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Macroeconomic Conditionality in Cohesion Policy: Added Value or Unnecessary Burden?

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Macroeconomic conditionality has become one of the major elements in discussions on the future of EU cohesion policy. Such conditionality would make the cohesion budget dependent on EU economic governance rules. This would have advantages for economic governance and, to a lesser extent, the efficiency of cohesion policy and the EU's Multiannual Financial Framework negotiations. Yet, conditionality also risks entailing serious disadvantages for the end beneficiaries and cohesion policy itself. If the EU decides to put macroeconomic conditionality in place, it needs to reconsider the design and agree on an ample cohesion budget.

The financial and economic crisis and ensuing eurozone sovereign debt crisis laid bare numerous failures in European policies, with light-touch financial regulation being one of the most evident policy mistakes. The crisis also revealed weaknesses in other policy domains. EU economic governance rules clearly proved unable to prevent a sovereign debt crisis from engulfing the eurozone. The EU's cohesion policy was also undermined by the crisis. As deficits soared, some Member States had difficulties in providing necessary co-financing for cohesion policy projects. Furthermore, due to the faltering economy, earlier cohesion policy projects failed to generate the expected economic return.

In response to these failures, wide-ranging policy reforms were undertaken. Strengthening the EU's economic governance is one of the key pillars of that reform. Some also argue that the EU budget should be conditional with respect to economic governance rules. As cohesion policy is one of the major EU expenditures, with €376 billion proposed by the Commission for the 2014-2020 financial framework, it is a prime candidate for linking the EU budget to economic governance.

Making the cohesion budget dependent on economic governance has become known as macroeconomic conditionality. It is only one of the conditionality scenarios under discussion, but it has led to the most heated debates.[1] The Commission hopes that it would create additional pressure on Member States to comply with the reformed EU economic governance rules and, at the same time, improve the effectiveness of cohesion policy. But the question is if such a mechanism could actually contribute to the strengthening of rules? It seems that one can find many arguments in support of conditionality in cohesion policy, but some questions may also be raised.

Despite the importance of macroeconomic conditionality in cohesion policy, so far only a few studies have been published on the subject. The purpose of this policy brief is to analyse macroeconomic conditionality as proposed for cohesion policy. In the first section, a brief description of the mechanisms is presented. The following parts concentrate on the advantages and disadvantages of the proposal and conclude with a summary.

THE CONTENT OF MACROECONOMIC CONDITIONALITY

The idea of linking disbursements from the EU budget with macroeconomic performance is not new. Under the 2007-2013 budget rules, it was possible to suspend financial support from one of the cohesion policy funds[2], at the final stage of the Excessive Deficit Procedure. These rules have not had many results. The EU only threatened once to use them, against Hungary in 2012, but in the end no sanction was applied. Several weaknesses of the mechanism explain why macroeconomic conditionality has not been used: it applies only to a small amount of cohesion policy funding, concerns only fiscal problems and can be used only as a "nuclear option" at the end of a lengthy procedure.

In its proposal for the 2014-2020 Multiannual Financial Framework (MFF), the Commission tries to overcome these difficulties. Rather than reversing macroeconomic conditionality, the Commission has sought to significantly increase its scope. The details of the Commission's proposal were laid down in a Draft Regulation of 14 March 2012 (Commission, 2012) and included in the recent version of the MFF negotiating box (Council, 2012).[3]

The idea is to make the disbursement of all Common Strategic Framework (CSF) expenditures dependent on Member States' performance under EU economic governance procedures. The CSF funds include all cohesion policy funds, i.e., the Cohesion Fund and the Structural Funds.[4] Macroeconomic conditionality also would apply to all of the stages of the economic governance procedures, from preventive surveillance and fiscal and macroeconomic

[1] Several forms of conditionality concerning cohesion policy are under discussion, including: 1) macroeconomic conditionality, 2) ex-ante conditionality, and 3) ex-post conditionality. This policy brief concerns only the first form.

[2] The Cohesion Fund was made dependent on respect for the EU's fiscal rules. Such conditionality was not applied to the Structural Funds.

[3] With its proposal, the Commission followed up on previous analyses and recommendations (see: Commission, 2010b; Van Rompuy Task Force, 2010; ECB, 2010).

[4] Two funds outside traditional cohesion policy also fall under CSF funds: the European Agricultural Fund for Rural Development, and the soon-to-be created European Maritime and Fisheries Fund. While this note focuses on cohesion policy funds, macroeconomic conditionalities would thus also be relevant for these agriculture and fisheries funds.

imbalances to financial assistance programmes.

The Commission proposes three different ways in which cohesion policy allocations could be reviewed.

Optional Suspension of Cohesion Funding

First, the European Commission may have the possibility to ask a Member State to amend its cohesion policy partnership contract. The Commission would be able to do so (while not being obligated to do so) when difficulties or imbalances are detected in a Member State. The request to modify the partnership contract would follow EU recommendations and/or warnings. The request to modify the partnership contract may occur after:

- economic policy or employment recommendations,
- measures on the basis of a eurozone specific treaty article (Article 136(1) TFEU),
- recommendations when opening the excessive deficit and imbalances procedures, or
- a country receives a European financial assistance programme (in case of the latter, the Commission would even be able to modify the partnership contract unilaterally).

The request to amend the partnership contracts is meant to allow the Member State to better address its difficulties. The goal is thus not to cut cohesion funding. Only in case the Commission judges that the amendments of the partnership contract proposed by the Member State are insufficient would the institution suspend part or all of the cohesion policy payments. Furthermore, such a decision would only be taken after a lengthy procedure of up to five months. Because of its length, the optional suspension procedure does not always fit in well with the rest of EU economic governance (Verhelst, 2012).

Mandatory Suspension of Cohesion Funding

A second way to suspend cohesion funding is much more automatic. The Commission would be obliged to suspend part or all of the cohesion policy payments and/or commitments when a Member State is found to not to have taken sufficient measures to correct its fiscal or macroeconomic problems. The suspension of payments is likely to have a bigger impact than the suspension of commitments, as it results in stopping the transfer of financial means to cohesion projects. The suspension of commitments concerns future payments and would thus mostly have an impact in the longer-term.

A mandatory suspension would only occur at the later stages of the economic governance process, when:

- a Member State does not comply with the specific measures set out by the Council in accordance with Article 136(1) TFEU,
- the Council concludes that no effective action has been taken under the excessive deficit or macroeconomic imbalance procedure, or
- a Member State does not sufficiently implement the adjustment programme that accompanies a European financial assistance programme.

The mandatory suspension is first meant as a sanction. In this respect, it is rather different from the optional suspension of cohesion policy funding, which mainly serves as an incentive for reforms to the Member States' cohesion policy priorities.

Potential Easier Access to Cohesion Funding

The last manner in which cohesion policy funding allocations can be reviewed is of a different nature from the two previous options. Instead of suspending cohesion funding, this third option can allow for easier Member State access to cohesion policy funds. This possibility would only apply in case a Member State enters into a financial assistance programme.

In practice, a Member State under financial assistance can request increasing EU co-financing by 10 percentage points. As a result, the EU could potentially finance up to 95% of a cohesion project in the poorest regions (instead of 85% in normal circumstances). Such an increase in EU co-financing would, however, not result in the country receiving more cohesion funding than was originally foreseen. Rather, the money could be spent on a smaller number of projects.

Nevertheless, due to the exceptional character of financial assistance programmes, it is likely that macroeconomic conditionality would be of a rather repressive character to EU members.

WHY MACROECONOMIC CONDITIONALITY IS AN ATTRACTIVE CONCEPT

Imposing macroeconomic conditionalities can have significant advantages. While the advantages mainly concern EU economic governance, macroeconomic conditionalities can also have beneficial effects on cohesion policy. Furthermore, an agreement on the matter could be of use in reaching compromise in discussions on the next MFF.

More Means of Enforcing EU Economic Governance Rules

One of the crucial flaws of pre-crisis EU economic governance was the inability to ensure a Member State's compliance with European rules. The reforms that have been adopted in response to the sovereign debt crisis partly addressed this failure. Yet, the resulting enforcement framework still faces shortcomings. Macroeconomic conditionality can offer five advantages over the existing means to enforce national compliance with EU economic governance rules.

First, macroeconomic conditionality is a more credible way of sanctioning a country. Current economic governance sanctions consist of deposits and fines that are imposed on a Member State. Such sanctions have an immediate negative impact on national public finances, which rather obviously adds to a Member States' difficulties. Macroeconomic conditionality would also impose a financial sanction but would not lead to a direct increase in the fiscal deficit. Instead, it would result in the non-disbursement of financial means from the EU to a Member State. While the eventual consequences might be similar (as suspending cohesion funding will also have an adverse effect), the sanction is politically more feasible. The higher credibility of macroeconomic conditionality makes it more likely to be applied.

As a second advantage, macroeconomic conditionality would allow for expanding the geographical scope of sanctions linked to EU economic governance. The existing economic governance rules only foresee sanctions for countries that are members of the eurozone. Macroeconomic conditionality would, in contrast, apply to all Member States.[5] While

[5] The UK might be exempted from macroeconomic conditionality due to Protocol 15 of the Treaty.

ongoing discussions rightly focus on strengthening economic governance inside the eurozone, we should not forget that the single market has rendered all national economies interconnected. Sound economic and fiscal policies therefore matter in every Member State.

Third, macroeconomic conditionality can be applied earlier on in the economic governance process, compared to the existing sanctions. Conditionality can result in sanctions even before a corrective economic governance procedure is opened[6]. That way, the EU can interfere in a more compelling way during the early parts of the economic governance procedure. Macroeconomic conditionality can thus help pressure Member States to reform their policies before a full-blown imbalance emerges.

Macroeconomic conditionality can, as a fourth advantage, be applied in a more automatic manner than the existing sanctions. The introduction of reversed qualified majority voting[7] has already reduced the role of the Council in decisions on sanctions. Macroeconomic conditionality can go a step further. The Commission suggests that sanctions would be imposed by a simple Commission decision or an implementing act. Since that would be more automatic, it would make macroeconomic conditionality sanctions less prone to political bargaining than economic governance sanctions.

Fifth, although not fully exploited in the Commission's proposal, macroeconomic conditionality could also serve as a positive incentive in enticing national policy reforms. As noted already, the Commission only proposes easier access to cohesion funding in case a country receives emergency financial assistance by the EU or the eurozone. However, the possibility of easier access to cohesion funding could be expanded to other phases in the economic governance process. In such a design, the access to cohesion funding could be eased in case a country acts upon the warnings and recommendations made by the EU. This would happen in addition to the possibility of suspending cohesion funding and applying penalties. Such a genuine carrot-and-stick approach could potentially be more effective than the existing focus on sanctions (Verhelst, 2011).

More National Ownership of EU Economic Governance

Besides being a better means of enforcement, macroeconomic conditionality can address another key flaw of EU economic governance – the lack of ownership in Member States. While rules and procedures for economic and fiscal policy coordination were agreed on the European level, they have not gained sufficient traction inside Member States. Policy coordination has too often developed into a bureaucratic procedure with minimal genuine national interest and commitment.

The reforms that took place since the start of the sovereign debt crisis have tried to tackle this problem. Most notably, the European Semester and the Euro Plus Pact increased the political importance of coordination among Member States. Notwithstanding these positive evolutions, the economic governance procedures remain very much in the hands of some parts of the central

[6] The six-pack reform introduced the possibility of an interest-bearing deposit by a eurozone country that fails to adhere to its Medium-term Budgetary Objective. This deposit would be required before a corrective procedure is opened. Yet, the interest-bearing character gives this deposit the role of a guarantee rather than a genuine sanction.

[7] Under the voting mechanism, a sanction proposed by the Commission is automatically adopted, unless the Council opposes the Commission's proposal by a qualified majority within 10 days of the proposal.

government. Although the regions and local administrations benefit from sound economic policies in the long-term, they enjoy few short-term gains in case EU economic governance rules are respected. As a consequence, their interest in economic governance tends to be limited.

Macroeconomic conditionality can change the way sub-central governments perceive EU economic governance, as regions and local administrations would face the possibility of having their European funding cut. This threat is likely to have a significant impact, especially in those regions that strongly rely on cohesion funding. As a consequence, regions and local administrations would start to exercise more pressure on the central government to meet the EU economic governance requirements.

In addition, local governments would have a bigger incentive to ensure the soundness of their own policies, notably their fiscal positions. The importance of the latter should not be underestimated. Local government spending alone represents almost a quarter of total public spending. In some Member States, local governments and regions run high deficits, significantly worsening the overall national figures[8] (Gancedo Vallina and Wahrig, 2012).

Potential Avoidance of Wasteful Spending of Cohesion Funds

Besides the potential positive impact on EU economic governance, macroeconomic conditionality can also be instrumental for cohesion policy. The economic results of cohesion policy depend heavily on the wider economic and regulatory setting. Therefore, European funds simply cannot bear fruit if other factors of economic growth are lacking.

The financial and economic crisis has shown indeed that the positive effects of investments in poorer regions can easily be undone by macroeconomic or fiscal imbalances. The real estate bubble in Spain, high private lending in Portugal and out of proportion public debt in Greece all undercut the results of cohesion policy. By increasing the effectiveness of EU economic governance, macroeconomic conditionality can help to prevent the build-up of fiscal and macroeconomic imbalances, and thus better ensure economic returns on cohesion projects.

Furthermore, by working towards more sound national policies, macroeconomic conditionality would make national budgets more resilient to economic shocks. As a consequence, Member States would be less likely to face the huge budget constraints that some of them experienced following the financial and economic crisis. This would reduce the risk of Member States being unable to provide their part of the financing of cohesion projects.

If a country does not take sufficient action to address its imbalances, despite all the European rules, macroeconomic conditionality sanctions can step in. Such sanctions would prevent using cohesion funding in a country where weak economic or fiscal fundamentals can undermine cohesion policy's returns. This way, macroeconomic conditionality again offers guarantees that cohesion funding is used in an efficient manner.

[8] In some Member States, local government contributed as much as 1% of GDP to the 2010 general public deficit. In decentralised countries, regional deficits can play an important role as well. In Spain, the deficits of the autonomous regions amounted to 3.5% of GDP in 2010, which by itself is more than allowed under the EU rules.

Facilitating the EU's Budget Negotiations?

Macroeconomic conditionality could be a way to ease the difficult negotiations on the 2014-2020 Multiannual Financial Framework. During the current, very complex bargaining over the new EU financing period, the main line of the dispute is between net beneficiaries and net contributors. The first group of countries wants to maintain at least the current level of funding, while the other group insists on reducing it by about 10%. Given its size, cohesion policy is one of the most important points of the negotiations.

The question arises whether conditionality attached to the second largest area of the budget could mitigate the impact of the deadly logic of *juste retour*? The answer is probably to some extent. The extension of macroeconomic conditionality in cohesion policy would meet the demands of net contributors for more effective use of available funds. One can imagine the introduction of extended macroeconomic conditionality in exchange for an ample cohesion policy budget as one of the key elements of a broader, complex compromise between the distant positions of net contributors and net beneficiaries.

The EU could even consider expanding macroeconomic conditionalities to the Common Agriculture Policy or even to the entire EU budget, as demanded by the net beneficiaries. Such generalised macroeconomic conditionality might be used as a lever to agree a budget that approaches the Commission's original proposal. For net beneficiaries, increased conditionality would then be the price they have to pay for such an agreement, while net contributors would have guarantees that the EU budget is well-spent. However, for several Member States, such generalised macroeconomic conditionality risks being a bridge too far. It would furthermore give rise to numerous legal and practical difficulties.

While macroeconomic conditionality could help in shaping a compromise, it is by no means a miracle solution. For example, it does not solve the problem of dependence on contributions to the EU budget based on Member States' gross national income (GNI), which mostly creates the complexity in the negotiations.

MACROECONOMIC CONDITIONALITY: OPENING PANDORA'S BOX?

Despite the existence of many indisputable advantages of creating more links between EU economic governance and cohesion policy, there are still some questions to be asked and pitfalls to be avoided. If not properly managed, macroeconomic conditionality can have a highly negative impact.

Incoherence in the Level of Responsibility

The first issue raised by the Committee of Regions (Committee of Regions, 2012) and also by various Member States during the EU Multiannual Financial Framework 2014-2020 negotiations, concerns the level of responsibility. Introducing macroeconomic conditionality in cohesion policy would imply that the prospective victim of the cuts would be different from the level of government responsible for economic policy decisions. This is because local governments are beneficiaries of most of the CSF funding while it is most often the central government that is accountable for economic and fiscal policies. Therefore, making local authorities responsible for the actions of the central government seems quite unfair. While it's a good thing that local politicians would exert

pressure on central governments to pursue sound economic policies, it is nevertheless doubtful whether sanctioning local governments for mistakes made by the central government is a positive evolution.

As mentioned before, regional governments are also often responsible for the accumulation of part of the public debt (e.g., Spain), however fiscal policy and responsibility for public finances may vary between regions and between Member States. The suspension of payments in a specific region because other levels of government (other regions or the central government) fail to take policy actions would create some sort of collective punishment, which is hard to justify.

More Stick than Carrot?

As currently envisaged, macroeconomic conditionality's "carrot" (i.e., easier access to cohesion financing) is unlikely to have a substantial effect. As noted already, the carrot can only be used for countries that are participating in an international financial assistance programme that have an exceptional character. It is also questionable whether the possibility to increase the maximum EU co-financing rate by 10 pp. could actually have a substantial effect on these countries due to the scope of their economic problems. The countries would obviously still face difficulties in providing partial financing of the EU projects, despite the limited increase in EU financing. Macroeconomic conditionality's carrot thus seems to have been proposed for countries that would have the most difficulties in taking advantage of it. Besides, the rise of the EU co-financing rate does not mean that the total cohesion allocation for a particular Member State would be increased. The EU co-financing would be, in fact, used for a smaller number of projects than previously planned (Verhelst 2012).

Furthermore, while using macroeconomic conditionality as a positive incentive might be a good idea, it runs the risk of being interpreted as a form of undeserved reward to profligate countries while other countries, experiencing fewer difficulties, would face their CSF funds being suspended. Therefore, the EU would have to design easier access to cohesion funding in such a way that it does not lead to moral hazard. Facilitating access to cohesion funding should only be the consequence of genuine –and often painful– policy reforms. Putting a framework in place that avoids moral hazard would require careful design.

The conclusions of the 5th Cohesion Report suggest that conditionality should be based more on positive than negative incentives (Commission, 2010b). The Commission clearly did not take up this suggestion in its proposal. A more balanced approach between incentives and sanctions should be considered.

Macroeconomic Conditionality and EU Governance Intricacies

Looking at the Commission's role in suspending the payments, it can be concluded that the EU's executive arm would be granted large discretionary power in this matter. This is particularly evident if we compare it with the Commission's role in the excessive deficit and excessive imbalances procedures, where the Commission proposal may be rejected by a vote in the Council. The proposed mechanisms for macroeconomic conditionality in cohesion policy provide limited Council involvement. This can be praised by countries that want to see an enhanced role for the Commission in the EU's economic governance, but it is difficult

to expect that all Member States could easily accept such a solution.

A comparison of the proposed form of conditionality with the current excessive deficit and excessive imbalances procedures leaves another question. On the one hand, these last two procedures provide for the possibility of imposing sanctions on a Member State that does not apply the EU recommendations to the amount of up to 0.5% of their GDP at most.[9] On the other hand, in some countries, cohesion policy funds constitute more than 3% of GDP each year (Hungary, Lithuania, Latvia and Estonia). Therefore, it seems logical to introduce a cap on the maximum amount of funds in relation to GDP that could be suspended. Otherwise, the major beneficiaries of the cohesion policy (most of which are outside the eurozone) will risk becoming major victims of macroeconomic conditionality. As a result, Member States outside the eurozone would be disciplined more severely than eurozone members. The Commission has not provided details on the matter. Yet, a legal framework on the size of possible sanctions seems indispensable.

The proposed form of increased macroeconomic conditionality in cohesion policy does not contain any differentiating mechanism between the eurozone and other Member States. Although respecting economic governance rules is important for all Member States, as was mentioned, this is clearly more important inside the eurozone, as countries sharing a single currency are more intertwined than the other Member States. As a result, a distinction in macroeconomic conditionality mechanisms between eurozone and non-eurozone countries would make sense.

Additionally, EU economic governance rules already foresee sanctions for eurozone countries in case of non-compliance with the EU's fiscal rules or in case of macroeconomic imbalances. Introducing the proposed form of macroeconomic conditionality would create a kind of double penalty for the same fault. The Charter of Fundamental Rights of the EU states that no one can be punished twice for the same criminal offence (Article 50 of the Charter). In case of macroeconomic conditionality, other rules seem to apply.

Undermining the Positive Results of Cohesion Policy

Another point of concern is the impact on the cohesion policy's functioning as such. Its mechanisms are quite distant from EU economic governance objectives; therefore, connecting these two areas may bring some undesired effects.

From the perspective of efficiency, conditionalities might be a positive evolution. However, these conditions would also dilute the original idea behind cohesion policy. Under its original conception, cohesion funding should primarily be used there where it matters most, i.e., the least prosperous regions, and not necessarily where it can have the best return. In this sense, the application of macroeconomic conditionality sanctions would be detrimental to the solidarity of cohesion policy and its re-distributional nature.

So far, cohesion funds have been seen as a relatively secure source for financing projects. The inclusion of wider macroeconomic conditionality in cohesion policy would lead

[9] At the end of the Excessive Deficit Procedure, a fine of up to 0.5% can be imposed. In the earlier parts of the Procedure, sanctions can amount to up to 0.2% GDP. In the Excessive Imbalance Procedure, sanctions can reach 0.1% GDP.

to interfering artificially in the project management cycle, e.g., by suspending funds. It might lead even to the collapse of projects that could contribute to increasing economic growth. It can ultimately result in the loss of reliability in the receipt of funds and thus might be judged as less attractive to obtain. This may happen in particular in beneficiary countries that are affected by fiscal problems (e.g., Hungary).

What's more, in certain situations, the sanctions may prove counterproductive. It may happen that the funding suspension could force a Member State to cancel projects or to finance the missing part of the budget on its own. This could lead to the cancelling or delay of other investments or increase public debt, thus further deepening the already existing fiscal problem.

CONCLUSION

Due to its possible advantages, macroeconomic conditionality is an appealing concept. It can be one of the measures to move towards a sustainable Economic and Monetary Union. For cohesion policy, macroeconomic conditionality can potentially lead to more efficiency. Furthermore, macroeconomic conditionality can be one of the key elements of a broader, complex compromise between the distant positions of the Member States on the next EU budget cycle. More European control on EU spending can bridge part of the gap between net contributors and net payers.

However, the EU must be careful with the ultimate design of macroeconomic conditionality mechanisms so that the costs do not outweigh the potential benefits. By making all funding conditional on national compliance with economic governance rules, macroeconomic conditionality risks too much focus in cohesion policy on efficiency. This could come at the cost of the least-prosperous regions, and thus European solidarity.

Therefore, if the EU decides to maintain wide-scale macroeconomic conditionality, the original Commission proposal needs to undergo at least three major changes:

1. Macroeconomic conditionality needs to be better aligned with economic governance procedures. The current one-size-fits all optional suspension procedure needs to be reconsidered.

2. Macroeconomic conditionality should avoid having a disproportionate impact in less prosperous regions and Member States, as well as affecting end-beneficiaries of cohesion funding. This can be done by focusing on the suspension of commitments of cohesion funding, with the suspension of payments as a last resort only. In order to equal the burden of sanctions, introduction of a form of capping in relation to the GDP of the Member States is essential.

3. Macroeconomic conditionality should have a better balance between incentives and sanctions. This can be achieved by increasing the possibilities for easing access to cohesion funding. Such a carrot-and-stick approach should reward thorough reforms.

Implementing these changes would soften the negative consequences of macroeconomic conditionality. However, even a redesigned conditionality framework would have considerable adverse effects. Any deal on macroeconomic conditionality would hence have to be compensated by a sufficiently ample cohesion budget, especially with regard to the poorer regions. Efficiency and solidarity must be two sides of the same coin.

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