regulation No. 1093/2010 establishing the EBA.[17]

However, at the ESM's request and as a precondition for direct recapitalization, the ECB is already entrusted to supervise fragile banks directly, regardless of the starting date of the SSM. What is not clear is how this will affect countries which opt-in to banking union, but are not in the euro area and thus have no call on the ESM. The agreement on the SSM specified a clear mandate for bank safety and soundness to the ECB, and its accountability to the European Parliament and the Eurogroup. The ECB will directly supervise banks accounting for about 80 percent of euro-area banking assets, including banks with over €30 billion in assets or 20 percent of national GDP, or if otherwise deemed systemic, e.g., given cross-border reach (IMF, 2013). Banks receiving or explicitly requesting assistance will be targeted first.

At the ECB, a supervisory board and a steering committee are being created. The legal basis for the ECB's supervisory authority is provided by the TFEU stating that *'[t]he ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system'* (Art. 127(5) TFEU). The enabling clause in Art. 127.6, referred to above, states that *'[t]he Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings'* (Art. 127(6) TFEU).

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[15] 'An important step towards a real banking union in Europe'. Statement by Commissioner Michel Barnier following the trilogue agreement on the creation of the Single Supervisory Mechanism for the Eurozone. European Commission, 2013, Press Release. http://europa.eu/rapid/press-release_MEMO-13-251_en.htm?locale=en.For a timeline see also http://ec.europa.eu/internal_market/finances/banking-union/.

[16] Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions 2012/0242 (CNS).

[17] Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No…/… conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

The European Council agreement conferred broad investigatory and supervisory powers on the ECB, which is responsible for the effective and consistent functioning of the SSM. National authorities remain responsible for the banks remaining under their direct supervision. Possible concerns about a conflict of interest between the ECB's monetary policy and supervisory roles have been allayed by the creation of the separate administrative structure within the ECB, but there will manifestly be a need for building up its capacity to fulfil the latter role.

Guidance on the design of an effective mechanism is provided in the Basel Core Principles – part of the wider international effort to impose stricter regulation on the financial system.[18] According to these principles, a number of preconditions and prerequisites must be met at the euro area level, including: (i) the implementation of coherent and sound macroeconomic policies; (ii) an established framework for financial stability policy; (iii) a well-developed public infrastructure; (iv) an effective crisis management, recovery and resolution framework to deal with bank failures; (v) an adequate safety net to deal with confidence crisis and guarantee systemic protection; and (vi) effective market discipline. As underlined by IMF (2013), prerequisites to establish a sound basis for the SSM include: (i) operational independence of the SSM; (ii) clear objectives and mandates; (iii) legal protection of supervisors; (iv) transparent processes, sound governance and adequate resources; and (v) accountability. The relevant regulation seems to meet these prerequisites, albeit the risks of the SSM/ECB being trapped in a fiscal dominance game are potentially high.[19]

Finally, to facilitate identification and action on systemic risks, including the internalization of cross-border externalities, some shift in macroprudential mandates and tools is envisaged, away from Member States and toward the ECB. Differently from the ESRB's macroprudential oversight role,[20] the ECB is given binding powers to be able to use macroprudential instruments. Importantly, Article 15 of Regulation No. 7776/1/13 gives the ECB the possibility to impose administrative sanctions *'[i]n accordance with Article 132(3) TFEU and Council Regulation (EC) No. 2532/98 of 23 November 1998'.* In particular, *'in order to enable the ECB to effectively carry out its tasks relating to the enforcement of supervisory rules set out in directly applicable Union law, the ECB should be empowered to impose pecuniary sanctions on credit institutions, financial holding companies and mixed financial holding companies for breaches of such rules.'* While this is very different from the ESRB, Art 18(2) stipulates that the tasks conferred upon the ECB by Regulation 7776/1/13 *'shall […] not interfere with its tasks in relation to the European Systemic Risk Board or any other tasks.'*

Finally, the *'ECB may require the competent authorities of the participating Member States […] to provide all relevant information for the ECB to carry out a comprehensive assessment, including a balance-sheet assessment, of the credit institutions of the participating Member State'* (Art. 27(4) Regulation No. 7776/1/13). While necessary for conducting its supervisory role, balance-sheets assessments could result in a conflict of interest/institutional bias especially when the ECB acts in its liquidity provision role (i.e. lender of last resorts for banks).

[18] The so-called 'Core Principles for Effective Banking Supervision', September 2012; http://www.bis.org/publ/bcbs213.pdf .

[19] The ECB, in its role of lender of last resort for banks, could have incentives, *ex ante,* to minimize liquidity operations that constitute a risk to its balance sheet, while, in its SSM role, advocate larger ESM interventions than what a 'neutral' supervisor would do.

[20] While this is very different from the ESRB supervisory role, Art 18(2) anyway clarifies that the tasks conferred upon the ECB by the Council regulation *'shall moreover not interfere with its tasks in relation to the European Systemic Risk Board or any other tasks.'*

2.4 Institutional and political changes

As the reforms have progressed, the roles of several of the EU institutions have also evolved. New bodies have been created to undertake specific tasks and it is worth reflecting on how their composition bears on their governance role. For example, the ESRB is an EU28 body dominated by central bankers and chaired by the ECB President, whereas the ESM is euro area only. In addition, ad hoc bodies, such as the Troika made up of the ECB, the Commission and the IMF or the Task Force to oversee change in Greece, have been established.

The increased frequency of European Council meetings and the regular slots in its agenda for dealing with economic governance have strengthened its role as a centre of strategic decision-making in economic governance. While crisis management has inevitably been top of the agenda in many European Council meetings in recent years, there have also been meetings at which longer term topics have been to the fore – most recently (October 2013), for example, the Digital Agenda.

What is significant about such developments is that they alter the process of initiating new policies. On one side, relationships between the EU institutions are subtly changed, with the Commission arguably losing ground in taking initiatives, while acquiring an enhanced executive and monitoring role. On the other, national parliaments and finance ministries are increasingly constrained in what they can decide, because of the combination of top-down rules and oversight mechanisms.

Yet it is not obvious that the European Parliament has been able to exert democratic oversight on increasingly technocratic modes of governance. It should, therefore, be no surprise that proposals from the Commission and the President of the European Council for further moves towards 'genuine' EMU have highlighted the need for greater legitimacy and accountability, even if these proposals are, so far, couched in rather vague terms.

Another dimension of political change affecting governance might be termed 'battles of policy ideas'. At the EU level, these battles tend to be expressed as 'austerity against growth' or 'Keynesian versus neo-liberal', though these labels are typically far too crude to shed much light on what is at stake. Rather, the conflicts are over the appropriate sequencing for achieving growth, notably whether macroeconomic stability and sustainable public finances should be seen as a pre-condition or a consequence. One camp, usually associated with a 'German' viewpoint, argues that the crisis is a reaction to an economic model which relied on rising debt (whether public, private or both) to underpin growth, but was unable to cope with the inevitable debt bubbles. In this analysis, a process of debt reduction is unavoidable, however painful it might be, so as to put the economy back on a sustainable trajectory. The alternative reading, not surprisingly heard in southern Europe, but often also from US economists, is that over-enthusiastic austerity policies have become the medicine that kills rather than cures the patient and that a more measured approach should be introduced.

It is self-evident that an austerity/rules approach has become the dominant paradigm, but it has been increasingly challenged as a result of popular (often populist) reactions, as well as the analytic standpoint that excessive austerity is self-defeating. In this regard, the balance between, crudely, debtors and creditors cannot be overlooked.

In recognition of the potentially damaging effects of austerity policies, agreement was reached, as noted in section 2.2, at the June 2012 European Council on a new Compact for Growth and Jobs. The Compact will, in principle, mobilise additional resources for economic

development, including through EIB lending and project bonds to complement Cohesion Policy investments in infrastructure. The Commission proposed using the proceeds of a financial transactions tax to finance growth enhancing investments. Many of the elements of this new initiative were discussed in a Commission communication[21] which sought to identify ways 'to unlock our growth potential, to open up opportunities for business development and tap the potential of new sources of jobs, for instance in the green economy, services, energy sectors, tourism, and in the digital economy as well as to raise the skills and innovation levels. Action is urgently needed to sustain recovery and living standards and to help tackle the challenges of ageing'. The communication also claims that 'meeting our climate change and energy targets by 2020 would generate up to five million jobs, increase Europe's energy security and help meet our climate change goals'. While such claims are carefully hedged and have to be treated with some caution, especially when the evidence suggests that little progress has been made, the Compact points to a 'high road' to structural reform, rather than just bearing-down on labour costs.

Efficiency gains as a means of bolstering competitiveness appear to be the primary rationale, rather than traditional cohesion goals, but progress has been limited (Commission, 2013c). Cohesion Policy is nevertheless mentioned as a source of funding for growth and the communication emphasises the extent to which, in 2012-13, Cohesion Policy had been reprogrammed to support growth and jobs, with a boost to spending on research and innovation, support for SMEs and labour market measures for vulnerable people together with investments in infrastructure and energy efficiency. Similarly, the use of Structural Funds to counter youth unemployment is highlighted.

2.4.1 The European Commission

The role of the Commission has changed in a number of ways, some of which are evolutionary in the sense that there has been a strengthening of its capacity to undertake existing tasks, while some are new. Yet the fact that some reforms, such as the Fiscal Compact, are under a separate inter-governmental treaty could be interpreted as a loss of influence for the Commission. Equally, it is clear that the Commission will have to provide some of the relevant support and analysis.

With the change to reverse majority voting to the SGP, the balance between the Commission and the Council has shifted away from the latter, and the more graduated sanctions also make their imposition more likely. Among the more significant changes in the Commission role are the new obligations covering the Semester, the enforcement of the MIP and scrutiny of the budgets of euro area Member States. In addition, the second element of the Two-Pack spells out how the Commission is to monitor the policies of countries facing financial difficulties, while the Commission involvement in Troika crisis missions. Though less visible at present, the Commission must be expected to play a prominent part in structural policies, including the Europe 2020 strategy.

2.4.2 The ECB

A potentially significant development for the ECB as an actor in the governance framework is its participation in the **Troika** missions for Member States subject to adjustment programmes. Here, the role of the ECB has been to help design and monitor, in liaison with the Commission and the IMF, the economic conditionality in the context of EU-IMF

[21] 'Action for Stability Growth and Jobs', COM(2012) 299 final, Brussels, 30.05.2012.

macroeconomic adjustment programmes in distressed euro-area countries.[22] This additional role of the ECB relates to the macroeconomic surveillance capacity and followed a European Council statement of 11th February 2010.

While the IMF model of assistance is rather straightforward – requesting a country to implement policies that are aimed at: (i) correcting the imbalances that led it to request assistance; and (ii) ensuring that the country will be able to repay the IMF, without resorting to measures that are harmful to itself or to its trading partners – EU conditionality is (also) to serve the purpose of *'safeguard[ing] the financial stability of the euro area as a whole and of its Member States.'* (Art. 3 of the Treaty Establishing the European Stability Mechanism).

ECB competences in this respect have been formalised and broadened by the Treaty Establishing the European Stability Mechanism. In fact, once a financial assistance programme has been approved, the ESM is expected to activate a stability support programme (ESM stability support programme) in the form of a loan to the requestor country. The assistance programme is conditional on agreement to, and compliance, with a strict macroeconomic adjustment programme, as set out in the Treaty on Stability, Coordination and Governance (TSCG). In fact, only countries having signed the TSCG can ask for ESM financial assistance, and the ESM only applies to the euro area. The TSCG, mandating – in its fiscal part (Fiscal Compact) – all countries to enshrine balanced budget rules and an automatic correction mechanism into national law (ECB, 2012),[23] ensures that governments retain the right incentive to implement the necessary fiscal tuning and structural reforms.

Importantly, the ECB does not publish independently its own assessment about the economic and political situation in a programme country, the progress with the implementation of the programme, or its assessment of the programme itself.

The role of the ECB in participating in the design and monitoring of financial assistance programmes has been harshly criticized. In particular, it has been pointed out how the ECB may suffer from an institutional bias both during the negotiation and implementation stages with a Member State owing to its liquidity provision role, institutional role and mandate (see European Parliament, 2012).

Finally, the ECB can play a role in surveillance missions within the **Macroeconomic Imbalances Procedure** (MIP) (Article 121(6) of the TFEU), in the context of the legislative package agreed between the EU Council and the Parliament (the Six Pack, entered into force in December 2011). The Pack limits the discretion of national authorities, backed up by sanctions (as contained in the Excessive Deficit Procedure). Article 9 of Regulation No. 1176/2011 on the 'prevention and correction of macroeconomic imbalances' in particular says that *'[t]he Commission may carry out enhanced surveillance missions to the Member State concerned, in order to monitor the implementation of the corrective action plan, in liaison with the ECB when those missions concern Member States whose currency is the euro […]'*. Article 13(3) further clarifies the role of the ECB in these surveillance missions saying that *'[…] the Commission may, if appropriate, invite representatives of the European Central Bank to participate in surveillance missions'* directly.[24] The results of such in-depth reviews (also with the participation with the ECB)

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[22] Countries outside EU-IMF programmes have been asked also to implement major reforms (e.g., Spain and Italy).

[23] The TSCG was signed (by all EU members, excluding the UK and the Czech Republic) in March 2012 and subsequently by Croatia.

[24] Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011.

shall be made public, albeit the ECB will not publish its own independent assessment. As for other macroeconomic surveillance roles, the ECB is hence given under the MIP a 'low profile' function (Darvas and Merler 2013).

With regard to the possible resort to Article 143 balance of payments support (COM(2012)0336 - the 'BoP proposal'), the ECB considered it should have less involvement in the preparation of the adjustment programmes and deemed it 'inappropriate' to assume such a role for a non-euro area Member State. Therefore, in its opinion of 7 January 2013 (CON/2013/2), it suggested a configuration which entails involvement at its own discretion. In particular, it required both Member States (Art 3.3 on the draft of macroeconomic adjustment programmes) and the Commission (Art 3.8 – concerning the changes that may be needed to each Member State's macroeconomic adjustment programme) to take 'into account the view of the ECB, should the ECB decide to give advice in this respect' only.[25]

2.4.3 The European Parliament

The European Parliament will have a crucial role in legitimising an economic governance system which has become more complex and in which the EU level has broadened its role. However, in holding the executive to account, several distinctive aspects of the system have to be accommodated. A critical one is that the European level has multiple definitions. Cohesion Policy, the preventive arm of the Stability and Growth Pact and macro-prudential supervision, for example, operate across the EU28; the oversight of national budgets through regulation 473/2013 applies to the euro area, as do the corrective arms of the Macroeconomic Imbalances Procedure and the SGP; the single supervisory mechanism has elements applicable to both the EU28 and the euro area; while the Fiscal Compact and the coordination provisions of the TSCG apply to 26 Member States.

Since the European Parliament is unambiguously an EU28 body, the scrutiny process will need to be flexible when confronted with euro area governance. Plainly, this is nothing new, insofar as the Economic and Monetary Affair (ECON) Committee has had to juggle with this conjunction since the start of the euro in its scrutiny of the ECB and, indeed, is currently chaired by an MEP from a non-participating Member State. But the substantial extension of the Commission role will accentuate the challenge, as discussed when United Kingdom MEPs were heard by the UK House of Lords.[26]

Although the REGI Committee's primary focus on Cohesion Policy means that it oversees an EU28 policy, the likely introduction of the new Convergence and Competitiveness Instrument[27] could raise difficulties if the new instrument is limited either to the euro area or the TSCG signatories. Similarly, the imposition of measures linked to sound economic governance on disbursement of the Structural and Investment Funds, in which some of the conditions may arise from euro area mechanisms, yet be applied to an EU28 policy, could complicate the tasks of the Committee.

2.5 The overall governance model

Taken together, the many changes in economic governance will result in a framework for policy-making that will circumscribe the room for manoeuvre of decision-makers and create

[25] For further details see http://ec.europa.eu/prelex/detail_dossier_real.cfm?CL=en&DosId=201752.

[26] Inquiry: Genuine Economic and Monetary Union, Hearing of the EU Sub-Committee on Economic and Financial Affairs, House of Lords, United Kingdom, 25th October 2013.

[27] 'Towards a Deep and Genuine Economic and Monetary Union: The introduction of a Convergence and Competitiveness Instrument', COM(2013) 165 final, Brussels, 20.3.2013

new obligations, and it is clear that much closer coordination of policy-making is foreseen. Indeed, the update report prepared by the cabinet of the European Council President in June 2013 spells out what such coordination is supposed to achieve and the principles it should follow. The note stresses:

- the capacity of economies to adjust to shocks as an objective, which can be understood as enhancing resilience;
- that coordination is especially important where there are cross-border spillovers;
- the importance of embedding it in existing EU procedures and of respecting the provisions of article 11 of the TSCG; but also
- that national ownership of reforms is crucial.

One of the key features of the evolving model of economic governance is the advent of the European Semester – identified in the June cabinet note as the critical procedure and reiterated in notes for a Sherpa meeting in November 2013 – which has become both a template for what policy needs to take into account and a crucial influence on the timing of decision-making. By structuring the governance system in this way, it has changed the modalities of surveillance by the EU level and has accentuated the need for regular dialogue between the Commission (above all) and the Member States. In practice, therefore, the EU institutions have collectively acquired a greater say in national policy-making, albeit with a number of unresolved and difficult questions about where the precise boundary should lie.
The Commission, in particular, has become more pivotal, intervening at different stages of the annual cycle around the European Semester, as set out in Box 2 which shows that the Semester is in fact a year round mechanism. Similarly the ECB has (notably with OMT) introduced more explicit conditionality. By contrast, the roles of the European Parliament and, more so, national parliaments are not always well-defined, and their opportunities to intervene in a timely manner are often limited.

While many of the Semester obligations apply most emphatically to the euro area countries, they also have an impact on non-participating Member States, especially where the latter have chosen to opt-in to governance mechanisms such as those covered by the TSCG or the emerging banking union. Nevertheless, it can be argued that the much closer scrutiny of euro area countries will reinforce the trend towards differentiation in governance. It, arguably, also makes it more likely that non-compliance – one of the main flaws in the original EMU system – will be mitigated, because there are more points at which Member States have to explain and account for their policy actions. The other side of this coin is that there will be less opportunity for national authorities to exercise discretion in policy.

Box 2: The timing and incidence of the Semester

Semester action	Timing	Incidence
Annual growth survey	Late autumn	All Member States
Initial bilateral meetings between Commission and Member States on implementation of Country-Specific Recommendations	Early in year	All Member States
European Council annual assessment and broad guidelines	March	All Member States
In depth reviews published	April	Selected Member States
Updated national reform plans, following bilateral meetings between	Spring	All Member States

Semester action	Timing	Incidence
MS and Commission		
Country-specific recommendations	Spring > summer	All Member States
Commission bilaterals with MS on implementation of reforms		
Draft national budgets	October 15th	Euro area excl. MoU countries
Commission verdict on budgets	Late autumn	Euro area excl. MoU countries

In addition, there is increasing resort to binding commitments on the part of Member States. These can be explicit, as in the Macroeconomic Adjustment Programmes of countries receiving financial assistance or the Corrective Action Plans agreed by countries subject to the excessive (macroeconomic) imbalances procedures, as well as to excessive deficits procedures. What these have in common is that they involve a prescribed course of action, backed-up by the threat of hard penalties (fines or withholding of funds) if they are not respected. What might be called the 'contractualisation' of governance is, however, a trend that is not well accepted in some Member States. For example, Hacker (2013) notes that France is very wary of the idea, whereas Germany and other 'northern' Member States are more comfortable with it and see it as a vital means of ensuring compliance with governance commitments.

As is explained in greater detail below, the contract principle – already well-established in Cohesion Policy – is being put forward by Germany and like-minded Member States as a possible means of addressing concerns about moral hazard in a putative new solidarity mechanism. The idea of contracts attracts support on both sides of the political fence in Germany and reflects a growing exasperation at the lack of compliance by so many Member States with the soft forms of coordination that have prevailed hitherto. For example, outgoing ECB Board member Jörg Asmussen – an SPD member, now serving in the new coalition government – observed in November 2013 that 'only one tenth of last year's country-specific recommendations have been implemented by the member states. We need to explore all possible avenues to give greater 'teeth' to the economic coordination processes. To our mind, the idea of reform contracts backed up by some financial incentives continues to be an interesting avenue'.[28]

[28] Speech at the Danske Bank Financial Forum, Stockholm, 5th November 2013.

3. CONSEQUENCES FOR COHESION POLICY

The changes to the EU's economic governance framework have important consequences for Cohesion Policy. Insofar as the economic governance reforms aim to provide a sound, stable and sustainable macroeconomic environment, the implications for Cohesion Policy are positive in providing a climate that is supportive for public and private investment and in maximising the effects of co-funded interventions. The problem, in the short term at least, is that the adjustment costs of fiscal consolidation will inevitably bring pressure to bear on public finances and Cohesion Policy co-financing. There are also governance challenges associated with the establishment and/or empowerment of economic governance actors, the need to re-prioritise or reshape Cohesion Policy strategies and projects and the administration of new requirements. This section clarifies the mechanisms through which economic governance will affect Cohesion Policy, discussing the risks and opportunities arising from the governance changes.

3.1 The changing role of the ECB

3.1.1 Monetary policy

As explained in section 2.1, the ECB is obliged to support the EU's general economic policies and objectives (as set out in Article 3 of the Treaty). These objectives include balanced economic growth, full employment and, crucially, economic, social and territorial cohesion, and solidarity among Member States. Yet the ECB's primary monetary policy objective of price stability may conflict with cohesion. Future interest rate rises to reduce inflationary pressure in core Eurozone countries could be harmful for the troubled peripheral economies by dampening aggregate demand, aggravating recession and increasing the real value of debt. Equally, interest rate cuts to curb deflationary pressures may not benefit the troubled countries because the monetary policy transmission mechanism in the Eurozone depends on banks, which have been less willing to lend to businesses in the most vulnerable and high-risk countries.

Nevertheless, the ECB's overriding objective of maintaining price stability contributes to economic stability which is, in turn, beneficial for cohesion. As DG ECFIN notes,[29] 'volatile changes in inflation and interest rates increase the gap between the richer and poorer groups and regions, as those with more wealth have more opportunities to protect themselves. With stable inflation and interest rates, the less well-off are better protected against the erosion of their wealth, their savings and their purchasing power.'

3.1.2 Liquidity operations and rescue funds

The likely implications of the new liquidity operations of the ECB (the OMTs) for Cohesion Policy – in the event that any Member State chooses to request them, which so far none has done – are mixed. On the one hand, bond purchases facilitate liquidity for governments by bringing bond yields and borrowing costs down (as occurred in Italy and Spain), and therefore can facilitate the co-financing of Cohesion Policy by national governments requiring such assistance. It is important to recognise that this 'unconventional' monetary policy action leads to tangible welfare gains for recipient Member States, even though it is not a visible and explicit transfer. On the other hand, the conditions that accompany the liquidity operations, linked to ESM assistance programmes, require fiscal/structural

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[29] See: http://ec.europa.eu/economy_finance/euro/why/stability_growth/index_en.htm

reforms, which restrict the ability of governments to co-finance Cohesion Policy investments. The counter-argument, and underlying rationale of conditionality, is that compliance should - over time - improve fiscal performance and provide a more stable economic environment, which would facilitate the co-funding and enhance the effectiveness of Cohesion Policy.

As with liquidity operations, rescue funds tied to adjustment programmes can provide much needed liquidity for troubled economies. The conditionality strings attached to adjustment programmes – although of second-order importance compared to the governance conditions for 'normal circumstances' - provide for strong external involvement and oversight from EU institutions. The Cohesion Policy regulatory framework for 2014-20 explicitly empowers the Commission to request revisions to Partnership Agreements and OPs to support ESFS/ESM conditions and recommendations. Similarly, an accompanying MoU is likely to include conditions and requirements for Cohesion Policy (e.g. to speed up absorption or reallocate funds, as was the case in Greece and Portugal). While the adjustment programme's fiscal and structural reform conditions are intended to contribute to a sound macroeconomic and structural framework, public finance consolidation requirements will inevitably reduce economic development expenditure and potentially increase co-financing challenges. As Prota and Viesti (2013) have emphasised 'Expenditure cuts in the context of fiscal consolidation strategies have happened mainly at the cost of public investments, the expenditure category expected to be growth-enhancing, exactly the opposite of what the current economic situation of many European countries would have called for.' Further, if the conditions of the adjustment programme are breached, suspensions to Cohesion Policy funding can be applied by the Council, Commission and Board of Directors of the ESM (including ECB representation).

3.2 Reforms of the governance of economic policy

3.2.1 Fiscal and macroeconomic discipline and surveillance

The most direct consequence of the strengthened fiscal discipline and surveillance for Cohesion Policy is the extension and strengthening of the principle of macroeconomic conditionality to all European Structural and Investment Funds. Member States would have to propose revisions to Partnership Agreements and OPs in response to Council recommendations or address excessive deficits, macroeconomic imbalances or other economic and social difficulties. They would potentially face finanical suspensions for non-compliance with economic governance procedures.

Pressure on governments to reduce deficits and to take greater account of the quality of public finances will have the greatest impact in the heavily indebted countries. As noted, this may also affect the approach governments take to incurring debt in order to finance public investment by encouraging investment in projects which yield a rate of return high enough to finance the debt incurred. This logic underpins the new 'investment clause' under the SGP, which allows temporary deviations from mid-term objectives for Cohesion Policy growth-enhancing investments under certain conditions. However, of the four Member State applications to use the investment clause in 2014 (by Bulgaria, Italy, Romania, Slovakia), two have been rejected (Italy and Slovakia) and decisions had not yet been taken at time of writing for the remaining countries (Bulgaria, Romania). Moreover, the overriding objective of the SGP is to bring debt down which inevitably increases the pressures on the national co-financing of Cohesion Policy.

3.2.2 The influence of the Europe 2020 strategy

In addition to the implications for spending on economic development and national co-financing of Cohesion Policy, the economic governance reforms also have implications for the objectives and priorities of ESI Fund programmes. This process was initiated by the Lisbon strategy, with limited effect in 2000-06 but more significance in 2007-13 when programmes were developed with reference to Community Strategic Guidelines (flowing from the Integrated Strategy for Growth and Jobs) and minimum levels of expenditure on 'earmarked' expenditure categories. However, the National Strategic Reference Frameworks developed by Member States often had little strategic value and generally made limited or no reference to National Reform Programmes, while earmarking requirements were undermined by the flexibility of category definitions (Mendez 2011).

The Europe 2020 strategy for smart, sustainable and inclusive growth increases the focus of Cohesion Policy on supply-side structural reforms, with a series of overarching guidelines, targets and flagship initiatives within the European Semester process. At the top of the strategic planning architecture for 2014-20 is the Common Strategic Framework, which translates the Europe 2020 strategy into a series of thematic objectives, governing principles and indicative actions for all of the ESI Funds. The purpose is to provide a strategic reference framework for the programming of Partnership Agreements and Operational Programmes. Unlike the previous Community Strategic Guidelines, the CSF would not only apply to the ERDF, CF and ESF but also to the EAFRD and EMFF, and it makes more explicit links to other EU policies and the new Flagship Initiatives. Building on the earmarking approach in 2007-13, the main operational mechanism for ensuring financial concentration on Europe 2020 themes is the ring-fencing of expenditure to RTDI, SME competitiveness, low-carbon-economy and social inclusion objectives. The programming should also take account of the headline targets, in those countries that have signed up to them, and Council recommendations issued under the European Semester process.

The relevance of the Funds to the Flagship Initiatives (FIs) varies according to their respective missions and thematic foci (Tödtling–Schönhofer *et al.* 2013). The ERDF has relevance for all seven Flagship initiatives, especially to the 'Digital Agenda,' 'Innovation Union' and 'Industrial Policy'. The 'Skills and Jobs' and 'Poverty' FIs are mainly supported by ESF, whereas 'Youth on the Move' is less directly linked, being mainly supported by other EU funding streams. The ESF plays a more indirect role in the Flagship Initiatives for 'Innovation Union', 'Digital Agenda' and 'Industrial Policy'. The Cohesion Fund, which supports investments in basic transport and environment infrastructure, has less direct relevance for the initiatives, with the exception of the FI 'Resource-efficient Europe'.

The question is whether the programming and management of Partnership Agreements and OPs for Cohesion Policy spending in 2014-20 fulfils the expectations of Europe 2020. The Commission insists that it will be taking a rigorous approach to assessing the quality of programmes and compliance with regulatory expectations (Hahn 2013). Equally, Member States have already made clear that they are looking for 'flexibility' in areas like thematic concentration, ex ante conditionalities and performance obligations. When the programmes are eventually launched, the Commission and Council have the tools to hold Member States to account as part of progress reporting and the European Semester process. However, the experience of the 2007-13 period with strategic reporting – and the reticence of the Commission in being directly critical of Member State performance in implementing Cohesion Policy – is not a good precedent.

3.2.3 Crisis management via the Troika and the task forces

Crisis management has involved greater Troika oversight and the setting-up of dedicated task forces to reshape Cohesion Policy strategies. For Greece, the impact of this additional oversight was initially double-edged (Tsipouri and Roubliova 2010; Tsipouri and Athanassopoulou 2012). There were negative impacts in that government attention was focused on international monetary markets and Troika negotiations, diverting attention from Cohesion Policy implementation, while restrictions on public finance constrained public investment. More positively, necessary structural reforms were introduced, including the promotion of foreign and domestic investments, and the taskforce sought to speed up Cohesion Policy absorption and reprioritise funding to the most important priority areas. Similarly, a task force between the Commission and Italy supported a major reprogramming of the NSRF – dubbed the 'Cohesion Action Plan', to concentrate funding on key strategic priorities. Hands-on support has also been provided to Bulgaria, Romania, Portugal and the Slovak Republic, with varied success, but viewed positively overall by the Commission (European Commission, 2013d). While not referring to Cohesion Policy *per se*, the European Parliament's Economic and Financial Affairs Committee has been critical of the Troika's working methods, particularly in terms of its poor forecasting record and lack of accountability (European Parliament 2013).

3.3 Financial regulation changes

The crisis has constrained private sector participation in Cohesion Policy in some countries because of subdued demand, deleveraging of the financial sector and pressures on bank lending, which provides the main source of external financing for business investment and an important source of match-funding for Structural Funds grants. New bank loans and credit to businesses have fallen substantially, especially to SMEs, and are likely to remain constrained by tighter bank conditions in the future. The supply and affordability of bank loans is especially problematic in the Member States facing the strongest market pressure.

Changes to financial regulation at EU level could help to address the fragmentation in banking/financial services across the EU and promote more uniform financing conditions for SMEs. The Commission, EIB and ECB are currently considering options for reviving the structured credit markets to support SME lending particularly to the more vulnerable Member States. Proposals include a joint risk-sharing mechanism combing 2014-2020 EU budget resources (under COSME, Horizon 2020) and Cohesion Policy funding with the lending capacity of the EIB, EIF and national promotional banks (Commission and EIB 2013).

3.4 Institutional and political changes

The establishment of certain new bodies, such as the ESRB, will not have obvious direct implications for Cohesion Policy, other than through what they imply for economic management at the national level. By contrast, the Troika and Task Forces have already taken on an active oversight role in troubled economies, with direct influence over use of Cohesion Policy in several countries.

The role of the European Council as a centre of strategic decision-making in economic governance may be strengthened, but the main inter-governmental body overseeing Cohesion Policy is the General Affairs Council. The main change for the future is more frequent meetings (every two years) to discuss the implementation and results of the ESI Funds and to provide input to the Spring Council's overall assessment of all EU policies to deliver Europe 2020 goals (European Council 2013).

The Commission in turn is likely to have a stronger executive and monitoring role of Partnership Agreements and OPs, at least with respect to macroeconomic compliance and in countries receiving financial assistance and under adjustment programmes. This applies not only to the main Funding DGs, but also to other relevant sectoral DGs and especially to DG ECFIN. At project level, the Commission will also have a more extensive role in the ex-ante appraisal of major projects over the value of €50 million (European Council 2013).

It is not clear how the European Parliament will be affected by these changes. The lack of involvement in economic governance processes has been a frequent criticism of the Parliament whose tasks have been reduced to economic dialogue and inter-parliamentary co-operation (Fasone 2013). With respect to Cohesion Policy, the Parliament's role in the implementation of measures linked to sound economic governance (formerly termed macroeconomic conditionality) under Article 23 of the Cohesion Policy framework regulation appears to be limited to being kept informed of the application of the Article by the Commission. During the regulatory negotiations, the Parliament called for a legislative role in decisions on macro-conditionality sanctions, but in the end will only be able to invite the Commission to explain its reasons for suspending ESI Fund commitments or payments.

4. THE ROLE OF COHESION POLICY IN REALISING MACROECONOMIC GOVERNANCE AIMS

The primary objective of EU Cohesion Policy is to strengthen economic, social and territorial cohesion in the EU. At the same time, Cohesion Policy contributes to wider macroeconomic governance objectives in the EU: compliance with macroeconomic rules; supporting recovery from crises; and financing investment linked to Lisbon/Europe 2020 goals, as well as enhancing the territorial dimension and coordination. This section investigates the means by which Cohesion Policy can shape the outcomes of the governance reforms and what they imply for the focus of Cohesion Policy.

4.1 Macroeconomic compliance

4.1.1 The lessons of the Cohesion Fund

One of the key shifts in governance has been the increasing importance of macroeconomic conditionality (Verhelst, 2012). Conditionality is not entirely new in Cohesion Policy, being a founding principle of the Cohesion Fund for two decades. It is therefore instructive to review the experiences and challenges faced in the practical application of the principle to the Cohesion Fund and the lessons for the future.

The creation of the Cohesion Fund was agreed by the heads of state under the Maastricht Treaty of February 1992 linked to the agreement on economic and monetary union. The Cohesion Fund would support infrastructure projects in Member States with a per capita GNP of less than 90 percent of the Community average (i.e. at the time, Greece, Ireland, Portugal and Spain) and which had a programme leading to the fulfilment of the EU's economic convergence conditions relating to government deficits. The principle of macroeconomic conditionality foresaw financial suspensions to new projects or new parts of projects if excessive deficit rules were breached (Council Regulation 1164/94). Reforms to the principle in 1999 and 2006 sought to clarify the decision-making procedure and timing of suspensions by requiring a qualified majority vote in the Council to implement suspensions to annual commitments the following year.

The historical record suggests that use of the Cohesion Fund as a preventative and sanctioning tool for pursuing EU macroeconomic goals has been of mixed value. Some countries have complied with Cohesion Fund conditionality requirements all of the time, namely Ireland – which was eligible for Cohesion Fund assistance between 1993 and 2006, before the crisis hit - and Estonia since its accession in 2004. The remaining Cohesion-4 countries and EU12 Member States have complied for some of the time, although most have been under an excessive deficit procedure since the crisis. When the Fund was first set-up in 1993, Greece, Portugal and Spain did not comply with the three percent deficit target for several years, but deficit and debt levels fell over time in line with the Council's recommendations.

The main driver of the improving fiscal performance was arguably the wider conditionality – the EMU convergence criteria - associated with the adoption of the single currency in 1999, although macro-conditionality may have played a supporting role. For instance, there is some evidence of a 'naming and shaming' effect on Spain in 1995 following the discovery of non-compliance and concerns about the potential loss of reputational credibility in the financial markets if Cohesion Fund suspensions were implemented (Vidal-Folch 1996; Borras 1998).

From a more critical perspective, the unwillingness of EU institutions to enforce sanctions despite breaches of deficit rules in some eligible countries suggests that macroeconomic conditionality has been a blunt tool. This can be partly explained by the discretion available to the Commission and Council to enact sanctions as well as the weakening in the credibility of the Stability and Growth Pact in the early 2000s.

Following the crisis and the strengthening of the EU's economic governance framework, a tougher stance has been taken by the Commission and Council, reflected in the first ever decision to suspend Cohesion Fund support to Hungary in 2012. This decision was revoked soon afterwards following the adoption of new measures by Hungary to reduce its deficit. It is difficult to assess whether the decision to suspend Cohesion Fund commitments played a significant role in the efforts of Hungary to improve its fiscal performance. The parallel conditionality pressure from a balance of payments assistance programme to Hungary tied to fiscal consolidation/surveillance may have had more influence, and domestic pressures for improving the sustainability of fiscal policy may also have played a part.

There is a further question as to whether sanctioning *commitments*, as in the case of Hungary, is a much milder penalty than sanctioning *payments*. The latter may stop project activity because the money to reimburse projects is not paid, while sanctioning commitments may only delay approvals. Further, suspensions of commitments would allow Member States and regions to continue implementing the Operational Programmes (OPs) based on payments from open commitments of previous years.

Finally, there is a wider issue about the political difficulty of following through on sanctions linked to deficits, when sanctions would make the fiscal situation worse. This may explain the reluctance of the Commission and Council to propose suspensions of the Cohesion Fund to Greece, Portugal or Spain in recent years. It also raises the problem of double standards, given that a suspension decision was adopted for Hungary, but not for these other countries that also failed to comply with agreed country-specific fiscal targets.

4.1.2 Macroeconomic conditionality in 2014-20

The 2013 reform of Cohesion Policy has reinforced and extended the principle of macroeconomic conditionality to all of the ESI Funds. The idea originated in the Commission's 2010 proposals for reinforcing EU fiscal surveillance and SGP compliance in the context of the Eurozone crisis (European Commission 2010a) and was subsequently included in the Fifth Cohesion Report proposals on Cohesion Policy reform (European Commission 2010b) and the formal legislative proposals (European Commission 2011).

The principle is codified in a specific chapter on 'measures linked to sound economic governance' in the Common Provisions Regulation (European Parliament and Council 2013, Chapter IV), which set outs two main requirements.

Member States will have to propose **revisions to Partnership Agreements and Operational Programmes** to support Council recommendations, or to address an excessive deficit, macroeconomic imbalances or other economic and social difficulties, or to maximise the growth and competitiveness impact of the ESI Funds for Member States receiving financial assistance from the EU. To minimise the administrative disruption, such requests cannot be made before 2015 or after 2019, nor in relation to the same programmes in two consecutive years. If a Member State does not respond 'satisfactorily' to the request for PA/OP revisions, the Commission may propose to the Council to suspend a part or all of the payments to the Member State concerned.

Suspensions of commitments and payments will be applied where a Member State fails to take corrective action in the context of the economic governance procedures under the following circusmtances:

- the Council decided that there had been non-compliance with measures proposed to strengthen the coordination and surveillance of their budgetary discipline or economic policy guidelines;
- the Council decided that there had been non-compliance with EU budgetary discipline requirements, notably actions for effective correction of an excessive deficit;
- the Council concluded that, on two successive instances, the Member State had not submitted a sufficient corrective action plan to address excessive macroeconomic imbalances or the Council adopted a decision declaring non-compliance;
- the Commission concluded that the Member State had not taken measures to implement the adjustment programme and decides not to authorise the disbursement of financial assistance granted; and
- the Board of Directors of the European Stability Mechanism concluded that the conditionality attached to an ESM financial assistance was not met and decided not to disburse the stability support granted to it.

Suspensions would be 'proportionate and effective, and respect equality of treatment between Member States, in particular with regard to the impact of the suspension on the economy of the Member State'. These circumstances were clarified following the conclusion of inter-institutional negotiations with the European Parliament by specifying several criteria to be taken into account in a new annex to the regulation (set out below).

Clarification on how financial suspensions will work in practice was provided in the European Council agreement of February 2013 on the Multi-annual Financial Framework and after the final trilogue with the European Parliament.

- Decision-making: proposals to suspend commitments would be made by the Commission and considered automatically adopted by the Council, unless the Council rejected the Commission's proposal by a qualified majority within one month. This is the same as the reverse qualified majority voting (RQMV) described in section 2.2, and provides the Commission with more decision-making power. By contrast, a decision to suspend payments would require an explicit QMV decision by the Council, on a proposal from the Commission. Following the conclusion of the inter-institutional negotiations in November 2013, the Parliament was granted the right to participate in all stages of the decision-making process on financial suspensions through a 'dialogue' with the Commission, although not involving co-decision or veto power over these decisions as the Parliament original requested.
- Priority to suspending commitments: priority would be given to the suspension of commitments rather than payments, the latter would only be suspended when immediate action was needed and in cases of 'significant' non-compliance.
- Double Capping: commitment suspensions would be up to 50 percent of the ESI Funds in the case of a breach under the 'excessive deficit procedure' and up to 25 percent in the case of an 'excessive imbalance procedure', rising to 100 percent and 50 percent respectively in line with the seriousness of the breach. Suspensions would also be subject to nominal caps of GDP, also varying according to the two procedures: 0.25 percent of GDP for excessive imbalances, and 0.5 percent of GDP for excessive deficits.

Beyond the double capping rule, further conditions and exceptions to minimise the economic impact of suspensions are specified in Annex III of the Common Provisions

Regulation. Specifically, suspensions can be reduced by 15-50 percent if the Member State concerned has a relatively high rate of unemployment, poverty/social exclusion or experiences a contraction of GDP for two or more years. Reductions would also apply if the suspensions are triggered during the last three years of the programme period, in 2018 (by 15 percent), 2019 (25 percent) and 2020 (50 percent).

Table 1: Economic and social conditions affecting the level of suspensions to commitments

Indicator	Reduction in suspension
Unemployment rate 2 percentage points above EU average during the year preceding the suspension trigger	15%
Unemployment rate 5 percentage points above EU average during the year preceding the suspension trigger	25%
Unemployment rate 8 percentage points above EU average during the year preceding the suspension trigger	50%
Share of people at risk of poverty or social exclusion 10 percentage points above EU average during the year preceding the suspension trigger	20%
Real GDP decline for 2 or more years	20%

Source: Based on Regulation 1303/2013, Annex III.

Regarding the scope of application, the suspensions would apply to all of a Member State's programmes and priorities proportionately excluding those that:

- are already subject to a suspension decision for not complying with PA/OP review requests,
- have had an increase in funding as a result of a reprogramming request addressed by the Commission in the year of the trigger event or within 2 years of an approved reprogramming decision;
- are of critical importance to addressing adverse economic or social conditions, namely supporting the Youth Employment Initiative, Council recommendations under the European Semester, or related to priorities supporting poverty reduction or to financial instruments for SMEs.

The macroeconomic conditionality provisions have been one of the most contested and divisive issues in the legislative negotiations. It was one of the 'red lines' of the European Parliament up until the final trilogue negotiations, but it failed to get support from any Member State to block the Commission's proposals, even though many Member States openly criticised the proposals during the agenda-setting phase and formal negotiations. The main criticisms raised were as follows.

- **Tension with cohesion goals.** Macroeconomic sanctions cannot be reconciled with the Treaty objectives of Cohesion Policy - to provide financial support for growth and jobs in countries and regions with the greatest needs.
- **Fairness.** Regions and beneficiaries would be punished because of failures of the central governments, which they could not influence.

- **Equality of treatment.** Less-developed countries and regions would be disproportionately affected by sanctions given their higher allocations under the ESI Funds.
- **Effectiveness.** Only those countries benefitting mostly from the Funds would be motivated to conduct prudent macro-fiscal policies.
- **Double jeopardy.** Stronger enforcement of sanctions/fines is already envisaged in the Six-Pack regulations, implying that macroeconomic conditionality in Cohesion Policy would introduce yet another penalty for the same offence.
- **Subsidiarity.** A number of Member States consider that the proposals would grant too much power to the Commission by allowing it unilaterally to amend Partnerships Agreements and Operational Programmes.

As noted, the rationale for strengthening macroeconomic conditionality was of an external nature, to reinforce EU fiscal surveillance and SGP compliance in the context of the Eurozone crisis, as explained in detail in Section 2. The motivation has also been framed in more positive terms relating to Cohesion Policy effectiveness: 'to ensure that the effectiveness of the funds is not undermined by unsound macro-fiscal policies' (European Commission 2011: 8). A recent econometric study by European Commission staff at DG ECFIN offers empirical support for this argument (Tomova *et al.* 2013), finding that the impact of Cohesion Policy on socio-economic objectives has been greater in EU27 countries with sound macroeconomic and fiscal policies in terms of low levels of government debt and net foreign liabilities.

A final argument that has been used to justify macroeconomic conditionality by the Commission (DG REGIO) is that it is in the long-term interests of Cohesion Policy to be firmly integrated into the EU's economic governance architecture rather than isolated. This remains to be seen. If a strict approach is adopted and financial suspensions are used on a regular basis, perceptions and support for the policy could weaken, as has occurred with the proliferation of audit activity, financial corrections and interruptions to address financial non-compliance in recent years (Mendez and Bachtler 2011). The real value as a deterrent would be if it ensures compliance yet is never used. The requirement to take account of the economic and social circumstances of the non-compliant Member State could prove to be important in this respect, notably in preventing the imposition of sanctions on distressed economies in a crisis situation.

4.2 Macroeconomic stabilisation

In the aftermath of the crisis, the EU recovery plan highlighted the need for a coordinated EU and national response and set out temporary stimulus measures along with a commitment to continue implementing structural reforms related to the Lisbon Strategy (European Commission 2008). Cohesion Policy was presented as a key lever to support the EU's macroeconomic stabilisation objectives, the overriding objective being to accelerate payments to Member States through the frontloading of expenditure and by providing budgetary stability and public investment during a period of budgetary constraint (Begg 2010; Mendez 2013).

The importance of Cohesion Policy as a source of funding during the crisis applied particularly to the EU12 Member States, Greece, Portugal, Spain and (southern) Italy where the Funds represent a high share of development spending (Applica and Ismeri-Europa 2011; 2012). This importance increased over time, following sizeable cuts in public investment expenditure between 2009 and 2011, particularly in Bulgaria, Romania, Spain, Greece and Portugal (European Commission 2013).

The reprograming of funds to different thematic priorities was a commonly used measure to address crisis-induced absorption challenges and/or to reprioritise funding towards the most pressing problems. In total, some 11 percent of Cohesion Policy allocations were reprogrammed across the EU between 2007 and the end of 2012 (European Commission 2013). Ireland stands out with a reprogramming rate of 44 percent of total allocations, followed by Portugal (28 percent), Malta (24 percent) and Greece (17 percent). Other countries with double-digit shifts in thematic allocations were Italy (14 percent), Spain (13 percent), Bulgaria and Lithuania (12 percent).

Increased EU co-financing was also requested by many Member States to alleviate pressures on domestic budgets. Most recently, co-financing increases were agreed for nine Member States during 2011/12 (Spain, Greece, Ireland, Italy, Lithuania and Portugal and to a lesser extent Belgium, France and United Kingdom) (European Commission 2013). Additional 'top-up' payments (increasing co-financing rates up to 95 percent) were made to countries with the greatest budgetary difficulties (Greece, Ireland, Latvia, Portugal, Romania and Hungary). The private sector contribution to co-financing has also been reduced in some Member States, notably in France, Portugal, Lithuania and the United Kingdom, although not all programmes reported private co-financing shifts limiting the reliability and comparability of this measure of private sector participation (Applica and Ismeri-Europa 2012).

The changes to co-financing in Member States facing the greatest budgetary difficulties were facilitated by two sets of legislative amendments, agreed by the Council and Parliament in 2011 (on a temporary basis) and in 2013 (extended till the end of the 2007-13 programme period), allowing EU co-financing rates to be increased by up to ten percentage points in countries receiving financial assistance under macroeconomic adjustment programmes (currently, Cyprus, Hungary, Romania, Latvia, Portugal and Greece). The 2013 amendments also allow a one-year extension of the automatic decommitment period of the 2011 and 2012 commitments for Romania and Slovakia to ease absorption pressures.[30]

Building on this experience, the regulatory framework for 2014-20 includes a permanent provision from the outset (Art.24) allowing for increased EU co-financing (up to 10 percentage points again) for Member States with temporary budgetary difficulties and receiving financial assistance programmes. This would not affect the total EU contribution to the programmes, which would remain at the level agreed when the programmes were approved.

4.2.1 Reservations about the stabilisation function of Cohesion Policy

There are a number of reasons for questioning the effectiveness of Cohesion Policy as a macroeconomic stabilisation tool. First, the budget for cohesion is modest on an EU-wide scale (at 0.3 percent of EU27 GDP) and cannot have a major impact at an aggregate level, despite accounting for a major share of government investment in some countries. Second, pro-cyclical crisis effects reduce investment demand and co-financing capacities restricting the policy’s spending capacity in troubled economies. Third, there are several in-built rigidities in the programming process. Late approval of the Regulations and new requirements lead to delays in approving, launching and spending funds. Similarly, onerous

[30] Regulation (EU) No 1297/2013 of the European Parliament and of the Council of 11 December 2013 amending Council Regulation (EC) No 1083/2006 as regards certain provisions relating to financial management for certain Member States experiencing or threatened with serious difficulties with respect to their financial stability, to the decommitment rules for certain Member States, and to the rules on payments of the final balance.

and inflexible administrative obligations and regulatory uncertainties limit the take-up of flexibility measures offered by the Commission, compounded by the administrative burden of managing overlapping programmes for two periods. Moreover, increasing pressure from the Court of Auditors and the Parliament's budgetary control committee to address non-compliance with financial rules has led the Commission to reinforce the use of financial interruption and corrections procedures, which has blocked payments to programmes in many countries.

The limits to this stabilisation role are clearly reflected in the rate of financial implementation. By the end of 2012 (the penultimate year of the 2007-13 multi-annual funding cycle for committing Cohesion Policy funds), only 40 percent of total allocations had been paid out to the Member States, albeit with major variations across countries (European Commission 2013). The top five spending levels were in Ireland (60 percent), Sweden (55 percent), Portugal (54 percent), Belgium (53.3 percent) and Estonia (52.2 percent). At the other end of the spending spectrum were Bulgaria (27 percent), Malta (30 percent), Czech Republic (30 percent), Slovak Republic and Italy (35 percent in both).

The case of Italy is particularly instructive in understanding the limitations of managing Cohesion Policy funding. Major efforts by the Italian government to address expenditure problems in 2007-13 have (so far) had limited results. This is, despite resort to a number of re-programming exercises, the use of sanctions, the creation of task forces in three regions, a temporary change in the domestic Stability Pact (to exclude significant amounts of domestic co-financing for Cohesion Policy programmes from the Pact's rules) and the adoption of a National Action Plan for Cohesion to reduce the domestic co-financing rate in the OPs in selected regions.

In terms of thematic priorities, it is notable that EU-wide spending has been significantly slower under the earmarked categories of expenditure linked directly to the Lisbon agenda compared to other priorities in the Convergence programmes targeting the less-developed regions, contrasting with the more-developed regions where both types of expenditure had similar spending rates (European Commission 2013).

4.2.2 Concluding comments

Several conclusions can be drawn about the role of Cohesion Policy in macroeconomic stabilisation during the crisis. First, Cohesion Policy has been used as a lever to support EU macroeconomic stabilisation objectives during the current crisis, particularly through the acceleration or front-loading of spending. Second, the counter-cyclical effect has been relatively modest for the EU as a whole given the small size of Cohesion Policy funding relative to EU GDP, but has been more significant in some countries receiving large financial allocations and that have been most affected by the crisis. Third, there are substantial impediments to using Cohesion Policy as a rapid and effective crisis management tool: the relatively small size of the policy's budget relative to the EU economy overall, the longer term nature of the policy's objectives at programme level, the downward pressure on domestic spending capacity during a crisis, and the administrative rigidities of the implementation system.

4.3 Lisbon and Europe 2020 funding and governance

Cohesion Policy funding has contributed directly and indirectly to achieving Lisbon and Europe 2020 structural reforms since 2000 and is expected to continue to do so in the 2014-20 programme period.

4.3.1 An investment budget for Lisbon and Europe 2020

The most important and distinctive contribution of Cohesion Policy to the Lisbon agenda is arguably financial, at least compared to other EU policies. In the 2007-2013 period, more than €230 billion was allocated to Lisbon priorities (2 and 3), around 80 percent of which was concentrated on the least-developed regions of the EU. The main operational mechanism for ensuring financial concentration on the Lisbon agenda was the earmarking rule requiring the allocation of a minimum share of expenditure to Lisbon-related interventions, 60 percent under the Convergence Objective and 75 under the Regional Competitiveness & Employment (RCE) Objective. Several Member States (Cyprus, France, Greece, Portugal and Spain) agreed a limited number of national exceptions (so-called 'national earmarking') deemed to be national priorities, providing some additional flexibility.

Table 2: Lisbon earmarking priorities within the Community Strategic Guidelines in Convergence Regions, 2007-2013

	Lisbon Earmarking		Non-earmarked	
Convergence	**€ bn**	**%**	**€ bn**	**%**
Attractive places to invest and work	66.6	35.6	75.1	77.5
Improving knowledge and innovation for growth	67.9	36.4		0
More and better jobs	43.1	23.1	2.8	2.9
National	9.2	4.9		0
Technical Assistance		0	8	8.2
Territorial Dimension		0	11	11.4
Total	186.8	100	96.9	100

Source: European Commission (2013b).

Table 3: Lisbon earmarking priorities within the Community Strategic Guidelines in RCE Regions, 2007-2013

	Lisbon Earmarking		Non-earmarked	
Regional Competitiveness and Employment	**€ bn**	**%**	**€ bn**	**%**
Attractive places to invest and work	2.6	5.9	6.7	59.0
Improving knowledge and innovation for growth	18.7	42.8		0.0
More and better jobs	21.7	49.5	0.4	3.7
National	0.7	1.7		0.0
Technical Assistance		0.0	1.7	14.7
Territorial Dimension		0.0	2.6	22.6
Total	43.7	100	11.4	100

Source: European Commission (2013b).

In their 2012 Strategic Reports, most Member States reported that the ESF in particular had been a key tool in preserving employment, containing unemployment, supporting the modernisation of the education sector, strengthening the labour market through reforms of the active labour market policies and education systems, and supporting public administration reform and better regulation (European Commission 2013).

The most quantifiable effect of this Lisbon reorientation on spending patterns within Cohesion Policy has been a significant shift in the thematic orientation towards R&D and innovation and away from basic infrastructure, particularly in the EU12 (Mendez 2011). The earmarking requirement encouraged Member States to focus their programmes for 2007-13 on a limited number of priorities, resisting the pressure from stakeholders for dispersion of resources across a range of policy fields (Bachtler and Mendez 2010). However, earmarking has also been criticised for being too top-down, for placing too much emphasis on financial inputs rather than outcomes, and for being administratively rigid in operational management and implementation terms (i.e. restricting managing authorities when seeking to shift funding to non-earmarked priorities). Moreover, earmarking did not prevent some Member States from dispersing funding across a wide range of expenditure categories limiting the ability to achieve a critical mass of funding for key priorities and interventions (Barca 2009).

The 2013 reform of Cohesion Policy has maintained the earmarking approach but based on a more prescriptive system of ring-fencing (Mendez 2013). In contributing to the Europe 2020 objectives for smart, sustainable and inclusive growth, the ring-fencing provisions require Member States to concentrate 50-80 percent of the ERDF in 2014-20 on the RTDI, SME Competitiveness and Low-Carbon Economy Thematic Objectives, with a sliding scale that allows for lower concentration in Less-Developed Regions (50 percent) and Transition Regions (60 percent) compared to More-Developed Regions (80 percent). Within these overall limits, further minimum thresholds have been specified for the Low-Carbon Economy Objective: 12 percent for Less-Developed Regions, 15 percent for Transition Regions and 20 percent for More-Developed Regions. By contrast, for the ESF at least 60-80 percent of the Fund's allocation per programme need to be concentrated on up to five investment priorities within the four Thematic Objectives: Employment; Social Inclusion; Education, Skills, and Learning; and Institutional Capacity. Again, there is a sliding scale

providing more flexibility to Less-Developed and Transition Regions. Further, at least 20 percent of the total ESF in each Member State should be allocated to the social inclusion objective.

A key issue to consider is whether this thematic approach is leading to an excessive 'sectoralisation' of Cohesion Policy and whether it will imply a stronger emphasis on the economic dimension of cohesion at the expense of the territorial and social dimensions. In the 2007-13 period, the Lisbon reorientation involved thematic and territorial shifts in allocations, in some cases away from the more disadvantaged areas within regions in favour of strategic priorities and projects in other areas (Bachtler *et al.* 2013). Moreover, the Less-Developed Regions have found it more difficult to absorb funds allocated to Lisbon-earmarked categories, both compared to more-developed regions and to non-earmarked spending priorities (European Commission 2013).

The shift in 2014-2020 towards RTDI and competitiveness may further weaken the territorial dimension and lead to absorption challenges, particularly in the countries and regions struggling most to recover from the crisis and with more basic development needs. There is a form of Catch-22 in which the low propensity to invest in R&D of so many of the Member States benefiting most from Cohesion Policy could aggravate absorption problems. Regarding the social dimension, the reform provides for an increase in funding to the ESF (relative to the other Funds) and ring-fencing to the social inclusion objective. However, there are concerns that the Commission is placing too much emphasis on the employability aspects, instead of a wider approach addressing various social inclusion issues and vulnerable groups (such as support for the elderly, immigrants, minors, women and child poverty). As with the competitiveness agenda, a shift in funding towards the ESF may lead to absorption challenges due to the difficulties in spending on softer initiatives in some cases or the lack of alignment with needs.

There is also a question of how the multiplying conditions on Cohesion Policy implementation will be managed by Member State authorities. The requirement for more targeted spending in line with Europe 2020 and thematic concentration is accompanied by pressure for more effective spending (under the new performance framework) as well as continued obligations for faster spending (under the decommitment rule) and greater regularity in expenditure to reduce the error rate. There will inevitably be tensions and possibly conflicts in meeting all these conditions simultaneously (Bachtler and Ferry 2013) and the thorny problem of unspent funds (*reste à liquider* or RAL) has emerged as a governance difficulty for the EU budget.

4.3.2 Policy coordination and territorial focus

A final important contribution of Cohesion Policy to Lisbon and Europe 2020 goals is in its governance and delivery. One of the main criticisms of the Lisbon agenda was the lack of domestic ownership of the strategy, especially at the sub-national level. The Lisbon and Europe 2020 agendas have a relatively centralized approach to policy coordination through a range of processes at EU level. There are no formally required partnership mechanisms for involving sub-national actors, although there is increasing involvement of the sub-national level in some countries in the formulation of National Reform Programmes and through territorial pacts with the regions (Committee of the Regions 2012). Nor was the territorial dimension of Lisbon and Europe 2020 explicitly addressed through, for instance, territorial impact assessment.

Unlike the centralised approach to policy coordination under the EU's economic governance architecture, Cohesion Policy is characterised by a multilevel governance model involving a high level of sub-national participation in all phases of the policy cycle. The alignment of Cohesion Policy with Lisbon and Europe 2020 has therefore contributed to increasing the territorial ownership of the goals, particularly through the strategic planning architecture based on a cascade of strategies: Community Strategic Guidelines (which becomes Common Strategic Framework for 2014-20) which translate Lisbon-Europe 2020 objectives into a high-level strategy for Cohesion Policy agreed at EU level to guide the elbaoration of National Strategic Frameworks (Partnership Agreements for 2014-20) at national level and Operational Programmes at national or regional level. However, the National Strategic Reference Frameworks developed by Member States often had little strategic value and generally made limited or no reference to National Reform Programmes. There has also been criticism of the Community Strategic Guidelines (for 2007-13) and Common Strategic Framework (for 2014-20) for a lack of a territorial dimension due to a thematic/sectoral approach that is insensitive to territorial specificities across different geographical levels.

Lastly, the multilevel governance model has an integrative potential for managing expenditure, and it is also salient that one of the major emphases in the wider economic governance reform is an intensification of coordination. The 'C' in the TSCG stands, after all, for coordination in a treaty that encompasses more than the Fiscal Compact. In principle, Cohesion Policy seeks to coordinate the objectives and funding streams of different policy areas and instruments, beginning with ERDF/CF and ESF, and extending to the other ESI Funds and EU policy fields. Coordination, through coherent strategies and implementation arrangements, is also expected at national and sub-national levels.

In practice, this has constituted one of the areas of added value of Cohesion Policy (Bachtler *et al.* 2013) but to varying degrees. Thus, improving coordination is one of the key objectives for the 2014-20 period. Strong coordination of expenditure certainly applies in Member States where ministries of finance have overall responsibility for Cohesion Policy (e.g. Latvia, Lithuania) or where there are strong coordination arrangements (e.g. Poland). The coordination obligations are less influential in countries where Cohesion Policy accounts for a small share of government investment, and particularly where the responsibility for managing Structural Funds programmes is dispersed over independently operating spending ministries or sub-national authorities.

5. PROSPECTS AND SCENARIOS FOR COHESION POLICY

The many changes in governance are bound to have effects on the conduct of Cohesion Policy and will interact with the various responses to the crisis still affecting many Member States. In addition, further reforms are likely, although how the governance architecture will evolve beyond the extensive measures already agreed is not readily predictable, because of differences of opinion about what should happen and in what order, and concerns by Member States about the likely burdens they will face. While the GEMU proposals present an obvious starting point, they provide a menu rather than a clear choice of dish. For this reason, a scenario approach is adopted. This section of the report starts by exploring prospects over the medium-term, then discusses the moves towards genuine economic and monetary union before developing two scenarios.

5.1 Prospects for the 2014-20 programme period

The current state of public finances in the EU provides indications of where the budgetary pressures associated with macroeconomic conditions in Cohesion Policy and co-financing constraints are likely to lie in the 2014-20 period. The latest EU data show that the annual budget deficit in 2012 was above three percent of GDP – the limit specified in the Stability and Growth Pact (SGP) - in 19 of the 27 Member States (European Commission 2013). The highest budget deficits were in Spain and Greece at around ten percent of GDP, although both are projected to fall rapidly in 2013 and 2014. A further four Member States had deficits in the range of 6-8 percent of GDP (Cyprus, Ireland, Portugal, United Kingdom). Government debt is well over the 60 percent of GDP ceiling specified in the SGP in half of the EU Member States, with rates at or above 100 percent in Belgium, Greece, Italy, Ireland and Portugal. Unlike the deficits, according to the Commission's forecasts, debt ratios are set to increase further in 22 Member States during 2014.

Based on recent experiences, many Member States may struggle to meet agreed budget deficit and debt level targets, and the outcomes of the examination of budget plans referred to in section 2 illustrate the limited room for manoeuvre. Moreover, in some countries, banks may face rising bad debt losses and require capital injections from national governments, potentially compounding the current debt problems. For the economically weaker Member States, access to financial markets is likely to remain restricted for the immediate future.

Figure 1 combines the country data on 2012 debt levels (distinguishing between countries above and below the SGP 60 percent threshold) with the relative scale of Cohesion Policy allocations for 2014-20 (as a share of GDP and related to the EU average). This reveals four country clusters.

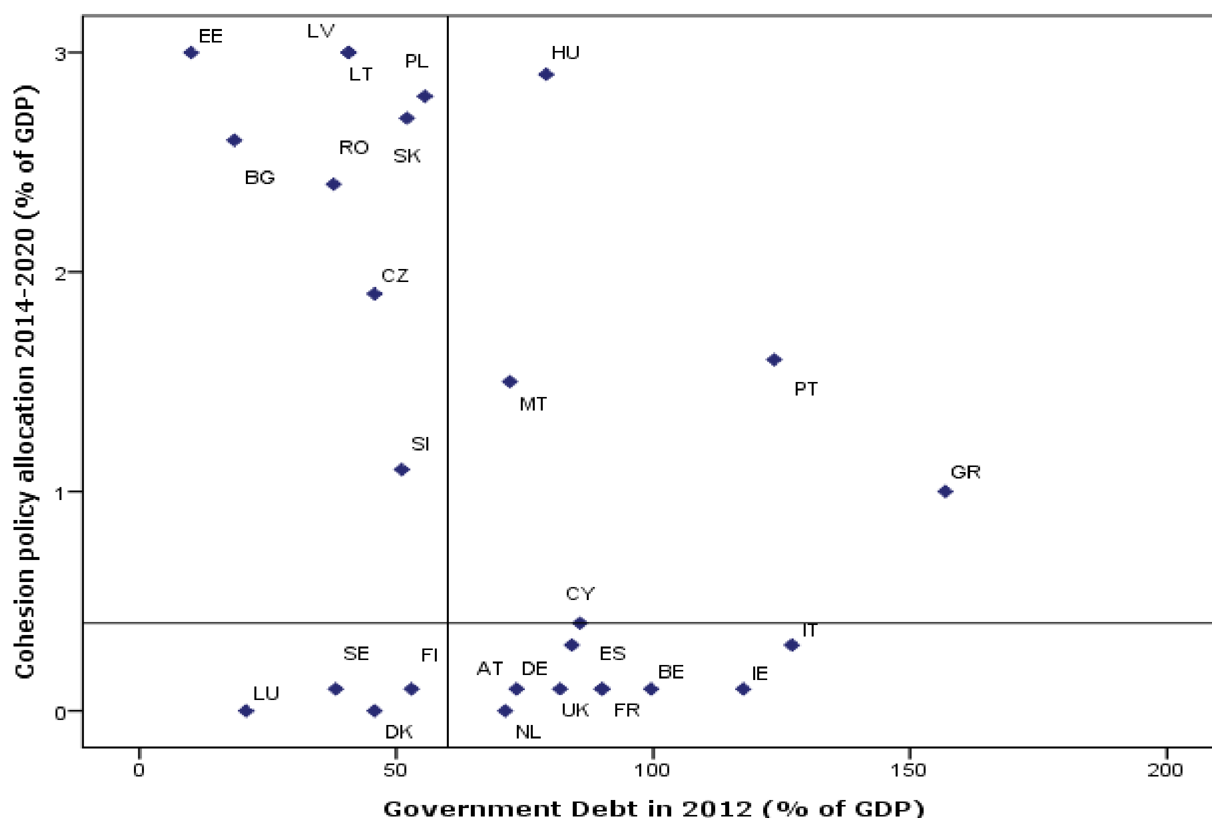
1) **High debt, high Cohesion Policy funding**: The first group comprises countries with relatively high debt (above the EU's 60 percent threshold) and high Cohesion Policy allocations (as a share of GDP) relative to the EU average (Cyprus, Greece, Hungary, Malta and Portugal).
2) **High debt, low Cohesion Policy funding:** Member States in the second group also have high debt levels but relatively low Cohesion Policy allocations (Austria, Belgium, France, Germany, Ireland, Italy, Netherlands, Spain, United Kingdom).
3) **Low debt, high Cohesion Policy funding**: Most of the EU12 countries have low debt and high Cohesion Policy allocations (Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia)

4) **Low debt, low Cohesion Policy funding**: The final group comprises Denmark, Luxembourg, Sweden and Finland, where both debt and Cohesion Policy allocations are relatively low.

The countries in the first category (Cyprus, Greece, Hungary, Malta and Portugal) are likely to face the largest fiscal adjustment pressure over the coming years as well as the most damaging economic consequences in the event of financial suspensions for breaches of macroeconomic conditionality rules. At the other end of the spectrum, the combination of low debt and relatively low cohesion allocations in Denmark, Finland, Luxembourg and Sweden limits both the likelihood of sanctions and their potential economic impact.

The impact of financial suspensions is subject to ceilings specified in Article 23 (para 11) of the Cohesion Policy framework regulation, based on a percentage of commitments for the following year (up to 100 percent) or as a percentage of GDP (up to 0.5 percent of nominal GDP). For most of the EU15 countries, the GDP ceiling would not apply because allocations are typically below 0.1 percent of GDP. Financial suspensions would therefore have a disproportionate budgetary impact on the EU12, Portugal and Greece.

Figure 1: Cohesion Policy allocations, 2014-20, and Government Debt (as % of GDP)



Source: Own elaboration from Commission data.

A crucial question is how the scale and scope of suspensions will be determined. Article 23, para 11 states that the decisions must *'be proportionate, respect the equality of treatment between Member States and take into account the economic and social circumstances of the Member State concerned, in particular the level of unemployment of the Member State concerned in relation to the Union average and the impact of the suspension on the economy of the Member State concerned. The impact of suspensions on programmes of critical importance to address adverse economic or social conditions shall be a specific*

factor to be taken into account.' The interpretation of these conditions (by the Commission in particular, but also the Council and the Parliament) in the coming years is of particular concern to countries like Portugal and Greece, where Cohesion Policy represents the principal source of public investment to support recovery from the crisis and for which suspensions – even if they are reduced to take account of the economic and social situation of the country – would be economically and socially counterproductive.

The main administrative effect of suspensions would be to disrupt the financial planning of programmes and projects, although as explained in section 4, a distinction should be drawn here between suspensions to commitments and to payments. A suspension of commitments would not have immediate and major consequences for financial planning or projects, which could still be funded through previous commitments (under the N+2/3 rule, there are two or three years to spend commitments). By contrast, a suspension of payments would not only disrupt financial planning at the programme level, but could also lead to projects being stopped on the ground due to a lack of funds to continue the investment or because of the financial uncertainty. In a worst case scenario, this in turn may require a reprogramming of funds to new projects involving additional administrative work for programme authorities. As noted, this would add to and compound the exisiting problems of payments interruptions and corrections caused in large part by the complexities of the financial management, audit and control rules.

Revisions to PAs/OPs to maximise the impact of the ESI Funds in Member States receiving financial assistance from the EU, as foreseen in the macroeconomic conditonality provisons on measures linked to sound economic governance, are likely to be challenging in political and administrative terms. Such negotiations would be more intense, both within Member States and between Member States and the Commission. Revisions to strategies imply taking money from certain interventions, public authorities and managers and reallocating it to others, which would be especially demanding where regional authorities are involved (e.g. regionalised or federal systems). Moreover, countries with budgetary difficulties may face capacity issues in their public administrations. Equally, the Commission has its own capacity constraints, and it is unclear whether it has the know-how to identify the best course of action for maximising the effectiveness of the Funds (Barca 2009). Indeed, evidence of what works and what does not in Cohesion Policy (or across different Member States) is inconclusive for an EU policy that has been evaluated more than any other – for a recent wide-ranging study (see Bachtler *et al*. 2013).

Within the Member States, inter-governmental tensions could arise from financial suspensions to regional allocations and/or the redirection of funding away from regional interventions as part of programme revisions, particularly where Cohesion Policy provides an important soruce of funding for development. Similarly, the requirement to revise OPs in response to EU recommendations as part of new economic governance risks being unpopular with regions, especially as they do not participate in the Council meetings that agree and fine-tune the recommendations. Moreover, there is a wider subsidiarity issue at stake here about whether the Commission should be able to force revisions to Cohesion Policy programmes in response to Council recommendatons that relate to Member States competences.

There are also monitoring and coordination implications from the closer alignment with the annual cycle of the Semester. Partnership Agreement and programme management authorities and secretariats would need to develop specific arrangements to monitor and review the recommendations and their implications on an annual basis. Alternatively, or in addition, it would be necessary to develop closer links and coordination arrangements between PA/OP management teams and the government bodies responsible for National

Reform Programmes and overseeing the implementation of Country-Specific Recommendations, which are often located in different ministries.

If the fallout of the economic and sovereign debt crisis raises challenges for public sector co-financing of Cohesion Policy, similar effects can be expected with respect to the participation of the private sector in Cohesion Policy. Private sector participation is likely to continue to be affected by subdued demand, deleveraging of the financial sector and pressures on bank lending, which provides the main source of external financing for business investment and an important source of match-funding for Structural Funds grants. New bank loans and credit to businesses have fallen substantially during the crisis, especially to SMEs, and are likely to remain constrained by tighter bank conditions in the future. A problem for some countries has been capital flight, sometimes exacerbated by loss of the most qualified labour. In short, the post-crisis context is one in which past assumptions about underlying conditions may need to be re-thought.

The supply and affordability of bank loans are especially problematic in the Member States facing the strongest market pressure. There are significant cross-national variations in interest rates on new loans to firms, ranging from over six percent (in Bulgaria, Cyprus, Greece, Hungary, Portugal, Romania) to much more favourable rates of around three percent or less (in Austria, Belgium, Czech Republic, Finland, Germany, Slovakia). Moreover, the cross-country fragmentation of financial markets has prevented the uniform transmission of the European Central Bank’s monetary policy stance to the interest rates on new bank loans, especially to firms in the troubled economies of the Eurozone (e.g. Greece, Italy Portugal, Spain) (ECB 2013; Neri 2013). Looking forward, the bank stress tests by the European Banking Authority and the asset quality review by the ECB are likely to intensify these pressures with further impacts on lending to SMEs. It is estimated that the Eurozone’s biggest banks will need to cut an additional €2.6 trillion from their €31.3 trillion balance sheets, and the impact could well be most pronounced on SMEs and on the peripheral economies (Thompson 2013).

Against this background, the need to boost SME competitiveness (earmarked for significantly more funding under Cohesion Policy in 2014-20) will acquire increased importance yet will also be more challenging in countries where business investment is subdued and access to finance is constrained. To address this, the Commission, EIB and ECB are currently considering options for reviving the structured credit markets to support SME lending, including a joint risk-sharing mechanism combining 2014-2020 EU budget resources (under COSME, Horizon 2020) and Cohesion Policy funding, with the lending capacity of the EIB, EIF and national promotional banks (Commission and EIB 2013). It remains to be seen when and how this will work, but it is possible that it could provide much-needed support for business investment in the most vulnerable economies.

5.2 Genuine economic and monetary union

Although much has already changed in recent years, progressively adding up to a substantial governance reform, further proposals are working their way through the system under the broad heading of ‘genuine’ economic and monetary union (GEMU) initially set out in the European Council’s Four President’s Report (European Council, 2012) and the blueprint for GEMU published by the Commission (2012). The Commission blueprint makes clear, in Section 1, that the rationale for GEMU is that there were profound flaws in the original conception of the governance of EMU. In a passage that resonates for the underlying aims of Cohesion Policy, it asserts that (p. 11) ‘steps towards more responsibility and economic discipline should be combined with more solidarity and financial support’. The four axes of these proposals are as follows.

An integrated financial framework would include the three components of banking union (a single supervisory mechanism, a common bank resolution mechanism and common deposit insurance) and the broader reforms of financial regulation already in train. Opposition from net creditor Member States makes it unlikely that common deposit insurance will be agreed any time soon, but it is to be expected that the other elements will be in place for the 2014-20 programming period of Cohesion Policy. While not obviously directly affecting the Cohesion Policy, the reforms associated with the integrated financial framework can be expected to have some significance in other ways by affecting the private sector, sovereign borrowing and the scope for the 'financial engineering' sometimes required for major projects.

An integrated budgetary framework encompasses the more stringent fiscal rules already agreed as part of the Six-Pack, Two-Pack and Fiscal Compact, but also opens the door to the establishment of a new fiscal capacity separate from the existing EU budget. There is no real sense of either how large any such new capacity will be or what is to be expected of it, although the Commission identifies targeted support for structural reform as a short-term function, while a role in macroeconomic stabilisation is envisaged in the longer term. Two obvious ramifications for Cohesion Policy are, once again, that tighter fiscal discipline for Member States could affect their capacity to co-finance Cohesion Policy, and that support for economic development from a new fiscal capacity could overlap with at least some forms of Cohesion Policy interventions.

The third dimension of GEMU concerns **closer coordination of national policies** which will build on the principles set out in Articles 121 (for the EU28) and 136 (for the euro area), as well as the 'coordination' dimension of the TSCG. Closer coordination is, in part, already occurring through the Semester process, but could also entail additional areas around tax. An implication of this axis for Cohesion Policy is that the rationale for policy intervention will include not just the benefits for the regions/places receiving support, but also wider common goals of the EU. This orientation was already visible in the expectation during the 2007-13 period that Lisbon goals would be prominent in Cohesion Policy. There is the potential for a tension between these coordination objectives and the Article 174 commitment to reduce regional disparities.

Democratic accountability and legitimacy raises a range of issues about how the closer supranational oversight of Member State policies is undertaken, and can be interpreted as a shift towards political union. The European Council document is sensitive to concerns articulated by national parliaments, especially where domestic political choice is heavily constrained. The Commission blueprint argues that the European Parliament is the natural body to exercise accountability, because the actions of the Commission and Council are at EU level, but it also affirms the crucial role of national parliaments. The Four Presidents' report also refers to national parliaments but appears to assign the main role to the European Parliament. There is, however, no real indication that the sub-national level of government is seen as part of this fresh look at legitimation.

The Commission blueprint offers an extensive list of specific proposals, but a number of these are speculative rather than firm. The Commission also distinguishes between proposals which can be implemented quickly, over the medium term, and over the longer term. Not surprisingly, many of the proposals have attracted dissent, and it is open to question whether they will be adopted, substantially amended or watered down, or simply abandoned. The resulting uncertainty inevitably complicates any assessment of what their implications will be for Cohesion Policy. Some GEMU proposals have, however, made tangible progress, making it easier to anticipate how they might affect Cohesion Policy. Two in particular are worth examining in greater detail, while two others illustrate the political challenges that have to be overcome.

5.2.1 The Convergence and Competitiveness Instrument

The proposed Convergence and Competitiveness Instrument (CCI) was to be adopted in the short-term, according to the Commission blueprint for GEMU, but is struggling to make progress, despite being firmly on the agenda of the December 2013 European Council. The Presidency Conclusions call on the President of the European Council in cooperation with the President of the Commission to develop the proposals, but with a new deadline of October 2014, a data apparently chosen to make it possible for President Barroso still to be involved before the end of his mandate.

The original purpose of the CCI was meant to be to assist Member States for which the lack of structural reforms can be expected to have a negative spillover effect on other Member States. It was supposed to combine a contractual approach, under which the Member State receiving the support would have to commit to specific measures and a timeline for implementing them, with a solidarity mechanism as a means of offering financial incentives. It was to be explicitly linked to the Country-Specific Recommendations emanating from the European Semester. The further orientations provided by the December 2013 European Council reaffirm the connection to the Semester through National Reform Programmes, but stress the primary role of the Member States in elaborating the plans (see Rubio, 2013, for an overview).

An indication of some of the sensitivities is visible in the apparent decision to rename CCI as 'Partnerships for Growth, Jobs and Competitiveness' and to insist that these will be about increasing 'the level of commitment, ownership and implementation of economic policies and reforms in the euro area Member States'. The partnerships will not apply to countries receiving financial assistance and thus subject to a MAP, consolidating the differentiation already occurring *within* the euro area, as well as between the euro area and the ten non-participating Member States. However, the system will be open to other Member States on a voluntary basis. The idea of a contract is retained, but is left vague, as is the nature of the solidarity mechanism envisaged as a contribution to facilitating reforms.

What is not clear is how large the financial support for the proposed new partnerships is likely to be, although the March 2013 communication (Commission, 2013e) states that it 'would be limited at the outset', but could grow if 'it proves to be an effective and cost efficient way of promoting reform'. The German Chancellor, Angela Merkel, has suggested that it would have a budget of €10-20 billion (around five percent of Cohesion Policy allocations). At this level, it is unlikely to have significant consequences for Cohesion Policy, but this could change if a more comprehensive approach to EMU is taken.

It would not be subject to MFF ceilings and would be 'included in the EU budget as external assigned revenues'. The December 2013 Presidency Conclusions signal that the solidarity mechanism could encompass guarantees and loans, not just grants, but also that it should not 'entail obligations for the Member States not participating'.[31] The Commission notes the risk of moral hazard arising from Member States potentially being 'rewarded' for delaying their structural reforms until they became eligible for the CCI, as well as the risk of deadweight in supporting reforms that would happen regardless. The logic is similar to that which applied when the Cohesion Fund was established of providing support for reforms that would either not happen, would be delayed or would be less ambitious than is needed because of constraints on public funding in the Member State.

[31] One uncertainty may be whether, based on this orientation, the MAP countries are not expected to contribute, and thus that the resulting budget is one for (today) fifteen of the eighteen euro area members. It also raises the question of what happens if any other country is subject to a MAP.

The Commission communication raised a series of question about the circumstances in which the CCI can be used, including whether it should be open only to the euro area or to others, and whether it should be a voluntary arrangement, triggered by being under the macroeconomic imbalances procedure or at the invitation of the Commission. What sort of reforms it covers would depend on the answers to these questions. It is envisaged that the CCI would be linked to National Reform Programmes, but both the communication and the December 2013 Presidency conclusions are somewhat vague on how it would relate to the Structural Funds, although the expectation (p.8 of the Commission communication) is that it should be consistent, coherent and complementary to the existing instruments, such as the Structural Funds, and in particular the European Social Fund. This formulation – especially the word 'complementary' – implies spending on actions different from those undertaken by Cohesion Policy. However, there is no mention of the regional level in what the CCI would support.

5.2.2 The new partnerships: complementary or competitive funding?

The prospect of new partnerships linked to structural-fiscal conditions would have two main implications for Cohesion Policy. First, tighter fiscal discipline on Member States granted financial support could affect their capacity to co-finance Cohesion Policy as noted above. Second, the new fiscal capacity could overlap with Cohesion Policy interventions. Whether this would lead to duplication or synergies will depend on the details of the solidarity mechanism and the nature of conditions design. As recognised by the Commission, 'the new financial instrument would need to be consistent, coherent and complementary to the existing instruments, such as the Structural Funds, and in particular the European Social Fund' (European Commission 2013). This wording does, however, leave many unanswered questions. Unless funded entirely separately from the EU budget, a Convergence and Competitiveness Instrument of significant size would be likely to reduce the budgetary resources, thematic coverage and territorial focus of Cohesion Policy, potentially substituting for ESI Funds in Eurozone countries and/or narrowing the interpretation of its Treaty mission. There are also implications for governance – both in terms of the degree to which EU institutions are involved in the design of the Instrument (compared to their current role in Cohesion Policy) and the multilevel governance model for the implementation of spending. There also appears to have been considerable resistance from a large majority of Member States to another form of oversight from 'Brussels'.

5.2.3 Banking union and Cohesion Policy

Banking union is proceeding, but it is also proving to be hard to secure agreement on some key provisions and the agreement on a single resolution mechanism reached at the December 2013 ECOFIN Council meeting, while significant in its own right, is a compromise which leaves a number of issues inadequately settled. The underlying aim of banking union is to resolve the inconsistencies inherent in an 'impossible trinity' articulated by Pisani-Ferry (2012), who argues that in a close monetary union, there cannot simultaneously be:

- a prohibition on direct monetary financing of the debts of Member States which appears to preclude the ECB from direct purchases of sovereign debt;
- no collective responsibility for public debt, such that Member States in difficulty are susceptible to market pressures much more rapidly than if there were a common borrowing capability; and
- interdependence between sovereigns and banks in each Member State which results in banks becoming fragile if they hold their country's public debt, while the fragility of the banks undermines the borrowing status of the sovereign that has to stand behind them.

Sovereign bonds issued by the treasuries of mature economic have conventionally been thought of as safe assets, but the problems in several Member States have shown that market sentiment can turn quickly, leading to a vicious circle, especially in smaller countries. Markets drive up interest rates, making borrowing by government more expensive and, in the limit, unaffordable, obliging governments either to resort to rapid fiscal consolidation or to seek a bailout which leads to a tough adjustment programme. Debt mutualisation, whether through Eurobonds, jointly and severally guaranteed by all Member States (at least of the euro area) or some other form is likely to be the eventual answer, but moves towards banking union are intended to provide some respite and, to that extent, offer a partial answer by easing the cost of borrowing.

However, the overhang of debt is also a concern for many countries and (echoing the debates in the 1990s between the 'economists' and the 'monetarists' about how rapidly to move towards monetary union) this, too, feeds into the debate about how to sequence moves towards full banking union. Some argue that redemption of debt should precede realisation of some of the more overtly 'federal' features of a full banking union and that the banks need to show that they fulfil various criteria before acceding to such a union (for example, the German Council of Economic Experts, 2012). This perspective would imply only slow realisation of the next stages of banking union. The Commission (2012), by implication, would like it to proceed rapidly (see also: the range of opinions in Beck (2012) and in the CESifo Forum special issue of December 2012).

Among the main contested area in the negotiations is policy towards failing banks. The biggest stumbling blocks are: on the one hand, the order in which different stakeholders are called upon to contribute to the resolution; and on the other hand, the degree to which different tax-payers contribute to a fiscal 'backstop'. The trilogue agreement on 12th December 2013 of the Bank Recovery and Resolution Directive (BRRD) is a significant advance which spells out the order of 'bail-in' of different parties. Whether it will be as decisive as claimed by Commissioner Barnier[32] in ensuring that 'massive public bail-outs of banks and their consequences for taxpayers will finally be a practice of the past' remains to be proven. At present, the proposals for common deposit insurance are making no progress, largely because such common insurance is, *de facto*, a form of debt mutualisation which continues to be unacceptable to creditor countries because of moral hazard concerns.

As a result of these uncertainties, banking union is likely to be incomplete over the short to medium term, with implications for the persistence of what Véron (2013) has called the 'doom loop' between sovereign debt and the banking system. So long as this loop is not closed, there is a risk that credit conditions in vulnerable Member States will be systematically worse than in 'safe' ones. The direct consequence for Cohesion Policy will be the effects on the willingness and capacity of the private sector to invest, including in projects supported by Cohesion Policy. The aggregate effect will be to raise the costs and reduce the availability of credit.

De Grauwe and Ji (2013) also draw attention to the curious feature that 'banks in the northern Eurozone have capital ratios that are, on average, less than half of the capital ratios of banks in the Eurozone's periphery'. The reason for this is that banks in countries with stronger public finances benefit from an implicit guarantee that their national governments have the wherewithal to help recapitalise them. The authors explain this by the fact that northern Eurozone banks profit from the financial solidity of their governments and follow business strategies aimed at issuing too much subsidised debt. In doing so, they

[32] Press release, 12th December 2013 on the trilogue agreement on the framework for bank recovery and resolution.

weaken their balance sheets and become more fragile – less able to withstand future shocks. Paradoxically, financially strong governments breed fragile banks. The opposite occurs in countries with financially weak governments. In these countries banks are forced to strengthen themselves because they are unable to rely on their governments. As a result they have significantly more capital and reserves than banks in the northern Eurozone.

5.2.4 An additional fiscal capacity

Other than the CCI, the budgetary side of GEMU is, so far, not making much progress. An additional fiscal capacity for dealing with asymmetric shocks would, in principle, ease the pressure on Member States needing to correct budgetary imbalances quickly, but would need to be large enough to make a decisive difference. Similarly, a move towards debt mutualisation would be expected to reduce the debt service burden for Member States facing market penalties which push up the spreads on their sovereign borrowing. Neither a large enough fiscal capacity nor early introduction of mutualised debt looks probable.

In the logic of fiscal discipline, a clear difficulty arises when there are substantial shocks affecting one or more Member States. If they then have to engage in more restrictive fiscal policy to conform to the new rules, the policy is likely to impart a downward pressure on demand. Elsewhere, the solution is for the federal level to take the strain by allowing the deficit to rise, but this is absent in the euro zone. According to Caudal *et al.* (2013) a euro zone budget could allow for both automatic stabilisers and discretionary fiscal interventions at the level of the zone as a whole and might also make it easier for the ECB to support a central debt as opposed to national public debt. In part the argument has to do with the difficulty in a period of recession, of achieving an optimal policy mix when Member States are subject to constraints as a result of EU governance processes.

How to finance an additional euro area fiscal capacity and what size it should be are also at issue. Ideally, a budget intended to fulfil a stabilisation function should raise revenue from an instrument and have spending that is anti-cyclical. Examples are corporate income tax, because it takes demand out of the system in boom periods and outlays for unemployment benefit which rise in periods of downturn. As always, the tricky part is how to share the burden fairly across Member States in such manner as to avoid both free-riding and moral hazard. Caudal *et al.* (2013) also argue that a Eurozone budget funded by true own resources would have indirect effects in underpinning the single market and, if orientated towards unemployment benefits, in promoting the social dimension of EMU. They do not mention Cohesion Policy.

5.2.5 Legitimacy and accountability

In relation to democratic legitimacy and accountability, the necessity of rethinking is widely recognised, but there is as yet little consensus on how to proceed. Some of the reforms of economic governance manifestly shift power to the Commission, the ECB and other agencies and, by so doing, weaken democratic oversight.

This drift towards what the renowned German political philosopher Habermas (2012) has called 'executive federalism' raises a number of issues. First, national parliaments lose some of their powers, not only over the setting of budgets, but also in the direction taken by supply-side policies. Increasing resort to conditionality – whether through macroeconomic conditionality applied to Cohesion Policy or the modalities of the Convergence and Competitiveness Instrument – can only accentuate this trend. There is a notion of political equivalence, articulated in the Commission blueprint and the Four Presidents' report, which is that because the governance innovations are at supranational

level, so too should be the democratic oversight. Thus, in the blueprint, it is stated (section 4.1, p.35) that:

> 'it is the European Parliament that primarily needs to ensure democratic accountability for any decisions taken at EU level, in particular by the Commission. A further strengthened role of EU institutions will therefore have to be accompanied with a commensurate involvement of the European Parliament in the EU procedures.'

There is then an assertion that 'the role of national parliaments will always remain crucial' and a call for cooperation with the European Parliament. The basis for the single supervisory mechanism is Article 127.6 (TFEU).

5.3 Scenarios

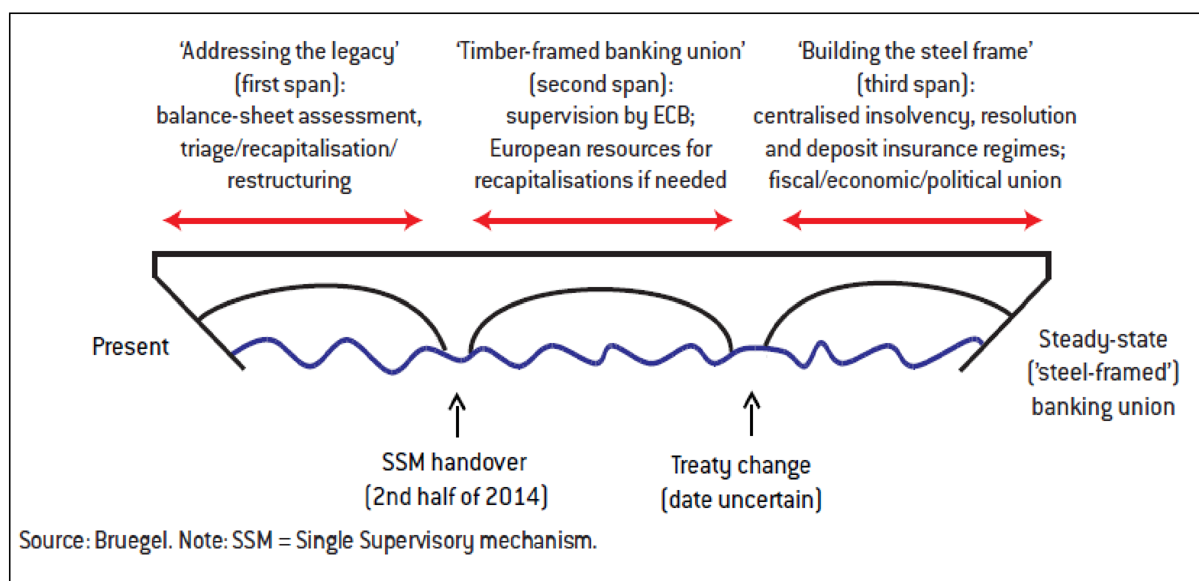
Because of the considerable uncertainty around how much of what has been proposed to establish GEMU will actually occur, it is hard to anticipate how it will affect the 2014-20 programming period for Cohesion Policy, as well as the subsequent development of the policy. In view of the continuing and often deep divisions among the EU Member States about how to proceed, a first scenario – '**Limited GEMU**' – would be that relatively little will change compared with the position reached as a result of the changes already introduced since the onset of the crisis. This could result either from relatively few of the proposals being adopted or from them being adopted in so limited a form that they do not make a substantial difference.

The second scenario – '**Comprehensive GEMU**' – is predicated on a much more extensive adoption of the measures in the Commission blueprint. They would entail additional transfers of power to the EU level resulting in what the blueprint refers to as 'progressive pooling of sovereignty and thus responsibility as well as solidarity competences to the European level'. It would also be likely to mean that some of the proposals, for example for an additional fiscal capacity, would larger in scale than in the first scenario.

Banking union exemplifies the difficulties in constructing scenarios. Véron (2013) observes that progress towards it has stalled somewhat, reflecting the disputes over how far it should go. The references by the German Finance Minister, Wolfgang Schäuble, to a timber-framed banking union, rather than one with a steel frame[33] suggested that sequencing is vital and Véron has proposed a timeline (see figure 2) which provides a way forward, albeit one with uncertain timing. He argues that a key first phase is dealing with the legacy of the crisis, but that progressively there needs to be resort to EU-level resources as a fiscal backstop, alongside EU level regulation and supervision.

[33] 'Banking union must be built on firm foundations', article in the *Financial Times*, 9 May 2013.

Figure 2: Véron's 'bridges' for moving to banking union



Source: Véron (2013)

5.3.1 Limited GEMU

Some of the additional measures proposed in the blueprints for GEMU are already well on their way to being adopted, notably the single supervisory mechanism, and some others are expected to follow. Although it has typically been difficult to arrive at a consensus, it is clear that secondary legislation, rather than treaty change, has been sufficient to achieve agreement. It therefore makes sense to regard an absence of treaty change as a defining feature of 'Limited GEMU'.

Already, too, differentiation – most obviously between the euro area and the non-participating Member States – has emerged as a characteristic, albeit not a 'two-sizes-fits-all' one. In particular, the United Kingdom, while generally supportive of moves to facilitate the better functioning of GEMU, has made clear that it does not want to part of it. By contrast, recognising that they have an interest in shaping a system they are likely to join, other Member States such as Poland and even Sweden are more receptive to being part of new and emerging arrangements. The latter group's interest is in pre-emptive shaping of GEMU. Yet although the opportunity to opt-in is increasingly being made available, the precise modalities of doing so are often unclear. Nor is it obvious whether, if a Member State chooses to opt-in to one dimension of GEMU, it necessarily has to accept others. All this is a recipe for uncertainty in governance.

There is, to a considerable extent, an overlap between the short-term measures and attempts to proceed without resort to treaty change, although various intermediate options exist. What might be called the 'ESM method' consisted of a limited change to just one article (136), accompanied by a separate treaty establishing the ESM. This was broadly endorsed in the ECJ's 'Pringle' judgement. For the Fiscal Compact, the approach was to agree a separate inter-governmental treaty (the TSCG), not least because of the perceived urgency. Moreover, it should be recalled that Article 16 of the TSCG provides for it to be incorporated into the legal framework of the EU:

> 'Within five years, at most, of the date of entry into force of this Treaty, on the basis of an assessment of the experience with its implementation, the necessary steps shall be taken, in accordance with the Treaty on the European Union and the Treaty on the Functioning of the European Union, with the aim of incorporating the substance of this Treaty into the legal framework of the European Union' – Article 16, TSCG.

Whether and how such incorporation takes place and for which of the new governance processes is a matter for conjecture. There are also bound to be legitimacy concerns if this kind of back-door approach integration is used too often, especially if it can be portrayed as elites proceeding without a proper democratic mandate from voters.

5.3.1.1 Implications for Cohesion Policy

It is clear that, in a limited GEMU scenario, a state-centric governance model will remain cardinal, as opposed to a 'EMU-centric' approach which would entail a progressive pooling of sovereignty at the EU level. This limited scenario would thus assume maintaining a setup where the individual Member States will remain ultimately responsible for fiscal policy and public sector debt, even though measures ensuring economic and policy coordination towards the goal of convergence and balancing competitiveness will have to be in place.

In this scenario, the scope for intergovernmental agreements will necessarily be strengthened. At the same time, however, the GEMU bargaining set-up will be weakened. Cohesion Policy will be more likely to take the form of side-payments from some Member States to others (Pollack, 1994). However, resources for such policies at the EU level will remain limited, lying instead in the preferences of individual Member States and intergovernmental bargaining ability. As outlined in Hooghe (1996, p.92), according to this state-centric model it will be up to the Member State executives to decide, 'by virtue of their near-monopoly of power on decision-making in the Council of Ministers', what form intergovernmental harmonization will take and under which rules. Individual Member States' preferences will, by and large, tend to prevail, structuring 'financial allocations, institutional design, and […] implementation' (*ibid*). Concerning Cohesion Policy, the Commission will retain its right of legislative initiative, drawing up the regulatory blueprint and proposing the financial envelope, and a key role in negotiating Partnership Agreements and programmes. This was also the intended setup for the currency union when it was created. Admitting a limited pooling of resources, the final decision on how much money to spend will remain within the Council of Ministers, although influenced by the European Parliament somewhat more than in the past, and *de facto*, within Member States.

Under this scenario, the possibility to impose conditionality will be limited if somewhat stronger than in the past. The 2013 Common Provisions Regulation (covering the 'ESI Funds: ERDF, ESF, Cohesion Fund, European Agricultural Fund for Rural Development and European Maritime and Fisheries Fund) establishes an important link between these funds and the national reform programmes, and extends macroeconomic conditionality from the Cohesion Fund to all of the ESI Funds. As noted, the Regulation's chapter on 'measures linked to sound economic governance' applies macroeconomic conditionality in two ways.

1. **Reprogramming:** the Commission would be empowered to request the Member States to propose revisions to Partnership Agreements and programmes to support the implementation of Council recommendations or to maximise the growth and competitiveness impact of the Funds for Member States receiving financial assistance from the EU. Payments could be suspended if the Member State does not take effective action in response to this request.

2. **Financial suspensions:** when a Member State fails to take corrective action in the context of the economic governance procedures the Commission is entitled to make a proposal to the Council to suspend part or all of the payments and commitments for the programmes of the concerned Member State.

Facing limited resources, the possibility of resorting to strong conditionality on ESI Funds is unlikely to be credible. In fact, if not considerably augmented, the EU budget will remain essentially unrelated to the functioning of the EMU. A larger use of resources, such as a

more comprehensive budget, was limited in the past to the extent that the interests of the EU as a whole (or, joint EU utility) did not necessarily match the sum of the utility of individual Member States (or, aggregate utility). This has had important implications for the process of EU integration, at both regional and national levels. In a limited GEMU scenario, it is difficult to see any move in the direction of further EU expenditure materializing.

There is also the issue of how suspensions of Cohesion Policy commitments or payments can be realistically applied to countries in severe economic difficulties. The Cohesion Policy Framework Regulation acknowledges that measures linked to sound economic governance need to take account of the economic and labour market situation in the countries targeted by providing for reductions in the level of suspensions. But even if the level is reduced, suspending one of the few sources (or only source) of government investment for countries in crisis could be severely counterproductive.

In summary, the 'Limited GEMU' scenario would not have major implications for Cohesion Policy compared with the changes already introduced since the crisis and as part of the 2013 reform of Cohesion Policy. As noted, this would result from relatively few of the proposals being adopted or from them being adopted in so limited a form that they do not make a substantial difference. Nevertheless, the current changes do have implications for Cohesion Policy in terms of the imposition of conditions, scope for co-financing and interaction with other EU policies and processes.

5.3.1.2 Issues for the European Parliament

The European Parliament's role during the implementation of Cohesion Policy is mainly to agree any new legislative amendments that may arise (being the co-legislator), to scrutinise the work of EU institutions (and to a lesser extent the Member States), to offer opinions and reports on important themes and interact with national/regional parliaments. These functions will not change in a limited GEMU scenario, although greater attention will have to be dedicated to economic governance themes and, in the REGI Committee in particular, the interactions and repercussions for Cohesion Policy. As noted, the most important issue for the Parliament in the inter-institutional negotiations on Cohesion Policy has been macroeconomic conditionality. Contrary to one of the EP's demands, it will not have a formal legislative role in the macro-conditionality decision-making process, but will be kept informed of developments through a 'dialogue' with the Commission. However, the EP could call the Commission and Member States to account on these issues in front of the relevant committees to increase the public transparency and accountability of the process.

5.3.2 Comprehensive GEMU

The deepening of governance implied in a **comprehensive GEMU** scenario could take several forms. Among the most plausible (though not necessarily politically realistic in current circumstances) are the following:

- A move towards significantly more intrusive oversight of Member State policies, building on the provisions already in the TSCG, the Two-Pack and the Semester process. If so, it would be expected to lead to intensifying demands for a recasting of accountability and legitimation.
- More rapid moves towards an authentic banking union, including both a more comprehensive common resolution mechanism than the 'timber-framed' one agreed in December 2013but also some form of common deposit insurance.
- The adoption of a substantially greater supranational fiscal capacity, with scope for stabilising asymmetric shocks.

  - A variant might be a temporary facility, as canvassed in the discussions on a Marshall plan for the worst affected southern Member States.
- Further debt mutualisation, potentially paving the way for Eurobonds.
  - Here, a possible variant is the short-term expedient of debt redemption (GCEE, 2012).

For each of these options, there are differing viewpoints on whether treaty change is needed and, if so, whether a limited change, as occurred for the ESM, would suffice. Proposals requiring a more comprehensive treaty revision imply a much longer process and are, therefore, only mentioned but not discussed further, given the time horizon for this study.

There is likely to be increased momentum towards differentiation in this scenario, but not exclusively a cleavage between the euro area and the rest.

5.3.2.1 Implications for Cohesion Policy

A more comprehensive EMU-level governance may create a situation where state executives' and EU institutions' interests may differ from one policy phase to another. Yet, EU institutions will have the necessary resources to act, and, therefore, enforce conditionality.

Compared to the limited EMU scenario, intergovernmental solutions should therefore only be considered exceptionally or as a temporary measure, perhaps serving as the initial step towards a Community solution and, whereas a comprehensive approach, of the type envisaged here, and entailing a progressive centralization of resources at the EU level, should be preferred. The latter would privilege a more efficient spending of resources, focusing on the EU's top priorities and add to the existing efforts at the national and regional levels on issues of growth, job creation, energy and poverty. This would imply a significant shift of policy responsibilities to the European level, and could presage Cohesion Policy being financially downgraded in favour of a separate fiscal capacity or to be run 'top-down' as a contribution to a range of EU-wide goals, and clearly implying a Treaty change. On this point, and as set out in the Commission blueprint, 'based on the progressive pooling of sovereignty and thus responsibility as well as solidarity competencies to the European level, the establishment of an autonomous euro area budget providing for a fiscal capacity for the EMU to support Member States in the absorption of shocks' should be warranted. Such a possibility will have important implication for Cohesion Policy, augmenting the room for manoeuvre at the European level.

However, the existence of a fund of this type prompts some questions. From the perspective of macroeconomic stabilisation in the EMU, the key issue would be indeed 'whether this fund would improve fiscal shock absorbers in the presence of asymmetric shocks' (Fuest and Peichl, 2012). In fact, in order to achieve macroeconomic stabilization, it would be necessary that contributions to the central European budget will decline automatically, in the presence of (country-specific) negative shocks, while central expenditures in the affected countries will have to increase (*ibid.*). Assuming the scope for a fiscal stabilisation of this kind would be larger under a comprehensive GEMU set-up, it is difficult to envisage more generous transfers without the latter being backed up by the ability to levy tax, a development that would be likely to require revenue raising power for the European Parliament.

In addition, exposing EU resources to conditionality, in order to avoid loose macro and national policies, as set out in the Commission proposal, may threaten regional integration,

augmenting the risk of lock-in processes, and creating a sense of victimhood and / or increased clashes at different levels of economic governance (regional, national, supranational).
In contrast to limited GEMU, this comprehensive GEMU scenario raises more profound implications for the future of Cohesion Policy, particularly for the budgetary and geographical focus of the policy. It is important to recall and stress that the underlying rationale for Cohesion Policy is to address the economic, social and territorial disparities that exist across the EU, and which may be exacerbated by EU policies such as EMU and the single market. As recognised in the Thomson Report when the ERDF was created and emphasised more recently in the Barca Report, a political union of Member States, which is implicit in the GEMU scenario, would be difficult to sustain if economic, social and territorial disparities are wide and increasing across the EU.

Looking forward, the Member States and regions most acutely affected by the crisis will face the most intense fiscal consolidation pressures yet will be in a weaker position to adapt to emerging EU and global pressures affecting development prospects. A recent ESPON study modelling future territorial development scenarios across the EU suggests a bleak outlook for territorial cohesion, at least in the short-term to medium-term. In particular, growing disparities are predicted between the core and periphery (southern and eastern) countries and regions as well as large labour migration and depopulation in many Central and Eastern European regions, at least up to 2030 (ESPON, 2013). While More-Developed Regions will be able to exploit the growth of global markets and emerging technologies from now to 2030, Less-Developed Regions and sparsely populated rural regions in Eastern countries will become increasingly depopulated due to out-migration of their young, more skilled people. The most optimistic model predicts regional convergence over the medium (2030) and long-term (2050), but at a much slower pace than in previous decades.

The implication of these scenarios is that there will continue to be demand for a well-funded Cohesion Policy to support regional development and cohesion in the EU. However, the financial and political realities of fiscal consolidation militate against any future increases in resources at EU-level, as was made clear in the recent cuts to the Cohesion Policy budget for 2014-20. Moreover, fiscal consolidation accompanied by the creation of other Eurozone budget lines, could lead to more pressure on the Cohesion Policy budget. As a consequence, the historical debate about whether Cohesion Policy should only support regional development in the poorest countries (with a smaller budget) is likely to resurface and could become more salient.

The Commission has always argued for a pan-EU Cohesion Policy to support all Member States, with a higher concentration of funding in the less-developed EU regions, as has been the case since the major landmark reform of 1988, despite doubts in many richer Member States (for an overview of the arguments, see Begg, 2009). It is worth recalling that the Commission's impact assessment of the 2013 reform examined a 'lagging country focus' option, which restricting funding to the less-developed Member States (European Commission 2011). The scenario implied a budget half the size of the alternative status quo option covering only those countries with an average GNI/head of less than 90 percent of the EU average and 22 percent of the EU population. While concentration on less-developed countries would save money for the EU budget, the option was rejected for four reasons: Cohesion Policy would become a redistributive policy losing its allocative benefits across the EU; there would be lower incentives to foster cross-border spill-over effects across countries and regions; the incentives to contribute to EU-wide priorities would decline; and there would be lower growth effects on the EU economy.

However, moves towards GEMU – including common deposit insurance as part of banking union, adoption of supranational fiscal capacity and Eurobonds – would inevitably place

downward pressure on the size of the EU budget and Cohesion Policy from the net payers because of the financial costs associated with these GEMU initiatives. Even though the net beneficiary countries would resist these pressures (as would the European Parliament and Commission), the policy direction could be towards less territorial and thematic coverage of Cohesion Policy, potentially substituting ESI Funds in Eurozone countries and/or narrowing the interpretation of its Treaty mission. At the same time as reducing the territorial/thematic coverage of the Cohesion budget, more intrusive oversight of the use of EU funding and of Member State policies could lead to many of the financial and governance challenges associated with the limited GEMU scenario.

In particular, it would involve stricter conditionality including more EU-level involvement in strategic decisions and thematic allocations, stricter and more automatic imposition of sanctions in cases of non-compliance, associated administrative and co-financing challenges and more highly politicised implementation processes. Moreover, a strengthened European Semester policy process could have a significant impact on Cohesion Policy as the Country-Specific Recommendations, issued annually in the context of the Semester, would have more binding implications for National Reform Programmes and put more pressure on the Member States to review or revise their Partnership Agreement and operational programmes' funding priorities on an annual basis. This would jeopardize the stability of the multi-annual approach that has been a programming principle and key dimension of Cohesion Policy's added value since 1988 (Mendez 2013).

5.3.2.2 A variant scenario

Consideration of the possible scenarios has to consider whether GEMU will involve new instruments. **GEMU without new instruments** would involve enhanced challenges for cohesion, with an enhanced need for Cohesion Policy to cope with the stabilisation pressures. This would probably lead to further shifts in the objectives of the policy, with increased 'thematisation' or sectoralisation of the policy (continuing the path set by the 2007-13 and 2014-20 reforms). There may also be pressure to modify the budget allocation model for Cohesion Policy in the negotiation of the MFF.

The implications of a **GEMU with new instruments** would depend on the scale of the funding involved. A CCI with a budget equivalent to five percent of Cohesion Policy would not significantly affect the policy, although there would be concern at a further top-slicing and pre-allocation of the Cohesion Policy budget, as in 2014-20 with the Connecting Europe Facility and the Youth Employment Initiative. A more substantially-funded CCI would present competition for the current (implicit, but arithmetically limited) stabilisation function of Cohesion Policy. There would clearly be a threat to the budgetary resources of Cohesion Policy, and probably a narrower focus for Cohesion Policy within those countries covered by the CCI. The question also arises as to the role of Cohesion Policy in non-CCI countries. The political economy of the MFF negotiations would also change, given the current role that Cohesion Policy plays in securing the required net balances of individual Member States (Bachtler *et al.* 2013). While in budgetary terms, Cohesion Policy may suffer, there may be benefits in terms of the management and implementation of the policy, freeing it (at least partly) from a stabilisation function and allowing a greater focus on regional and local development in disadvantaged parts of the EU.

5.3.2.3 Issues for the European Parliament

Moves towards a comprehensive GEMU, involving significantly more intrusive oversight of Member State policies, would be expected to lead to intensifying demands for a stronger accountability and legitimation and, accordingly, a stronger decision-making and scrutiny role by the European Parliament. There are four sets of implications. The first is the Parliament's role in the design and operation of enhanced GEMU measures and

instruments; here the resistance of the Commission and Member States to Parliament's influence on the exercise of macroeconomic conditionality is not a promising precedent. Second, there is the process by which the Parliament is able to hold other actors to account, and the potential need for more scrutiny of the Commission, Commissioners, and national ministers in front of Parliamentary committees. Third, the ability of the European Parliament to hold other institutions to account would require better insights on how GEMU measures are affecting countries and regions on the ground, in particular to be able to judge the rationale and implications for sanctions. Lastly, there are internal organisational issues for the Parliament, notably the relationship and inter-committee dialogue (e.g. between the Regional Development, Budgets, Economic and Monetary Affairs committees), and the extent to which the different committees are involved in scrutinising new governance mechanisms.

6. CONCLUSIONS: GOVERNANCE, LEGITIMACY AND IMPLICATIONS FOR THE EUROPEAN PARLIAMENT

In the words of European Parliament Resolution 2012/2151, passed on the 20 November 2012, 'the time has come for the political leaders of and within the Union to demonstrate their determination, creativity, courage, resilience and leadership to remove the remaining deficiencies that continue to hamper the proper functioning of the EMU'.

There can be little doubt that extensive changes in the principles and mechanisms for managing economic and monetary union were needed and that there are both immediate and longer term ramifications of these changes. Redressing the imbalances that arose in the first decade of the euro was something which clearly had to be done, but which has manifestly also had a decidedly uneven territorial impact. Looking at current macroeconomic data and projections, it is evident that the adjustments taking place in, especially, southern Europe are accentuating regional disparities across the EU and there is a credible argument that the governance framework is part of the reason. However, it is important to distinguish between the effects of crisis management and the longer term changes wrought since 2010, and thus to avoid too glib an interpretation of the effects of the reforms.

6.1 The consequences and legitimacy of governance reforms

The array of recent governance reforms will have pronounced effects on the ability of Member States to plan and fund their own economic development strategies. Their freedom of manoeuvre is likely to be circumscribed and they will have to adapt to the new realities of economic integration. Yet, some of the directions for further change and their implications for legitimacy remain uncertain.

Mody (2013) argues that the 'muddling through' approach which has characterised the EU since the Greek crisis erupted cannot be sustained and must be strengthened by much more decisive commitments to restructure sovereign borrowing and in banking, alongside fiscal restraint. Fragmentation of banking into national financial systems, undoing one of the pillars of the single market, has been a trend, but one which is incomplete, leaving its own vulnerabilities. Constraints will arise from three main sources.

- The **squeeze on national budgets** resulting from the various mechanisms designed to promote fiscal sustainability. Particularly where substantial co-funding of Cohesion Policy initiatives is required, a consequence could be to lower effective spending. The problems already evident in some Member States in absorbing Structural and Investment Funds could be aggravated.
- **Conditions imposed** as part of the recasting of governance processes which constrain the choices open to national and sub-national levels of government and make their spending contingent on actions over which they may have no control. It is a difficult issue precisely because a 'carrot and stick' logic requires both sorts of incentives.
- **Top-down priorities** set by the EU level on the disbursement of Structural and Investment Funds which oblige governments to use domestic resources as well as receipts from national sources on designated classes of public investment. Two potential objections can be raised, the most obvious of which is that imposition from above – irrespective of whether one-size-fits-all – goes against the a desire for subsidiarity in decision-making. However, economic concerns also arise around whether the policy prescription is correct, whether generally or specifically for the region in question.

In addition, the re-emergence of national credit risk and the continuing problems of the banking sector in some Member States make it more likely private borrowers will face higher interest rates in more vulnerable Member States and, conceivably, regions.

6.1.1 Intervention logic

In relating economic governance to cohesion, ideas about different approaches to economic development need to be brought into the picture. In earlier programming periods of Cohesion Policy, after the reform of 1988, investment in infrastructure was regarded as a necessary condition for regional development (Biehl 1991; Bachtler and Gorzelak 2007). The logic behind these interventions was that unless regions attained adequate standards of transport or basic services, they would be 'off the radar' for productive investment and would struggle to establish flourishing SMEs. Physical investment could become the basis for breaking out of a low-development equilibrium, alongside efforts to enhance human capital. This logic of building up the capital stock justified large-scale investment in major projects, some taking several programme periods to complete, and can be characterised as 'extensive' in the sense of a growth in the supply of the main factors of production.

Since the late 1990s, the logic of development has shifted towards endogenous growth, with innovation and research-led economic development stressed in policy packages (see, for example, Malecki 1997). The logic in this latter case is one of improving the quality of inputs as the basis for growth, rather than their quantity. These new orientations accorded with the Lisbon agenda and, to varying degrees, also gave greater prominence to social cohesion as a determinant of economic growth.

Over the 2000-06 and 2007-13 periods, Cohesion Policy has been assigned different roles, notably in advancing the structural reform agenda of the Lisbon strategy and, subsequently, the Europe 2020 strategy. In the regulations for 2014-20, earmarking is again a prominent feature of the policy and Cohesion Policy has acquired additional tasks in supporting macroeconomic adjustment. Moreover, although there will still be a concentration of Cohesion Policy spending in the Less-Developed Regions, all other regions are eligible to receive some support.

6.2 Reconciling governance reform and Cohesion Policy

Progressively, the reforms of economic governance are putting in place a system for economic policy making which will shape both how policy choices are shaped and the implicit preferences for the economic model to be pursued. As an illustration of the latter, successive Annual Growth Surveys, the latest of which was published in November 2013 (Commission, 2013f), have emphasised the quality of public finances in the context of an over-arching recommendation to ensure growth friendly-fiscal consolidation. As recommendations, they are not binding on Member States (although more so for euro area members than others), but the thrust of the Commission guidance is that priority should be given to 'expenditure on Europe 2020 targets'.

A possible interpretation is that the broad thrust of economic development policy is determined more from above than in the past and that room for manoeuvre at Member State level and at regional level will be diminished. Although such a trend could already be discerned in the links between the Lisbon agenda and Cohesion Policy during the 2007-13 programme period, the intensification of surveillance of national economies and the increased prominence of the European Semester in the calendar of policy-making reinforces the trend. There is also a new configuration of policy influence in which the ECB and the Brussels institutions have a greater say in strategic policy decisions. Whether or not it is

comfortable with the role, the ECB can affect cohesion outcomes through its actions in the bond markets or (via the ESRB) on macro-prudential matters, even if the longer term expectation is that crisis management responses be regarded as exceptional. So too does the Commission through its influence on national budgets and its broader obligations on macroeconomic stability. It will take time to ascertain whether or not implementation and compliance with the rules follow the new architecture, but to the extent that they do, tricky problems of legitimacy will arise,

In parallel, the Commission in the Annual Growth Survey calls for better controls on State aid and signals that they should be reduced. The difficulty here is that there is often a fine line between a State aid and a regional development incentive which advances economic cohesion. In this regard, there is limited debate on what forms of expenditure are most likely to reconcile potential conflicts between cohesion and competitiveness objectives, pointing to a theme which the REGI Committee may want to explore. The balance between physical investments and the softer instruments of regional development (innovation, human capital, social inclusion, possibly even health care) in fostering growth needs debate, especially taking into account differences in the circumstances of individual regions or classes of regions.

Questions also arise about how the governance arrangements for Cohesion Policy could change. Areas for debate include the rates and terms of co-financing, with a number of options which might be explored. For example, irrespective of the co-funding rate, the time-scale over which the national or regional component is paid could be varied: instead of simultaneous payment, ERDF contributions could be paid earlier in periods of economic difficulty (as happened in the fiscal stimulus package in 2009-10).

6.3 GEMU and Cohesion Policy

The likely impact of GEMU on cohesion goals will be contingent on which of the proposals are approved, the order in which they are introduced and the parameters for the different elements.

6.3.1 Banking union – key for cohesion?

Banking union has the potential to ease the negative feedback loop between sovereign debt and bank fragility and, if it does so, would be positive for cohesion objectives. However, the outcome very much depends on the details of banking union. The December 2013 agreement on a single resolution mechanism (SRM), following on from the single supervisory mechanism (SSM) already agreed, is significant because it means that two of the three components of banking union are now expected to be operational from 2015, even if both have been somewhat watered-down from their original conceptions. However, the third, a common approach to deposit insurance, has been side-lined and is unlikely to be introduced in the foreseeable future.

Moreover, the resolution fund envisaged as part of the SRM, to be funded by annual levies on banks, will take ten years to reach its target size of €55 billion. Before then, the risks will not be shared among the countries participating in banking union. This means that, in the event of problems in resolving a bank and/or compensating depositors, the public finances of the Member State in which the bank is based will still constitute the fiscal backstop. In effect, therefore, the toxic link between banks and sovereigns which triggered the adjustment programmes in Ireland and Cyprus, and which came close to doing so in Spain, have not been dealt with.

Indeed, there is one aspect of the moves towards banking union which could make matters worse: if the ECB, in its capacity as lead supervisor, identifies problems which lead to a bank being closed or scaled-down in ways which rely on tax-payer support, a supranational entity would be causing a fiscal burden for a Member State, but would have no obligation to help.

Incomplete banking union can be interpreted in two ways. One is that it is a sequence in which much remains to be settled, but with reasonable clarity about the eventual destination. In this interpretation the principal policy challenges will be how to manage the transition. The alternative explanation is that political resistance to burden-sharing will mean that only an incomplete banking union can be attained. Leaving resolution funding predominantly at national level would mean perpetuating the bank-sovereign doom-loop. Hence the nature of fiscal backstops beyond what was agreed in December 2013 is a crucial issue for the Parliament to consider.

Lending to SMEs has been a victim of the banking crisis (Darvas 2013). Given the still fragile state of many banks, the asset quality review (AQR) which the ECB, quite rightly, is conducting in anticipation of the start of the single supervisory mechanism, could expose problems and carries risks which some Member States may struggle to mitigate or resolve. A tough AQR outcome could lead to renewed difficulties for banks in some Member States which could also result in calls on public finances to support recapitalisation, but may also oblige banks to be tougher about non-performing loans.

The fact that unsecured bank creditors will be called after shareholders in paying for resolution could also accentuate regional disparities, and if the bail-in of depositors is also countenanced, the effect could be greater still. Such bail-in has the immediate effect of cutting credit in already vulnerable economies, but could also have a knock-on effect in reducing the willingness of lenders to extend new loans to these regions. Since resort to the ESM also requires that shareholders and unsecured creditors should be first in line, the hierarchy of 'bailing-in' could have a significant effect on financial conditions in affected regions or Member States. A resulting policy issue is whether, in the range of instruments established in the last few years, there is enough cheap finance to enable banks which are fundamentally sound to be nursed back to health. It is something that can only be properly assessed after some time and the potential benefits for governments need careful measurement. The rescue of Swedish banks in the early 1990s eventually had no net cost for the government, while Micossi *et al*. (2013) note that the US TARP programme has generated net gains for the US Treasury in cash terms.

6.3.2 Additional fiscal capacity at euro area (plus) level

A new fiscal capacity also has the potential to contribute to cohesion, especially if it enables a Member State hit by an asymmetric shock to adjust more flexibly than if it has to rely exclusively on its own fiscal resources. However, there is a difficult border-line between temporary and more permanent support. Because regional disparities are so persistent, most Member States have domestic equalisation systems in which the net contributors and recipients vary only marginally, if at all, over long periods of time. Considerable creativity has gone into devising stabilisation instruments which would be neutral over normal economic cycles, but the more successful they are in this respect, the more problematic they risk becoming in others. An unemployment criterion, for example, could result in stabilisation flows from poorer to richer Member States which would be hard to reconcile with a pure cohesion goal.

The problem in the EU is, as so often, that the available funds are either too limited or too hedged around with conditions to be fully effective. For the REGI Committee, an associated issue is whether the directions being taken by governance reforms affecting the financial sector will create new forms of systematic disadvantage for Less-Developed Regions or Member States undertaking extensive macroeconomic adjustment programmes.

6.4 Issues for the European Parliament

Behind the apparent consensus about the way forward for economic governance, there are many issues which have been left unresolved either because they are too difficult or because it has not been possible to agree on the implicit sharing of burdens involved. The European Parliament, for example, has already called for a social pact for Europe as part of the moves to GEMU. A compelling case can, similarly, be made to include cohesion as a core economic governance goal. Several other themes could be examined by the Parliament in seeking to shape the evolution of governance and its effects on cohesion. This section discusses a range of relevant issues.

A first is the logic of transfers as part of EMU. The Glienicker group (2013), composed of eleven Germans from different backgrounds, has argued that there is a dangerous complacency in their country about the approach to the crisis. The group calls for deeper integration and argues that 'it is in Germany's self-interest to overcome fears about a transfer union and to stop dismissing any constructive proposal as an attempt to pull the money out of German pockets'. For the European Parliament, this could be an important message.

Whether the emerging system is sufficiently coherent is a second issue. Even with the Semester and the provisions of the Fiscal Compact, arriving at a sound mix of fiscal, monetary and structural policies remains elusive. There have been many viable proposals for new instruments, whether based on unemployment rates or some other criteria, but they have lacked the sort of momentum that could be generated if pushed by the Parliament.

A third issue is the symmetry of the impact of governance reforms. The Commission may have declared that Germany has an excessive surplus, but it is not likely to trigger an early response, pointing to one of the weaknesses of the governance framework in which the traditional asymmetry between surplus and deficit countries is exacerbated by a lack of effective remedy. German commentators largely reject the view that Germany needs to boost domestic demand. Yet, as Springford and Tilford (2013) argue, the German real exchange rate is now undervalued as a result of several years of wage restraint and this makes it harder for other Member States to make headway in both intra and extra EU trade. This is something which has direct repercussions for adjustment strategies, and thus cohesion outcomes, and may be an area in which the REGI Committee can bring pressure to bear.

Fourth, there is a potentially worrying inconsistency between demands for safer banking at the same time as more bank lending to break the credit squeeze on SMEs and the construction sector. In addition, with the so-called 'timber-framed' resolution system, the bulk of the obligations will remain with Member States, with only a gradual build-up of a bank-funded resolution fund before a fuller banking union with an EU level backstop becomes viable, the latter only after treaty change. For this reason, the doom-loop has not been broken and banking problems risk weighing on the worst affected Member States for some time. They could lead to new fiscal problems for sovereigns and is a facet of GEMU that should not be allowed to drag on too long.

A further question is how well equipped the economic governance system is to cope with new challenges. Massive adjustments have taken place in several Member States (Dervis *et al*. 2013), especially those accorded a bailout, and more is in the pipeline. But in the next phase, the focus will have to shift to sustaining recovery and social cohesion. Greece exemplifies the challenges: having had to make a huge fiscal adjustment, it is now faced with rebuilding a shattered economy. According to Chrysoloras (2013), the two main needs today are to avoid overly onerous debt service (perhaps by easing debt terms, rather than explicit default) and investment to 'expand the country's productive base, increase wealth production, and alleviate the social crisis, until the ongoing structural reforms bear fruit'. This is partly about rebalancing at EU level, but it also suggests that Cohesion Policy may need to be rethought to deal with such challenges.

From a Cohesion Policy perspective, there are two main issues for the European Parliament to consider. The first is the **legitimacy of GEMU**, and the degree to which decisions on economic governance and its operation are being made by the Commission, Council and ECB, with (hitherto) weak oversight and accountability by the Parliament. It is also important that, when the European Parliament is involved, it should not just be through the Economic and Monetary Affairs Committee and the Employment Committee. For example, there is a compelling case for the Regional Development Committee to be part of the annual inter-parliamentary meeting on the European Semester. After all, Cohesion Policy, in many Member States is a large proportion of public investment and thus has a significant impact on growth prospects. Moreover, if the drift towards 'contractualisation' of governance continues, the use of ESI funds will inevitably be part of the picture.

The legitimacy issue goes much wider than Cohesion Policy but is particularly pertinent because of the importance of the policy as a share of the EU budget, its importance for financing government investment in some of the poorest countries or most troubled economies, and the use of Cohesion Policy funding as a sanction (possibly counter-productively) in cases where macroeconomic policy conditions are not fulfilled. If the experiences of conditionalities under the Cohesion Fund are any guide, the use of sanctions for breaches of macroeconomic conditionality may be limited in their application, yet a precedent has been set for relatively weak Parliament influence on their operation.

The second set of issues concerns the **rationale and design of Cohesion Policy**. The reforms of the policy for the 2007-13 and 2014-20 have had, or are having, important effects on what the policy does, where funding is spent and who makes decisions on the allocation of resources. As noted in the previous sections, there has been a creeping process of sectoralisation of Cohesion Policy, driven by the imperatives of the Lisbon agenda and Europe 2020 strategy, and political decisions to safeguard the Cohesion Policy budget by casting it as the delivery agent for EU objectives.

One of the casualties of this process – in some countries - is multi-level governance, with a rationalisation of programme architecture, increased centralisation of programme management and top-down decision-making, and even less involvement of local authorities and economic and social partners (in some cases driven also by domestic reforms of public administration). Whether GEMU develops in a limited or more substantial form, there will be pressures on the budget, objectives, priorities and governance of Cohesion Policy, particularly if new instruments emerge. Not all these pressures may be negative for the policy, for example if they rationalise the multiplicity of sometimes conflicting objectives currently experienced by the policy, give it more thematic or spatial focus, and simplify its administration. The Parliament could play a valuable service with some early thinking on how, in practice, Cohesion Policy might be adapted or even redesigned under different arrangements for GEMU.

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ISBN 978-92-823-5304-2
doi: 10.2861/49877

Publications Office