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MACRO-ECONOMIC CONDITIONALITIES IN COHESION POLICY

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MACRO-ECONOMIC CONDITIONALITIES IN COHESION POLICY

EUROPEAN PARLIAMENT

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

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REGIONAL DEVELOPMENT

MACRO-ECONOMIC CONDITIONALITIES IN COHESION POLICY

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Abstract

This note discusses the European Commission's proposal to introduce wide-scale macro-economic conditionalities in cohesion policy. In essence, this would make cohesion funding dependent on respecting the European economic governance rules. The note finds that such conditionality would be advantageous for economic governance, but it is likely to have a negative impact on cohesion policy. More importantly, it is doubtful that the European Commission's proposal would contribute to achieving the overarching goal of both policies: balanced economic growth in Europe.

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LIST OF ABBREVIATIONS

BEPGs	Broad Economic Policy Guidelines
CAP	Corrective Action Plan
CSF	Common Strategic Framework
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EIP	Excessive Imbalance Procedure
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
GDP	Gross Domestic Product
IMF	International Monetary Fund
MoU	Memorandum of Understanding
MS	Member State
MTO	Medium Term Budgetary Objective
QMV	Qualified Majority Voting
SGP	Stability and Growth Pact
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the EMU

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EXECUTIVE SUMMARY

This note discusses the European Commission's proposal to expand significantly macro-economic conditionalities in the 2014-2020 programming period. Such macro-economic conditionalities would make European cohesion policy funding in a Member State dependent on the country's compliance with the economic governance procedures.

European Economic Governance

The EU's Economic Union has been put in place to deal with ever-closer European integration, notably the Monetary Union. It lies down a set of objectives that are to be achieved by the Member States. The objectives are translated in binding norms, as well as softer policy targets, and cover the Member States' fiscal and economic policies. To achieve these objectives, a set of European economic governance procedures have been put in place.

A preventive economic governance procedure focuses on surveillance and coordination of the Member States' fiscal and economic policies. As part of this procedure, the EU can issue non-binding warnings and recommendations to the Member States. If the preventive procedure proves insufficient to ensure compliance with the binding norms, two corrective procedures can be enacted. These two procedures are a) the Excessive Deficit Procedure, which deals with fiscal imbalances and b) the Excessive Imbalance Procedure, which deals with macro-economic imbalances. The corrective procedures are stricter for eurozone members, who face financial sanctions when failing to comply. Providing conditional financial assistance to a Member State in severe financial difficulties serves as an option of last resort in the economic governance procedure. In such cases, the EU does not only define the goals that are to be achieved by the Member State, but also negotiates the national policies to achieve those goals.

Macro-Economic Conditionalities

The EU's Economic Union has so far been unable to prevent major crises in public finances amongst the Member States. Therefore, a key element in strengthening Economic Union could be the introduction of wide-scale macro-economic conditionality. The European Commission envisages extending the existing partial macro-economic conditionality to all cohesion policy funds, as well as the agriculture and fishery funds. Macro-economic conditionality would furthermore cover all of the economic governance procedures and apply to both fiscal and macro-economic issues.

If a Member State does not comply with European economic governance recommendations, the European Commission could request a change in national cohesion policy strategic documents. The European Commission would subsequently be able to suspend cohesion policy payments if a Member State does not sufficiently modify its national cohesion policy strategic documents. Such optional suspension would come at the end of a procedure that could take up to five months. The long duration of this optional suspension procedure would be difficult to integrate with the economic governance procedures and its sanctions.

The European Commission's proposal also foresees the mandatory suspension of cohesion policy funding in case the European economic governance's corrective or financial assistance procedures move beyond their early stages. Mandatory suspension can take the form of either the suspension of cohesion policy commitments or the suspension of cohesion policy payments. The latter is likely to have a bigger impact on individual projects, as the suspension of commitments would still allow for payments based on earlier commitments.

Besides macro-economic conditionality's use as a punitive measure, conditionality may also result in easier national access to cohesion policy funding. This would, however, only be possible when a country is subject to a financial assistance procedure. By limiting the use of macro-economic conditionality as an incentive, the European Commission missed the opportunity to propose a more balanced 'carrot-and-stick' approach.

The Consequences of Macro-economic Conditionalities

In terms of economic governance, macro-economic conditionality would have mostly positive effects. It would enlarge the existing sanction 'toolbox' and increase the bottom-up drive for sound fiscal and economic policies, as local governments would have much more to lose in the economic governance process. The macro-economic conditionality would offer a more automatic, somewhat innovative sanction that applies to the entire set of economic governance procedures. This would alter the non-binding nature of the preventive governance procedure. Macro-economic conditionalities would furthermore apply to all Member States, thus introducing the possibility of sanctions for non-eurozone countries.

With regard to cohesion policy, macro-economic conditionality can have some beneficial consequences. It could in particular reduce unproductive spending of cohesion policy funding. Despite this positive element, the proposed macro-economic conditionality would have a rather negative impact on cohesion policy. Negatives consequences on cohesion policy include:

- Cohesion policy becoming less fair: Regions would be hit by macro-economic conditionality sanctions, even though they are for the most part not responsible for upholding the economic governance rules. Furthermore, the suspension of cohesion policy funding could have a disproportionally negative consequence for the poorer regions and Member States, as they are more dependent on such funding.

- Cohesion policy funding becoming less reliable: Even if sanctions were never applied, macro-economic conditionality would result in uncertainty with regard to the funding available for future projects. The application of macro-economic conditionality sanctions could furthermore result in the non-execution of ongoing projects.

Beyond the effects for economic governance and cohesion policy separately, the overarching consequences of macro-economic conditionality need to be considered. Macro-economic sanctioning risks having counterproductive consequences in terms of achieving sustainable and balanced growth, a goal common to both economic governance and cohesion policy. Yet without the possibility of sanctions, macro-economic conditionality would remain toothless, and thus ineffective.

There are some available options that would reduce macro-economic conditionality's negative effects while at the same time safeguarding its positive potential. One option implies using macro-economic conditionality as a 'carrot-and-stick' instrument. Secondly, macro-economic conditionality sanctions could be better aligned with the economic governance process. Finally, sanctioning could primarily involve the suspension of commitment, with the suspension of payments used only as a last-resort. Even when taking into account these potential improvements, it could prove problematic to turn macro-economic conditionality from an attractive idea into a useful practice.

INTRODUCTION

As part of the discussion surrounding the proposed 2014-2020 Multi-annual Financial Framework, the EU's longstanding cohesion policy is once again under review. Historically speaking, changes to cohesion policy have often been taken as additional steps to accompany increasing European integration. This was the case for successive EU enlargements and the Lisbon Strategy. The reinforcement of the Economic and Monetary Union (EMU) following the eurozone sovereign debt crisis is also likely to lead to changes in the design of cohesion policy.

An important part of the cohesion policy reform debate focuses on attaching conditionalities to funding. Conditionality in cohesion policy is not something new. Over the years, different types of conditionalities have been put in place, including conditions with regard to the management of individual projects and horizontal principles such as transparency and non-discrimination. As an additional type of conditionality, the 2007-2013 cohesion policy framework made the Cohesion Fund dependent on national respect for the EU's fiscal rules (such conditionality was not applied to the other cohesion policy funds). The European Commission's 2014-2020 proposal seeks to increase dramatically this type of conditionality, dubbed 'macro-economic conditionality'. The European Commission proposes to introduce macro-economic conditionality across all cohesion policy funds. The scope of macro-economic conditionality would also be increased, as conditionality would concern all stages of the European economic governance procedures and cover both fiscal and macro-economic issues.

The proposal to make cohesion policy more dependent on economic governance should not come as a surprise. Both policies have since long been seen as key elements in supporting the European project. Indeed, ever-closer integration requires a common approach to economic policy, as well as support for those who have difficulties in 'catching-up'. To this extent, both cohesion policy and economic governance aim to achieve one of the key goals of European integration: sustainable and balanced economic growth. By linking cohesion policy to economic governance, macro-economic conditionality intends to improve both policies. This note reviews whether the type of macro-economic conditionality proposed by the European Commission would be able to achieve this goal.

Chapter 1 starts by providing an overview of the European Economic Union that accompanies the Monetary Union. Chapter 2 examines the extensive economic governance process that has been elaborated to achieve Economic Union. Subsequently, Chapter 3 looks at the content of macro-economic conditionality as proposed by the European Commission, as well as its integration with the economic governance process. The consequences of macro-economic conditionalities for both economic governance and cohesion policy are discussed in Chapter 4, and finally a conclusion draws together the key findings of this note.

1. THE FUNDAMENTALS OF EUROPEAN ECONOMIC UNION

KEY FINDINGS

- European integration, especially its Monetary Union, requires the coordination of economic policies. For this reason, a European Economic Union has been put in place. The Economic Union has expanded over the years, and is still evolving in response to the eurozone sovereign debt crisis.
- The Economic Union has three key goals: a) converging national policies, b) ensuring respect of key principles and c) stimulating economic growth and competitiveness.
- The Economic Union in essence leaves policy-making to the national level, but defines a number of common objectives. These objectives cover both fiscal policies (deficit and debt levels), as well as macro-economic policies (competiveness, internal and external imbalances).
- The objectives of Economic Union take the form of binding norms and soft targets. Binding norms concern mandatory objectives and corrective procedures can follow if these norms are not respected. Some of the norms are more stringent for eurozone countries than for the other Member States. Soft targets deal with objectives that Member States must aim to achieve. No sanctions are foreseen when a Member State fails to achieve these targets.

European integration renders the participating Member States increasingly interdependent. Both the single market and the Monetary Union resulted in national economies being closely intertwined. As a consequence, economic booms are mutually beneficial for Member States and, conversely, Member States are easily affected by each other's downturns. In addition to this increasing interdependence, the process of globalisation spurs international competition. If Europe is to remain prosperous, it must not remain idle. Therefore, both European integration and globalisation call for closer economic cooperation among EU Member States.

The need for economic cooperation has resulted in an extensive European framework for economic and fiscal objectives, which has become known as the EU's Economic Union. The following section will provide a brief overview of how Economic Union has evolved into its current form, and will then discuss the objectives of Economic Union. In the following Chapter, this note discusses the economic governance process that aims to put the objectives of Economic Union into practice.

1.1. An Expanding Framework

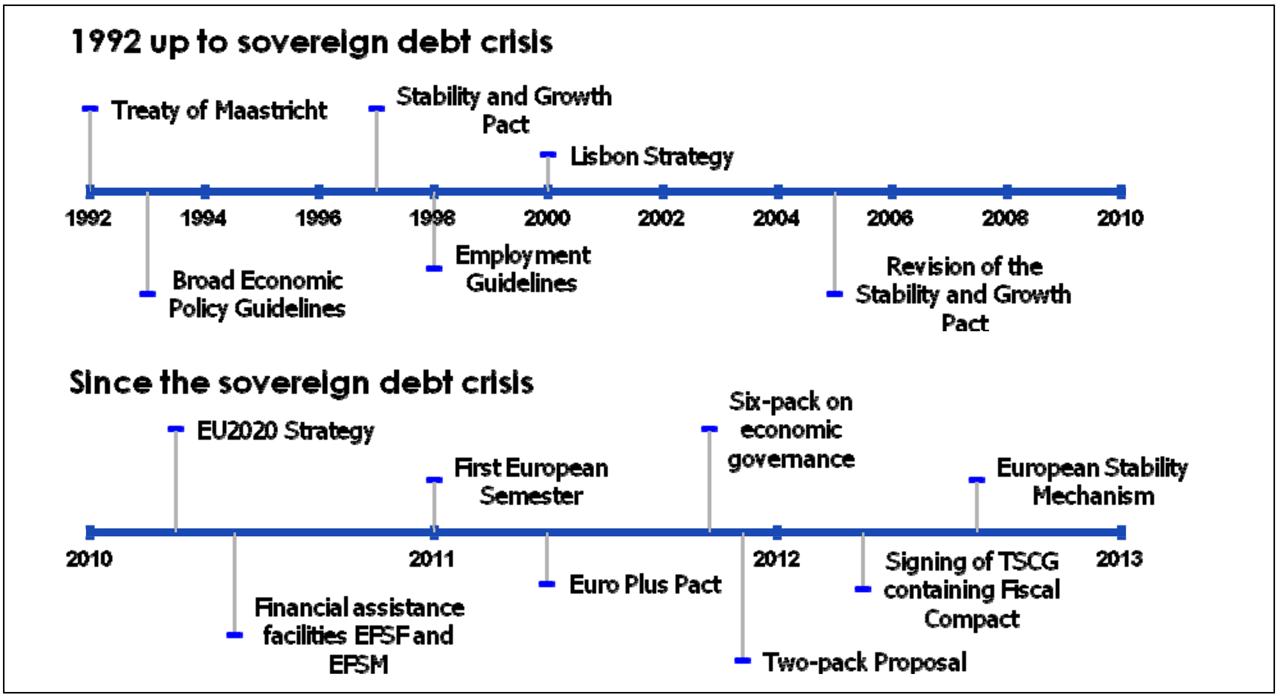
The ambition to streamline economic policies across Member States dates back to the early days of modern European integration. The Treaty of Rome already provided the initial step towards European economic coordination, calling for the progressive approximation of economic policies of the Member States[1].

[1] Part 1, Article 2 of the Treaty of Rome.

The need for economic policy coordination intensified as European integration progressed. The decision to move to a Monetary Union provided a decisive impulse. Signing the Treaty of Maastricht in 1992 thus represented a major step forward in economic policy coordination.

A number of measures aiming to monitor and coordinate policies across Member States followed the Maastricht Treaty (see Figure 1). The multi-annual Broad Economic Policy Guidelines (BEPGs) were adopted for the first time in 1993 with the aim of coordinating general economic policies. In 1997, multi-annual Employment Guidelines followed, which focused on improving employment. In terms of fiscal policies, the 1997 Stability and Growth Pact (SGP) added to the rules of the Maastricht Treaty. All these instruments of Economic Union were modified afterwards, in an effort to improve their relevance; the Lisbon Strategy integrated the BEPGs and the Employment Guidelines, while the Stability Pact was modified in 2005.

Figure 1: European Economic Union since the Treaty of Maastricht



Source: Own compilation.

The EU's Economic Union framework and its reforms did not allow it to escape the sovereign debt crisis that has engulfed the eurozone since early 2010. As a response to the crisis, the EU sought to step-up its economic coordination and surveillance. The EU 2020 Strategy aims to be a more effective successor of the Lisbon Strategy. Other policy initiatives aimed to strengthen the Economic Union objectives (i.e. the Fiscal Compact[2]), its governance (the European Semester) or both (the six-pack on economic governance). In addition, eurozone financial assistance instruments were put in place (the temporary EFSF and EFSM and the permanent ESM). This Economic Union framework is bound to change in the coming years, as policymakers seek a lasting response to the eurozone sovereign debt crisis.

2 The Fiscal Compact is part of the Treaty on Stability, Coordination and Governance in the EMU (TSCG).

1.2. The Objectives of Economic Union

In essence, Economic Union aims to work towards key objectives of European integration as laid down in the Treaties, i.e. '*promote [...] the well-being*' of the EU citizens and contribute to '*the sustainable development of Europe based on balanced economic growth*'[3]. To achieve these overarching objectives, the Member States should see their economic policies as a matter of common concern and coordinate their policies accordingly. Furthermore, Member States need to respect key common principles, such as sound public finances and a sustainable balance of payments[4].

These objectives of Economic Union have been translated in a set of binding norms and non-binding targets. The difference in their compulsory nature reflects Treaty requirements, as well as the perceived importance of each of the objectives. As a consequence of the eurozone sovereign debt crisis, the scope of both the binding norms and the softer targets has been considerably extended.

1.2.1. Binding Norms

Legal Basis

- Article 126 TFEU
- Fiscal Compact of the Treaty on Stability, Coordination and Governance in the EMU
- Regulation (EC) No 1467/97 (consolidated version): corrective arm of the SGP
- Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Prior to the sovereign debt crisis, policymakers were most concerned with the sustainability of fiscal policies. To this extent, the Maastricht Treaty introduced the two core fiscal norms that apply to all Member States. On the one hand, the Treaty limits the annual **public deficit** to 3% of GDP. A limit to **public debt** was also put in place. Gross public debt is, in principle, not to exceed 60% of GDP. If public debt does exceed this threshold, Member States are to ensure that it is lowered at a sufficient pace. For a long time, the debt norm was largely ignored, as it was not made operational. This – finally – changed when the six-pack on economic governance was introduced[5].

The Stability and Growth Pact introduced the **medium term budgetary objective** (MTO), an additional, tougher fiscal norm. The MTO restricts Member States' structural (i.e. over-

[3] Article 3 of the consolidated version of the Treaty on European Union, OJ C 83, 30.3.2010, pp. 1–45, hereinafter TEU.
[4] Article 119(3) and Article 121(1) of the consolidated version of the Treaty on the Functioning of the European Union, OJ C 83, 30.3.2010, pp. 47–388, hereinafter TFEU.
[5] The six-pack introduced a numerical debt-reduction rule, which determines the required pace of debt-to-GDP reduction for Member States whose debt exceeds 60% of GDP. The rule stipulates that these Member States have to reduce the difference between their debt level and the 60% debt target by 1/20th per year on average. To take into account yearly fluctuations, debt reduction is measured on a three-year basis. For countries under an Excessive Deficit Procedure as of November 2011, a transition period is foreseen. See: Article 1(2b) of Regulation No 1177/2011 (OJ L 306, 23.11.2011, pp. 33–40).

the-cycle) deficit to 1% of GDP at most[6]. As the MTO was not part of primary legislation before the sovereign debt crisis, it did not carry the same weight as the deficit and debt norms. The Fiscal Compact will render the MTO compulsory and stricter for the eurozone countries. Conditional on successful ratification[7], the Treaty will oblige eurozone countries to adopt a national balanced budget rule (the so-called Golden Rule) that limits future MTOs to a deficit of 0.5% of GDP at most[8]. For non-eurozone countries, the MTO remains at a deficit of 1% of GDP at most and is less binding than the other fiscal rules. For them, the MTO is only to be taken into consideration in addition to the other binding norms.

Member States can invoke a number of exceptions that allow a temporary deviation from the fiscal norms mentioned above. This notably concerns weak economic growth. Prior to the crisis, exceptions undermined the effective application of the norms. Yet, at the same time, such exceptions were to make the rules smarter, i.e. sensible from an economic point of view. The EU must therefore find a difficult balance between strict and sensible fiscal norms (Keller-Noëllet, Lepoivre and Verhelst, 2011).

Binding norms for macro-economic policy had been considered less important than fiscal rules when the EMU was created (Commission of the EC, 1990). The six-pack changed this discrepancy by introducing a **macro-economic scoreboard**, which contains indicators that focus on external and internal imbalances, as well as competitiveness[9]. For each indicator, specific thresholds have been defined. The scoreboard applies to all Member States, although some variables are stricter for eurozone countries than for their non-eurozone counterparts.

As macro-economic norms remain more controversial than fiscal norms, the macro-economic scoreboard is less rigid than the fiscal rules. The European Commission can regularly modify the scoreboard's content, and the interpretation of the indicators is supplemented by further economic analysis. This is to avoid a counterproductive application of the scoreboard.

1.2.2. Soft Targets

Legal Basis

- Articles 121(2) and 148 TFEU
- Regulation (EC) No 1466/97 (consolidated version): preventive arm of the SGP

Contrary to binding norms, soft targets deal with policy fields linked to economic governance where strict rules are deemed either non-desirable or unnecessary. Soft targets mainly concern macro-economic policies.

The **EU 2020 Strategy** is the vital policy document in the domain of soft macro-economic targets. This strategy aims to achieve '*smart, sustainable and inclusive growth*' throughout

6 The structural deficit tries to filter out fiscal evolutions that are purely due to cyclical changes in the economy. Temporary fiscal measures are also excluded from the structural deficit, to exclude one-off measures. See Article 3(2)a of Regulation (EC) No 1466/97 (OJ L 209, 02.08.1997, pp. 1–5).

7 The TSCG is meant to enter into force in 2013 if at least 12 eurozone countries ratify it by then.

8 Given the impact of the ongoing crisis on eurozone countries' budgets, a transition period is foreseen in which the countries need to make marked progress towards the 0.5% goal.

9 External imbalances include the current account balance and net international investment position; competitiveness includes export market shares, nominal unit labour cost (ULC) and real effective exchange

the EU and has laid down a set of targets to be achieved by 2020. These targets concern employment, research and development, education, social policy, climate and energy (European Commission, 2010).
The **Integrated Guidelines for Growth and Jobs** define a comprehensive set of policy targets for Member States. These targets detail the EU 2020 Strategy, as well as other objectives of Economic Union. The guidelines integrate two Treaty-based instruments: the Broad Economic Policy Guidelines and the Employment Guidelines[10]. Annex 1 lists the Integrated Guidelines that apply until 2014.

The **Euro Plus Pact** is also relevant in terms of soft targets. The Pact was adopted in 2011 by 23 Member States[11], setting out policy goals in four areas: competitiveness, employment, public finances and financial stability. Apart from the commitments in the Euro Plus Pact, participating Member States are required to formulate regularly new targets that work towards achieving the Pact's goals (European Council, 2011).

The soft targets have often been criticised for their lack of results. They have so far had indeed only a limited impact on Member States' policies. Nonetheless, they have been able to expand Economic Union and its governance to domains where binding norms were not feasible. In this sense, the soft targets did have a positive effect on Economic Union.

rates; internal imbalances cover private sector debt, private sector credit flow, house prices, public sector debt and unemployment.

10 See respectively Article 121(2) TFEU and Article 148 TFEU. In strict legal terms, the BEPGs and the Employment Guidelines are issued separately. In practice, the documents have been combined in the Integrated Guidelines.

11 Only the Czech Republic, Hungary, Sweden and the United Kingdom do not participate in the Euro Plus Pact.

2. THE EUROPEAN ECONOMIC GOVERNANCE PROCEDURES

KEY FINDINGS

- European economic governance aims to achieve the objectives of Economic Union and consists of three types of procedures. Each type of procedure deals with a different stage of the economic governance process.
- A preventive procedure aims to achieve the objectives of Economic Union through surveillance and coordination. The procedure concerns all Member States and is characterised by non-binding peer-review and policy guidance.
- The corrective procedures are enacted when a Member State has an excessive imbalance. The procedures comprise of a) the Excessive Deficit Procedure for fiscal imbalances and b) the Excessive Imbalance Procedure for macro-economic imbalances. The corrective procedures are stricter for eurozone countries than for the other Member States.
- The financial assistance procedure provides financial resources to Member States that have difficulties in accessing financial markets. For eurozone countries, stricter rules and conditions apply.
- The European Parliament is involved in the economic governance process through the EU's Economic Dialogue, but the institution does not have formal powers to steer the economic governance procedures.

In order to meet the objectives of European Economic Union, a complex procedural machinery has been put in place, known as European economic governance[12]. European economic governance consists of three types of procedures dealing with: the prevention of imbalances (2.1), the correction of imbalances (2.2) and financial assistance to Member States (2.3). These procedures have different degrees of coerciveness, depending on the stage in the governance process, and whether or not the concerned Member State is part of the eurozone.

As part of the Economic Dialogue, the European Parliament can invite key actors to appear before the relevant Committees[13]. Therefore, despite lacking formal powers to steer the process, the European Parliament is involved in the economic governance procedures.

[12] In this note, European economic governance is conceived as comprising both instruments that are part of the EU, as well as instruments that have been created outside of the EU framework (notably the ESM).

[13] The European Parliament's Committees can invite the Commission, the Council Presidency, the President of the European Council and the President of the Eurogroup. The President of the ECB is invited to the European Parliament in the framework of the Monetary Dialogue. See: Article 2(a)b of Regulation (EC) No 1466/97 (consolidated version); Article 2a of Regulation (EC) No 1467/97 (consolidated version); Article 6 of Regulation (EU) No 1174/2011; Article 3 of Regulation (EU) No 1173/2011 and Article 14 of Regulation (EU) No 1176/2011.

2.1. The Preventive Surveillance and Coordination Procedure

Legal Basis

- Articles 121(2) and 148 TFEU
- Regulation (EC) No 1466/97 (consolidated version): preventive arm of the SGP
- Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances
- Council Recommendation of 13 July 2010 and Council Decision of 21 October 2010 (the Integrated Guidelines for Growth and Jobs)
- Code of conduct containing specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes

The preventive surveillance and coordination procedure is the starting point for European economic governance. As part of this procedure, the EU monitors whether its binding norms are upheld and works towards achieving the soft European targets (see supra). The preventive procedure covers both fiscal and macro-economic policies. The procedure is very similar for eurozone and non-eurozone countries, although reforms following the sovereign debt crisis include some differentiation between the two categories of Member States.

The preventive procedure comprises a wide set of procedural steps and reporting instruments, but is largely centred on the European Semester. Surveillance and coordination nonetheless continue throughout the remainder of the year and can result in non-binding warnings and recommendations.

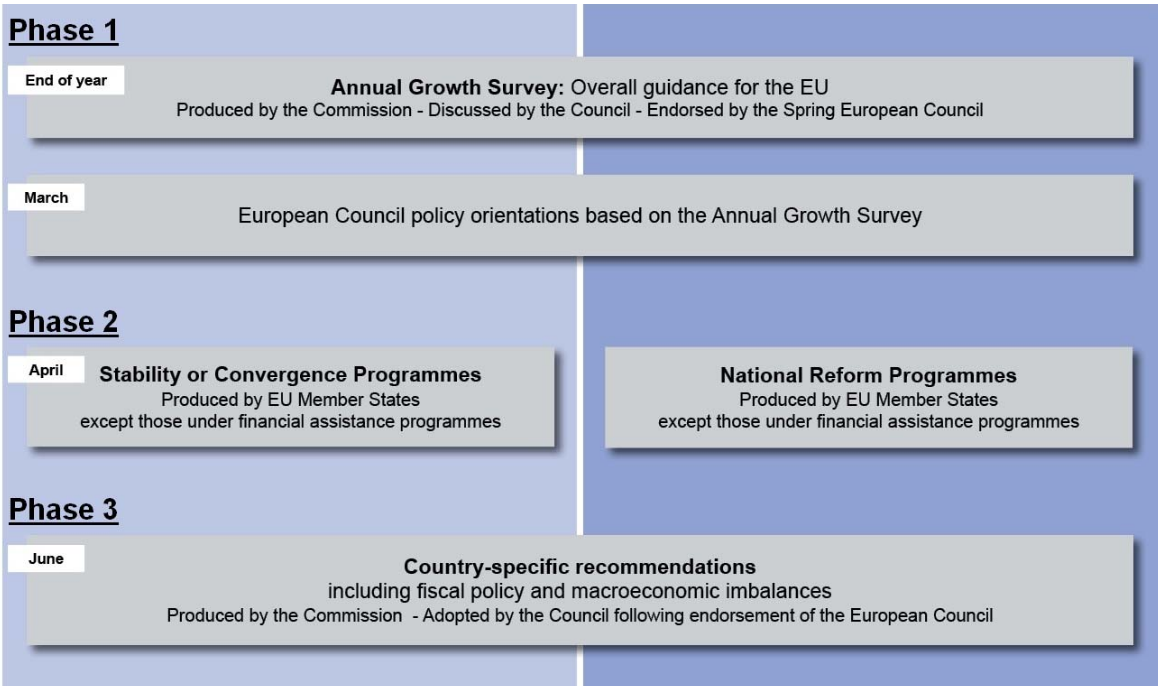
2.1.1. The European Semester

The European Semester takes place during the first six months of each calendar year[14] and was for the first time put into practice in 2011. One of the major innovations of the European Semester is the fact that it provides an integrated framework for reviewing fiscal and macro-economic policies. The European Semester essentially comprises three phases (see Figure 2 for an overview).

The European Semester starts with the preparation by the European Commission of general policy orientations. The EU 2020 Strategy and the multi-annual Integrated Guidelines (see 1.2.2) provide a major source of inspiration for these policy orientations. The European Commission offers additional input by means of its Annual Growth Survey on general policy priorities and the Alert Mechanism Report on macro-economic imbalances. The Council adopts the general policy orientations, which are subsequently endorsed by the Heads of State or Government at their Spring Summit.

[14] The actual implementation of the European Semester has drifted somewhat from this idea, as the European Semester is in fact initiated at the end of the previous calendar year with the publication of the European Commission's Annual Growth Survey.

Figure 2: The European Semester



Note: This Figure already takes into account the two-pack on economic governance.
Source: European Commission and own compilation

In the second phase of the European Semester, attention shifts to the national capitals. During this phase, the Member States detail in two national policy programmes how they intend to meet the objectives of Economic Union, taking into account the aforementioned general policy orientations[15]. The programmes detail future national policies, as well as their respective timing. A first programme, the National Reform Programme, focuses on macro-economic policies, including commitments in the framework of the Euro Plus Pact. In the second programme, Member States adopt national fiscal programmes, referred to as Stability Programmes for eurozone countries and Convergence Programmes for the other Member States.

During the third and final phase of the European Semester, the European Commission reviews each national programme. On the basis of its review, the European Commission proposes country-specific recommendations for each Member State. The Council then discusses these recommendations and applies modifications where necessary. The European Council subsequently endorses the recommendations, followed by their formal adoption by the Council. The latter closes the European Semester.

2.1.2. Second Semester Surveillance and Coordination

Surveillance and coordination do not finish at the end of the European Semester. In the second part of the year, national performances and policies continue to be monitored by the European Commission. Apart from continued surveillance, Member States are also required to provide an update of their economic and fiscal data. Importantly, this update includes more detail on the following year's budget.

[15] The European Commission's two-pack proposal proposes to provide an exception for eurozone countries that receive financial assistance. They would be exempted from adopting the programmes, as they are already under a separate, more intense surveillance process. As of October 2012, there was no final agreement on the two-pack.

The European Commission's two-pack proposal intends to deepen the reporting requirements for eurozone countries only[16]. In October of each year, eurozone countries would be required to present the following year's budget to the EU. These budgets would then be assessed and, where needed, further guidance would be provided. The submission of next year's budget and its evaluation would typically be done prior to budgetary discussion in national parliaments – a sensitive issue in Member States.

2.1.3. Non-binding Guidance in Case of Policy Deviations

When deemed necessary, the EU can provide specific ad-hoc guidance to a Member State. Such guidance will occur when a country's economic or fiscal policies are considered inadequate in light of the Economic Union's objectives. The European Commission can issue warnings to a Member State, outlining particular risks[17]. The Council, for its part, can adopt recommendations in which it calls on a Member State to take specific policy actions[18].

These warnings and recommendations go beyond the aforementioned procedural country-specific recommendations, as they point to manifest shortcomings. This makes them useful tools. However, as such guidance remains non-binding, the impact of these tools is limited.

In addition to the warnings and recommendations, the six-pack on economic governance introduced the possibility of an interest-bearing deposit if a eurozone country fails to adhere to its Medium-term Budgetary Objective. For eurozone countries, this reform thus partially introduces sanctions during the preventive economic governance procedure. Yet, the interest-bearing character gives this sanction the role of a guarantee rather than a genuine penalty. As a consequence, the preventive procedure remains non-coercive for both eurozone and non-eurozone countries.

2.2. The Corrective Procedures

Corrective procedures step-in when preventive surveillance and coordination proves ineffective at upholding the binding norms of Economic Union. Two procedures have been put in place: a) the Excessive Deficit Procedure (EDP), which is to address fiscal imbalances and b) the Excessive Imbalance Procedure (EIP) aimed at dealing with a macro-economic imbalance. Regular preventive surveillance and coordination would continue alongside these procedures, and would obviously be geared towards ending the imbalance.

As these corrective procedures are more compelling than the preventive procedure, their exact design has been subject to more intense debate. Member States outside the eurozone were not willing to be subject to the same stringent rules as those using the single currency. For this reason, the rules are differentiated between the two categories of Member States. A general procedure applies to all Member States, while additional rules only apply to the eurozone.

[16] See COM(2011) 821 final and COM(2011) 819 final, both of 23 November 2011.
[17] Article 121(4) TFEU.
[18] rticle 121(4) TFEU and Article 148 TFEU in case of employment issues.

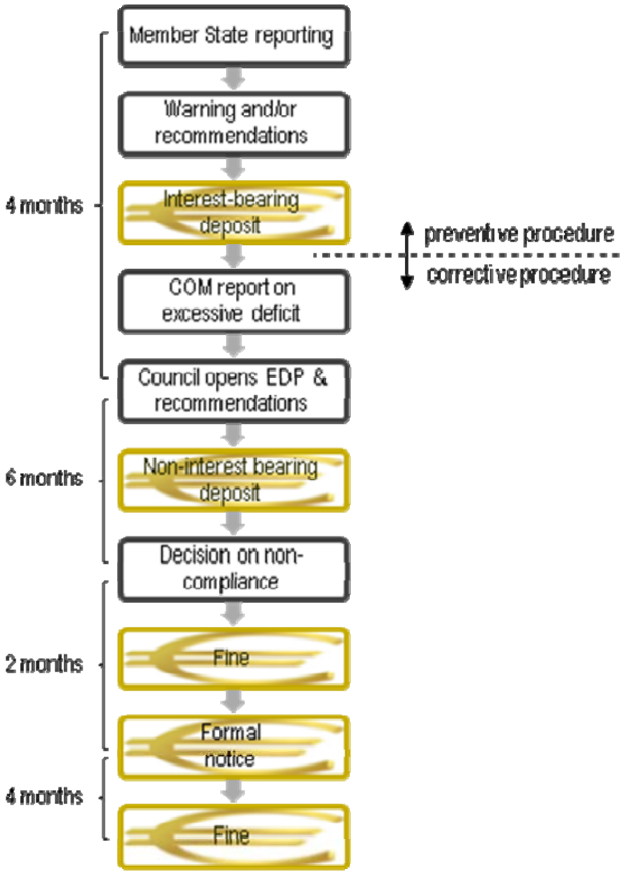
2.2.1. The Excessive Deficit Procedure

Legal Basis

- Articles 121 and 126 TFEU
- Regulation (EC) No 1466/97 (consolidated version): preventive arm SGP
- Regulation (EC) No 1467/97 (consolidated version): corrective arm SGP
- Regulation (EU) No 1173/2011 on the effective enforcement of budgetary surveillance in the euro area

If the preventive economic governance procedure reveals a fiscal imbalance in a Member State, the Excessive Deficit Procedure is enacted. In this case, the decision to open the EDP should be taken within four months of budgetary reporting during the preventive procedure (as part of the European Semester or the second semester update). In contrast to its name, the EDP can be based on both excessive deficit and debt levels[19]. Figure 3 provides an overview of the procedural steps in case of fiscal imbalances.

Figure 3: Fiscal imbalances and the road to sanctions



Note: The euro symbol refers to steps that apply to eurozone countries only.

Source: Own compilation.

[19] Article 126 TFEU foresees the 3% deficit-to-GDP ceiling and the 60% debt-to-GDP norm as the main criteria to launch the EDP. In addition, the European Commission is to take into account all other relevant factors, including the MTO. The Council for its part makes an overall assessment, thus looking beyond the two aforementioned criteria. Annex 2 provides an overview of the Member States under an EDP.

The General Procedure

When the European Commission is of the opinion that a binding fiscal norm is – or risks being – violated, it is to draw up a report on the Member State's excessive fiscal imbalance[20]. The Council subsequently carries out an '*overall assessment*' (allowing for flexibility in its judgement) in which it decides whether to open the EDP. If the Council determines that a country has an excessive deficit, it simultaneously recommends policy actions to the Member State[21].

The Member State then has six months to take actions based on the Council recommendations[22]. The Council (on recommendation by the European Commission) is to evaluate at the end of that period whether the actions taken by the Member State are sufficient. If not enough has been done, the Council then issues a decision on non-compliance to the concerned Member State. The matter would then be discussed at the level of the European Council. For non-eurozone countries, the EDP terminates here[23]. Eurozone countries on the other hand can face subsequent sanctions (see infra).

In the past, the effectiveness of the EDP has been limited. An important reason was the large degree of political judgement left to the Council, as decisions in the EDP have to be taken by a qualified majority vote (QMV)[24]. The enforcement procedure can only advance to the next stage if the Council reaches a qualified majority decision on the matter. For eurozone countries, this rule has been partly modified.

Additional Eurozone Measures

Due to the perceived importance of fiscal discipline within the Monetary Union, stricter eurozone rules have been put in place. The Maastricht Treaty already foresaw a eurozone specific part of the EDP that follows the Council decision on non-compliance (see supra). In case of such a decision, a eurozone country is given two additional months to take the necessary actions. If no sufficient actions occur before this deadline, a formal notice is provided to the eurozone country, which is once again accompanied by policy recommendations. When the eurozone country fails to take sufficient actions, the Council can decide on a sanction within four months of the formal notice. Yet, this last resort '*nuclear option*' has been left unused (Van Rompuy, 2010).

To render sanctions more relevant, the six-pack reform has put in place a gradual sanction system. A first, albeit light, enforcement instrument can already be applied during the preventive surveillance procedure, as an interest-bearing deposit is demanded when a eurozone country fails to meet its Medium-term Budgetary Objective (see supra). Once the EDP is initiated, a eurozone country can be requested to make a non-interest bearing deposit. A fine can be administered if the country fails to take sufficient action once the EDP has been opened.

The non-interest-bearing deposit, the interest-bearing deposit and the fine after opening the EDP all amount, as a rule, to 0.2% of the eurozone country's GDP. If a country does

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[20] The Economic and Financial Committee subsequently provides an opinion on the European Commission's report.

[21] After the entry into force of the TSCG, this procedure and its voting rules will be in some circumstances different for eurozone countries (see infra).

[22] Three months if warranted by the situation.

[23] In line with Article 139(2) TFEU, no coercive means can be used for non-eurozone countries during the EDP.

[24] Qualified majority voting is used by the Council under the ordinary legislative procedure, as well as for other votes (see Article 16 TEU and Article 238 TFEU). A qualified majority is based on voting weights that have been attributed to the different Member States, taking into account the size of their population. On 1 November 2014, a 'double majority' will replace this system. It will be based on the number of Member States in favour of a proposal and the population that these Member States represent.

not take sufficient action, a sanction will typically rollover to a more stringent one (i.e. an interest bearing deposit would be turned into a non-interest bearing deposit, while the latter would be turned into a fine).

Decisions on these new sanctions are taken by so-called Reversed QMV. Under this voting mechanism, a sanction proposed by the European Commission is automatically adopted, unless the Council opposes the European Commission's proposal by a qualified majority within ten days of the proposal. This overturns decision-making in the Council, giving additional clout to the European Commission.

The last resort fine foreseen by the Maastricht Treaty also remains in place. It can range from 0.2% to 0.5% of the eurozone country's GDP, depending on the severity of the fiscal imbalance. The sanction is still to be decided on by ordinary QMV, although the Fiscal Compact will revise this rule to some extent when it comes into force (see infra).The fine is imposed annually until the Council has decided that the country has made sufficient progress to reverse the fiscal imbalance.

The entry into force in 2013 of the TSCG's Fiscal Compact will result in important changes for eurozone countries in terms of the voting procedure to open the EDP, as well as during the remainder of the procedure.[25]. It will introduce Reversed QMV throughout the EDP if the European Commission proposes to open the procedure on the grounds that the 3% deficit ceiling has been breached[26]. However, the importance of this rule is softened for two reasons. Firstly, the Reversed QMV only applies when the procedure has been enacted due to a breach in the deficit ceiling. If the European Commission wishes to initiate the EDP for any other reason (e.g. the debt norm), normal voting rules would have to be followed. Secondly, the Fiscal Compact cannot alter the content of the EU Treaties. Consequently, the Reversed QMV rule is, to a great extent, a gentlemen's agreement. The true value of this agreement will ultimately be tested in crisis situations.

2.2.2. The Excessive Imbalance Procedure

Legal Basis

- Article 121 TFEU
- Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances
- Regulation (EU) No 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area

The preventive procedure, in particular the Alert Mechanism Report (see 2.1), can bring to light certain macro-economic imbalances. The detection of such imbalances can lead to a corrective Excessive Imbalance Procedure. The procedure was created as part of the six-pack reform and remains largely untested[27]. A general procedure is applicable to all Member States, with stricter rules applying to the eurozone (similar to the EDP).

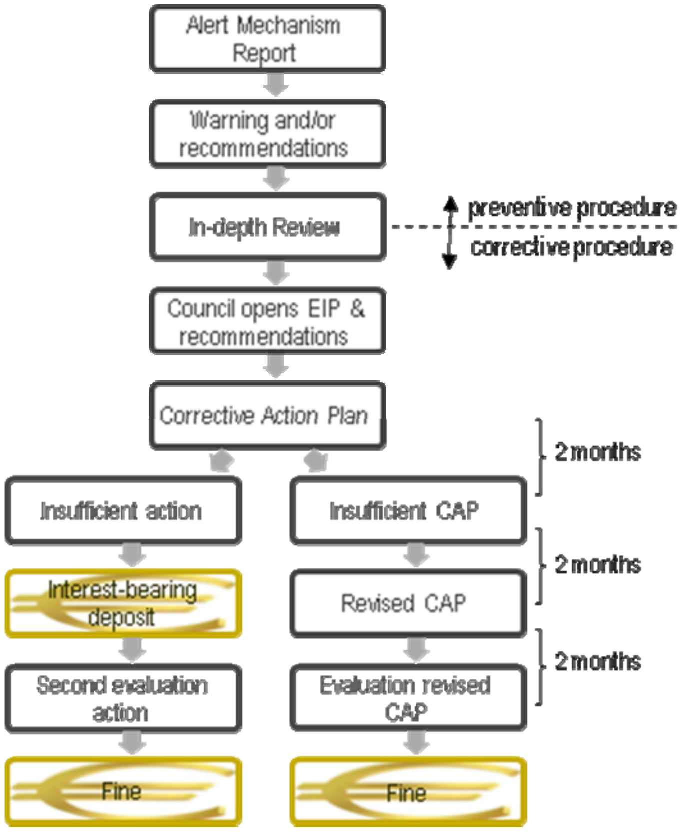
[25] Conditional on the successful ratification of the Treaty (see footnote 7).
[26] Article 7 of the TSCG.
[27] In 2012, in-depth reviews of twelve Member States took place. None gave rise to opening the EIP.

The General Procedure

When the preventive surveillance and coordination procedure points to a potentially excessive macro-economic imbalance, the European Commission is to carry out an in-depth review of the Member State's economy. If the review finds that the imbalance is excessive or risks becoming so, the European Commission must inform the Council, which can subsequently open the EIP. If the Council indeed decides to initiate the EIP, it simultaneously adopts recommendations that aim to counter the excessive imbalance.

Member States subject to an EIP must adopt a Corrective Action Plan (CAP), which should contain the reforms the Member State will undertake, as well as an implementation roadmap. The European Commission provides a report on the CAP's sufficiency, after which the Council can ask the Member State to adopt a new, more ambitious version of the document. This decision must be taken within two months of the submission of the original CAP. In these circumstances, the Member State has an additional two months to adopt a new CAP.

Figure 4: Macro-economic imbalances and the road to sanctions



Note: The euro symbol refers to steps that apply to eurozone countries only.

Source: Own compilation.

If the CAP is deemed sufficient by the Council, the European Commission monitors the country's progress in putting the plan in practice. To allow for sufficient monitoring, the Member State has to submit regular progress reports. The European Commission, for its part, can conduct surveillance missions in the Member State. On the basis of its monitoring, the European Commission subsequently provides an assessment of the country's progress towards meeting the objectives stated in the CAP.

Based on a recommendation by the European Commission, the Council then votes on whether the Member State has taken sufficient action to address its imbalance. Reversed QMV applies in case the European Commission finds that the Member State has not taken the necessary actions. By limiting the space for bargaining in the Council, Reversed QMV renders the procedure more mechanical.

The Council vote can have two outcomes. One the one hand, the Council can decide that a Member State has taken the necessary reform actions. In that case, the EIP is held in abeyance, and can subsequently be closed if the next Council assessment concludes that the excessive imbalance has been rectified. On the other hand, the Council can decide that measures have been insufficient. Then, it will once again demand measure to be undertaken by the Member State. For non-eurozone countries, no enforcement measures are foreseen beyond this decision, which risks rendering the procedure rather non-committal for them.

Additional Eurozone Measures

The EIP is more demanding for eurozone countries, that risk financial sanctions. These sanctions can be imposed for two reasons. Firstly, the Council can decide to impose a fine if two successive deadlines do not result in a sufficient CAP. The fine can be imposed each consecutive year until the Council decides that the countries' CAP is sufficient.

Alternatively, sanctions can be imposed if a country does not take sufficient corrective action after having adopted a CAP. This initially involves an interest-bearing deposit, but can then be turned into an annual fine if a subsequent Council assessment finds that adequate action still has not been taken.

The fines and deposits are not to exceed 0.1% of the country's GDP, which is smaller than the sanctions in cases of fiscal imbalances. All decisions on sanctions are made by Reversed QMV, which makes the possibility of sanctions more likely. It should be remembered, however, that sanctions are only enacted during the latter part of the procedure, making macro-economic sanctions less gradual than their fiscal surveillance counterparts.

2.3. The Financial Assistance Procedure

Legal Basis

- Article 143 TFEU and future Article 136(3) TFEU[28]
- Treaty establishing the ESM
- EFSF Framework Agreement (consolidated version)
- Regulation (EC) No 332/2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments (consolidated version)
- Regulation (EU) No 407/2010 establishing a European financial stabilisation mechanism

The financial crisis has shown that the fiscal situation of a Member State can deteriorate to such an extent that accessing financial markets becomes nearly impossible. Several Member States, as a consequence, required European financial assistance. Under these circumstances, the governance process becomes significantly more intrusive, as the country must allow substantial European involvement in its national policies. This goes beyond the other economic governance procedures, in which the EU sets out objectives, but essentially leaves the means to the Member State.

Rules on financial assistance make a clear distinction between eurozone and non-eurozone Member States. The possibility of financial assistance inside the eurozone was seen for a long-time as counterproductive, which has resulted in different financial assistance facilities.

2.3.1. The Assistance Facilities

Non-eurozone Countries

Financial assistance to Member States facing financial difficulties, i.e. balance of payment assistance, had been foreseen as far back as the Treaty of Rome[29]. Since 2009, the total amount of financial assistance available under this facility has been set at EUR 50 billion[30]. The balance of payments assistance facility can only be used for non-eurozone countries. Following the financial crisis, balance of payment assistance was provided to Hungary (EUR 5.5 billion), Latvia (EUR 2.9 billion) and Romania (EUR 5 billion)[31].

Eurozone Countries

For eurozone countries, financial assistance was omitted deliberately prior to the sovereign debt crisis. Policymakers feared that putting in place a financial assistance mechanism for eurozone countries would lead to imprudent fiscal policies (often referred to as moral hazard). This is reflected in the Treaty's no bailout clause[32].

As the sovereign debt crisis aggravated, eurozone financial assistance was nonetheless put in place. A temporary financial assistance facility was created, consisting of two parts:

- The European Financial Stabilisation Mechanism (EFSM) backed by the EU budget; and
- The European Financial Stability Facility (EFSF) backed by the eurozone members.

The permanent European Stability Mechanism (ESM), which was inaugurated in October 2012, is to replace the temporary financial assistance facility. The ESM has a lending capacity of EUR 500 billion. It will gradually reach this lending capacity, as tranches of paid-in capital are provided[33]. In the meantime, the EFSF can still exceptionally provide

[28] Article 136(3) is to be introduced on 1 January 2013, depending on the successful ratification in the Member States of European Council Decision No 2011/199/EU of 25 March 2011.
[29] Article 108 of the Treaty of Rome, current Article 143 TFEU. With the creation of the Monetary Union, eurozone countries were excluded from such assistance.
[30] Regulation (EC) No 431/2009 of 18 May 2009.
[31] These sums only concern assistance provided by the EU via the balance of payments assistance. See Annex 3 for an overview of total financial assistance.
[32] Article 125(2) TFEU. The name of this clause can be somewhat misleading, as it does not imply a complete ban on financial aid. Rather, it states that neither the Union, nor the Member States are to be liable for or assume the commitments of (another) Member State. Thus, debt of an EU Member State cannot be passed on to other Member States, nor can other Member States be held accountable for it.
[33] The ESM's lending capacity would increase as tranches of paid-in capital are provided by the eurozone countries. Five such tranches would be provided until early 2014, which is after the EFSF expires.

assistance until it expires in July 2013[34]. This is to ensure a full fresh lending capacity (thus not taking into account former financial assistance) of EUR 500 billion (EFSF, 2012).

The ESM is able to provide various forms of financial assistance. It can provide loans or precautionary credit lines to governments, financial assistance to financial institutions[35] or sovereign bond market support. Other types of assistance can equally be put in place.

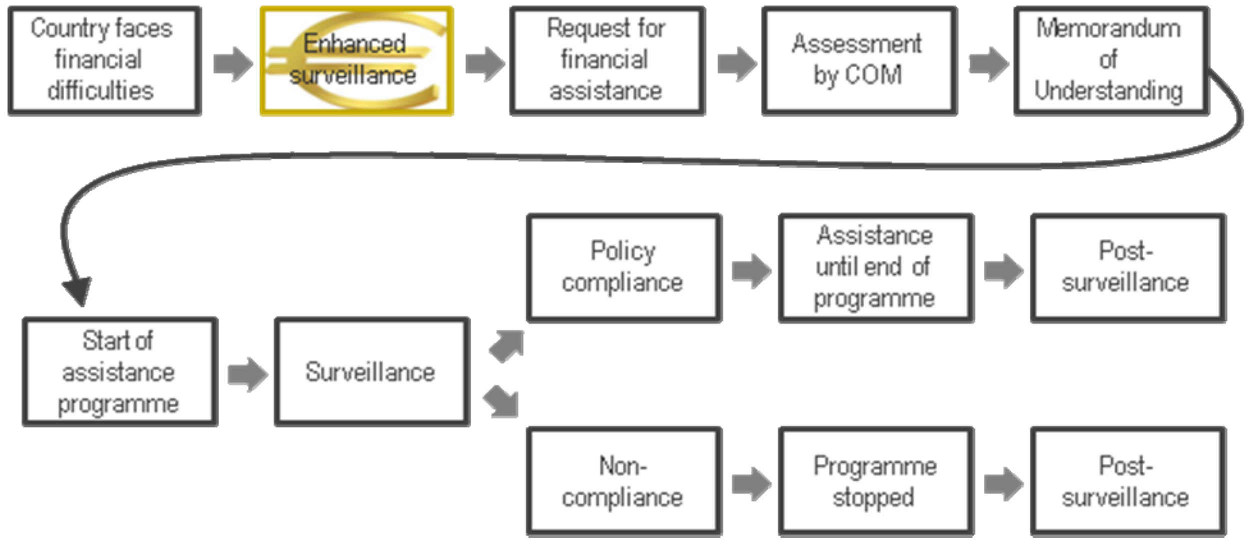
Four eurozone countries have entered into financial assistance programmes. The eurozone financial assistance facilities agreed to provide EUR 145 billion to Greece, EUR 40 billion to Ireland and EUR 52 billion to Portugal. In 2012, Spain was granted up to EUR 100 billion of financial assistance to clean-up its financial sector. Cyprus also requested financial assistance, and is thus to become the fifth eurozone country under the European rescue facilities. Annex 3 provides an overview of international financial assistance provided to EU Member States.

2.3.2. The Assistance Procedure

The procedures for financial assistance to eurozone and non-eurozone countries essentially follow the same path, although the procedure is more intrusive for eurozone members (see Figure 5). The main difference between eurozone and non-eurozone countries concerns the steps taken prior to financial assistance being granted.

For eurozone countries, the two-pack proposal stipulates that a country can already be put under enhanced surveillance when threatened by serious difficulties in relation to financial stability. The Council can even recommend a eurozone country to apply for financial assistance. Such enhanced surveillance prior to financial assistance does not apply to countries outside the eurozone.

Figure 5: The financial assistance procedure



Note: The euro symbol refers to steps that apply to eurozone countries only.

Source: Own compilation.

[34] The EFSM for its part has no expiration date, but is to be wind down when the '*exceptional circumstances threatening the financial stability of the European Union as a whole*' come to an end.

[35] As of writing, such assistance is provided via the Member States' government. The June 2012 Eurozone Summit indicated that direct support to financial institutions would be made possible when '*an effective single [European] supervisory mechanism is established*'.

Both eurozone and non-eurozone countries can themselves request financial assistance when accessing financial markets becomes problematic. In these circumstances, the European Commission provides an assessment of the country's financial health and needs. Criteria for assistance to eurozone countries are more clearly defined (and thus stricter). For eurozone countries, the European Commission[36] must consider the following:

- Whether or not there is a risk to the financial stability of '*the euro area as a whole or of its Member States*[37]';
- If public debt in the eurozone country is sustainable. If not, a (partial) default is to be considered prior to any financial assistance.

In addition to the European Commission's assessment, a draft adjustment programme is prepared containing the reforms to be undertaken by the Member State. These conditions are referred to as the 'conditionalities' attached to the financial assistance. Based on the assessment and the draft adjustment programme, fellow Member States decide whether or not to grant financial assistance. For non-eurozone countries, the Council adopts this decision by QMV. For eurozone countries, the situation is somewhat more complicated. Use of the EFSM is decided in the Council by QMV. In the EFSF and the ESM, the eurozone countries' finance ministers make the decision by unanimity. However, an emergency may allow for a special QMV procedure[38].

In case a country is granted financial assistance, the loan conditions and draft adjustment programme are formalised in what is known as a Memorandum of Understanding (MoU). Subsequently, the financial assistance programme is put into practice, with the country concerned to carry out the policies contained in the MoU, and the lenders to provide financial assistance in several tranches.

Throughout the duration of the financial assistance programme, the European Commission monitors compliance with the programme's conditionalities. In general, a compliance assessment is carried out before each subsequent tranche of financial assistance is given. The assistance programme can be brought to a halt if a country, after earlier warnings, does not comply with the conditionality requirements. If, on the other hand, a country respects its conditionalities, the financial assistance programme is continued until completion. Even after the assistance programme has finished, a country remains subject to post-programme surveillance that can potentially lead to further financial assistance.

36 As an exception, ECB analysis is to provide the basis for assistance in the secondary bond market (Article 18(2) ESM Treaty).
37 Article 13(1)a of the ESM Treaty.
38 This is the case when the European Commission and the ECB both find that the lack of financial assistance would threaten the economic and financial stability of the eurozone. In that case an 85% majority of the ESM capital stock is sufficient to agree on financial assistance.

3. PROPOSED MACRO-ECONOMIC CONDITIONALITIES

KEY FINDINGS

- Macro-economic conditionality proposed by the European Commission implies making cohesion policy dependent on the economic governance process. Cohesion policy funding would be suspended when a Member State is deemed to take insufficient action to address a macro-economic or fiscal problem. Alternatively, access to cohesion policy funding could be facilitated for countries under a financial assistance programme.

- Macro-economic conditionality does not distinguish between eurozone and non-eurozone countries, an important difference in comparison to economic governance sanctions.

- The suspension of cohesion policy funding can concern commitments and/or payments. A suspension of commitments would not have major consequences, unless the cause of the suspension persists for a prolonged period. Suspending payments can have a bigger impact.

- The decision on the suspension of cohesion policy funding can be optional or mandatory. Due to the length of the optional suspension procedure, this type of sanctioning does not fit in well with the economic governance procedures.

Although it is hotly debated and controversial inside the European Commission itself[39], the European Commission's proposal on cohesion policy post-2013 envisages introducing wide-scale macro-economic conditionalities[40]. With its proposal, the European Commission took into account earlier recommendations of the Van Rompuy Task Force on economic governance (Task Force, 2010).

The macro-economic conditionalities proposed by the European Commission would render cohesion policy funding dependent on the economic governance process. In the 2007-2013 financial framework, macro-economic conditionalities had already been introduced for the Cohesion Fund, while not for the Structural Funds (the European Regional Development Fund and the European Social Fund). Furthermore, macro-economic conditionalities only applied to the fiscal side of economic governance[41]. In its latest proposal, the European Commission advocates extending macro-economic conditionalities to all the Common Strategic Framework (CSF) Funds.

The CSF funds cover the traditional cohesion policy funds, which include the two Structural Funds and the Cohesion Fund. Two funds outside traditional cohesion policy also fall under the CSF funds: the European Agricultural Fund for Rural Development, and the soon to be

[39] See for example the comments by the Director-General of the European Commission's Directorate-General for Regional Policy at the Conference of Peripheral Maritime Regions of Europe (2011).

[40] Chapter IV of European Commission, Proposal for a Regulation laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund covered by the Common Strategic Framework and laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Council Regulation (EC) No 1083/2006. COM(2011) 615 final/2, 14 March.

[41] Article 4 of Regulation (EC) No 1084/2006 of 11 July 2006 establishing a Cohesion Fund and repealing Regulation No 1164/94, OJ L 210, 31.7.2006, pp. 79–81.

created European Maritime and Fisheries Fund. While this note focuses on the cohesion policy funds, macro-economic conditionalities would hence also be applied to the aforementioned agriculture and fishery funds.

This Chapter starts by providing an overview of macro-economic conditionalities as proposed by the European Commission, and then continues to examine how macro-economic conditionality would fit into the different economic governance procedures.

3.1. Two-sided Conditionality

The type of macro-economic conditionality proposed by the European Commission would be a two-way street. Cohesion policy funding could or would have to be suspended if certain economic governance requirements were not met and, conversely, co-financing requirements could be eased if a country receives European financial assistance. In contrast to the economic governance sanctions, no distinction is made between eurozone and non-eurozone countries. Macro-economic conditionalities would hence apply to both in a similar manner.

3.1.1. Suspension of Cohesion Policy Funding

In terms of suspending cohesion policy funding, the European Commission's proposal makes a distinction between optional and mandatory suspension, which would take place at different stages of the economic governance procedures. The European Commission proposal also contains elements on the severity of suspensions (with an important distinction between suspending commitments or payments) and on how a suspension could be lifted.

Optional Suspension

In the case of an optional suspension, the European Commission can decide to initiate a procedure that can bring about the suspension of cohesion policy payments. The prime goal of this procedure is to strengthen the EU's position when persuading a country to modify its national cohesion policy strategic documents (i.e. the Partnership Contract and relevant operational programmes). Such modifications should make it easier for the country to meet the objectives of Economic Union. A suspension of funding would occur if a Member State fails to adapt its national strategic documents in a sufficient and/or timely manner.

Under the proposed optional suspension procedure (see Figure 6), the European Commission would be empowered to initiate the optional suspension procedure at specific moments in the economic governance processes. It could be initiated under the following circumstances:

- Surveillance shows that a Member State is not progressing sufficiently towards the norms and targets of Economic Union[42];
- The Council bases its recommendations on the Treaty's provisions that specifically concern the eurozone. Such cases would be rare[43];
- A corrective fiscal or macro-economic procedure (EDP or EIP) is launched[44];
- A Member State is granted financial assistance.

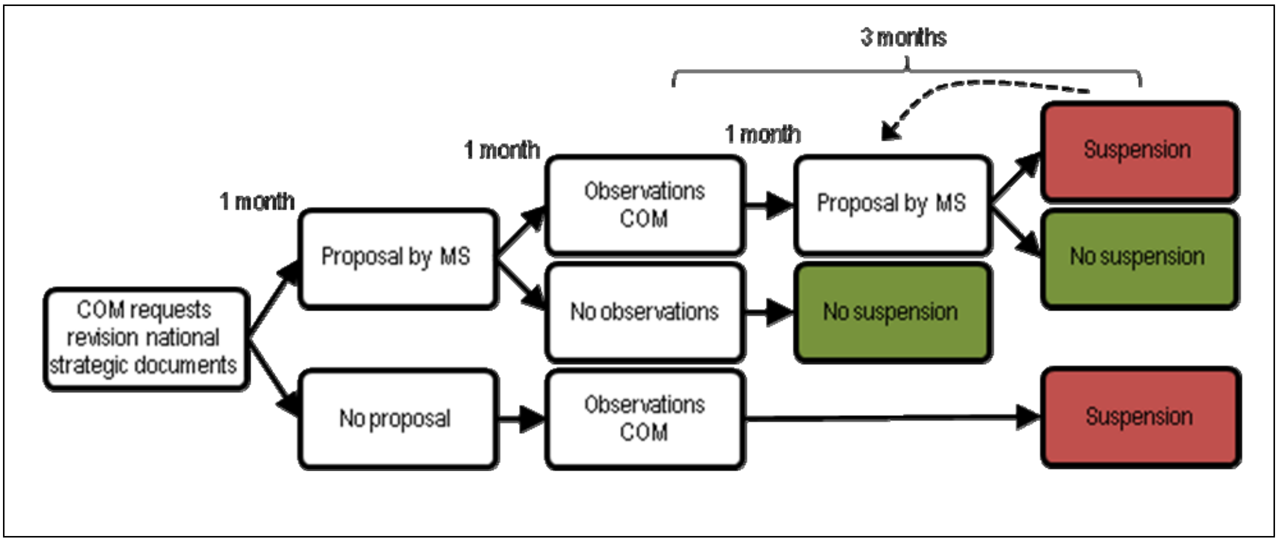
[42] Based on achieving the BEPGs and the Employment Guidelines.

[43] This concerns recommendations based on Article 136(1) TFEU. As of writing, the recommendations to Greece when it received its first financial assistance programme are the sole use of country-specific recommendations under Article 136(1) TFEU. Subsequent financial assistance to eurozone countries had been accompanied by a MoU, instead of recommendations based on Article 136(1) TFEU. Further assistance programmes are likely to be accompanied by a MoU instead of recommendations based on Article 136(1) TFEU. This would make the use of the Treaty Article rather rare.

In cases where a Member State is granted financial assistance, the European Commission would also be allowed to directly and unilaterally modify the strategic documents. If it prefers, the European Commission could also follow the general optional suspension procedure.

In the circumstances listed above, the European Commission would be able to open the optional suspension procedure (although it is not obliged to do so), requesting a Member State to revise its national cohesion policy strategic documents. Following such a request, the Member State would have one month to propose amendments to its Partnership Contract and relevant programmes. Subsequently, the European Commission would evaluate these amendments (the proposal again allows for one month). If the European Commission accepts the Member State's proposed amendments, the national strategic documents would be modified accordingly. In that case, there would be no suspension of cohesion policy funding.

Figure 6: The optional suspension procedure



Source: Own compilation.

If, on the other hand, the European Commission was not satisfied by the Member State's proposed amendments[45], it makes observations to the Member State. In that case, the Member State would have to propose new amendments to its national strategic documents. If the European Commission was still unsatisfied with the amendments, it could decide to suspend partially or fully cohesion policy payments. This decision would be made by an implementing act, although the European Commission's proposal does not specify which implementing procedure would be used (the examination procedure or the consultative procedure). According to the proposal, a suspension should occur within three months of the European Commission's observation. In total, the optional suspension procedure can therefore take up to five months.

Mandatory Suspension

The goal of mandatory suspension of cohesion policy funding goes beyond optional suspension, as it aims to induce wide-ranging policy changes to correct fiscal or macro-economic problems. This not only concerns the national cohesion policy strategic documents on which optional suspension focuses, but also the country's other policies.

44 The optional suspension procedure would be linked to the recommendations that accompany the EDP or EIP.

45 A particular (yet unlikely) situation would be if a Member State does not propose amendments in a timely manner. In that case, cohesion policy funding can also be suspended.

Mandatory suspension entails prompter sanctioning, instead of the extensive procedure used for optional suspensions.

According to the proposal, the European Commission would be obliged to suspend cohesion policy payments and/or commitments at specific points during the economic governance procedures. The suspension is linked to those points in the governance process where a Member State has not acted sufficiently to address its manifest fiscal or economic difficulties. This comprises situations where a Member State:

- Takes insufficient action when under a corrective procedure (EDP or EIP)[46];
- Fails to comply with recommendations based on the Treaty's provisions that specifically concern the eurozone[47];
- Does not meet the requirements of its financial assistance programme.

The mandatory suspension should occur in the form of an implementing act, although the European Commission's proposal again does not specify which implementing procedure would be used. While the sanction might be mandatory, the content of the sanction would lie very much in the hands of the European Commission.

The Severity of a Suspension

The European Commission's proposal remains rather vague on the scale of possible macro-economic conditionality sanctions. More detailed guidelines on the potential severity of sanctions should result from the legislative discussions on the European Commission's proposal and/or be adopted in subsequent legislative documents.

A crucial element of a suspension is whether it concerns commitments and/or payments of cohesion policy funding. Commitments refer to the funds that the EU annually commits to transfer to a Member State for financing cohesion policy projects. Payments refer to the actual transfer of financial means from the EU to cohesion policy projects via national authorities. In case of an optional suspension, the suspension would concern payments. In the event of a mandatory suspension, the European Commission proposal suggests allowing the European Commission to decide on whether to suspend commitments and/or payments. That decision is of particular importance. If the suspension only concerns commitments, payments can still occur on the basis of prior commitments. In that case, projects would be financed until all prior commitments have been met. A suspension of payments, on the other hand, would imply ceasing financial transfers, which can have a direct impact on individual projects that receive cohesion policy funding (see 4.2).

With regard to the size of a suspension, the European Commission proposal offers two guidelines. Firstly, a suspension should be proportionate, which implies that it should relate to the seriousness of the cause of suspension. Suspensions in the preventive economic governance procedure should therefore lead to a more limited suspension than those that occur at a later stage.

As a second guideline, a suspension should ensure equal treatment, or fairness, among Member States. This notion relates to the impact of the suspension on a Member State's economy. In similar circumstances, a country that is more reliant on cohesion policy

[46] This comprises failure to a) act upon the recommendations accompanying the opening of the EDP (Article 126(8)TFEU), b) act upon the final notice of the EDP (Article 126(11)TFEU), c) adopt a sufficient CAP (Article 8(3) of Regulation (EU) No 1176/2011) or d) take the needed actions if under the EIP (Article 10(4) of ibid.).

[47] See footnote 43.

funding should thus see less of its funding suspended than a country where funding is less important. Suspensions could be capped, for example, at a specific percentage of GDP. However, equal treatment would be difficult to put into practice (see 4.2).

Lifting a Suspension

A suspension of cohesion policy funding is not intended to be permanent. If certain requirements are met, the suspension is to be lifted. As a general requirement, the European Commission needs to agree to the amendments to the national cohesion policy strategic documents that were proposed by the Member State. A mandatory suspension would only be lifted if, in addition, the relevant economic governance procedure has moved in a positive direction and the initial reasons for the suspension no longer apply.

Lifting the suspension of payments would result in paying-out the suspended funds. When a suspension of commitments is lifted, those commitments would be re-budgeted. The proposed 2014-2020 Multi-annual Financial Framework only allows for a re-budgeting of commitments up to two years after the initial commitments. This means, for example, that cohesion policy commitments for 2014 can be re-budgeted in the 2015 and 2016 budgets. In such circumstances, the country will not lose the cohesion policy funding to which it was entitled. However, if the suspension persists beyond two years, a Member State can lose parts of the cohesion policy funding that it was set to receive[48].

3.1.2. Easing Access to Cohesion Policy Funding

Macro-economic conditionality would not only serve as a potential sanction, but could also be used as a positive incentive. To this extent, the European Commission proposes the possibility of facilitating access to cohesion policy funding for a Member State under a financial assistance procedure (see 2.3). The European Commission proposal remains vague on how exactly the decision to ease the co-financing requirements would be made. The proposal only indicates that the Member State must first request an increase in the co-financing rate before the increase can be put into practice[49].

Under the European Commission proposal, it would be possible to increase the co-financing rate of cohesion policy priority axes by 10 percentage points. As a consequence, European cohesion policy funding could finance a larger fraction of a cohesion policy project, which would in turn reduce the required contributions from Member States. European co-financing could then finance up to 95% of the funding for a project in the poorest regions, while projects in the richest regions could at least be co-funded at a rate of 60% (with various different co-financing rates in between)[50]. Increasing European co-financing does not mean increasing the total amount of cohesion policy funding for that Member State. It would rather result in using the money on a smaller number of projects than was originally foreseen.

An increase in the co-financing rate of financially troubled Member States is undoubtedly useful, given the fact that it is difficult for such countries to provide their part of the required financing. This problem is in fact common to most countries that face an economic or fiscal imbalance. Therefore, only providing easier access to cohesion policy funding to countries receiving financial assistance seems arbitrary. As financial assistance programmes will be rare, an increase in EU co-financing would remain exceptional and macro-economic conditionalities would mainly have a punitive effect. A more balanced

[48] Article 8 of European Commission proposal COM(2012) 388 of 6 July 2012.
[49] Article 22 of European Commission proposal COM(2011) 615 final/2 of 14 March 2012.
[50] Under the Commission's proposal, higher co-financing by the EU would also be possible in other specific situations (see Article 110 of COM(2011) 615 final/2).

carrot-and-stick approach is possible: this would entail additional circumstances where access to cohesion policy funding can be facilitated for countries that undertake actions to overcome their fiscal or economic problems (Verhelst, 2011b).

3.2. Integration of Conditionality and the Economic Governance Procedures

Macro-economic conditionality would not act in a vacuum, but would instead complement existing enforcement mechanisms of the European economic governance procedures. Therefore, the sound integration of macro-economic conditionality and the different economic governance procedures requires close attention.

3.2.1. The Preventive Surveillance and Coordination Procedure

The preventive surveillance and coordination procedure is in essence conceived as non-binding, and thus contains virtually no sanctions (see chapter 2). Macro-economic conditionality can potential make the preventive procedure more stringent – a most significant change in policy.

An optional suspension procedure could be initiated in case of non-binding warnings or recommendations. Such warnings and recommendations concern a very wide range of issues, covering fiscal and macro-economic policies. The possibilities of macro-economic conditionality sanctioning would even stretch beyond the grounds for sanctions foreseen in the economic governance procedures. A Member State could for example be sanctioned when failing to adopt certain policies (e.g. labour market reforms), while the corrective governance procedures only foresee sanctions when specific norms are not respected (e.g. surpassing the unemployment rate ceiling)[51].

Macro-economic conditionality could alter the nature of the preventive surveillance and coordination procedure. However, this verdict should be somewhat nuanced. The main aim of optional suspension in the preventive economic governance procedure is not to simply suspend cohesion policy funding. It is intended to give the EU more power when persuading Member States to modify cohesion policy programming. In this sense, macro-economic conditionality sanctions are unlikely to materialise very often during the preventive surveillance and coordination procedure, although they do remain a possibility.

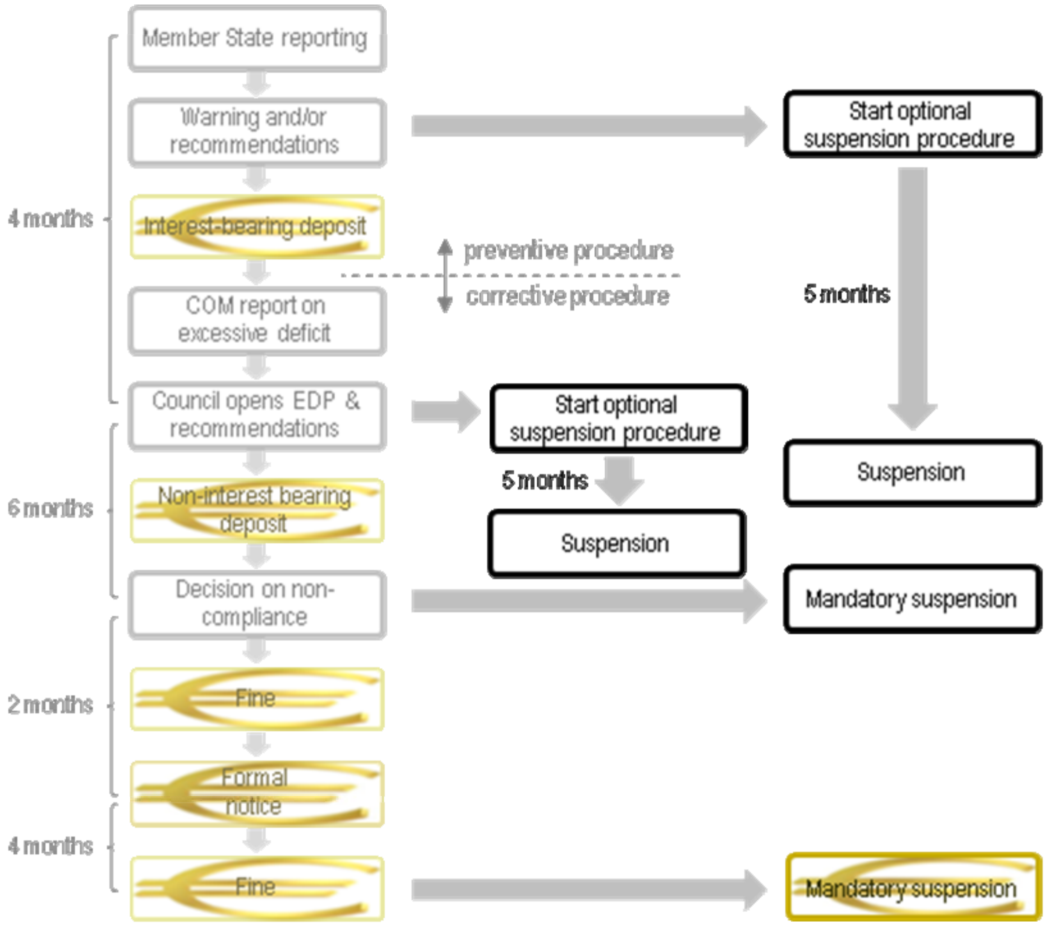
3.2.2. The Excessive Deficit Procedure

As was discussed above, macro-economic conditionality can result in opening an optional suspension procedure during the preventive economic governance surveillance and coordination procedure. Due to the tight time limits in the EDP and the lengthiness of the optional suspension procedure (up to 5 months), an overlap is possible. A suspension of cohesion policy funding that results from the preventive economic governance procedure would most likely only enter into effect during the subsequent corrective EDP. The cause of the macro-economic conditionality sanction would then no longer correspond with the state of the economic governance process. This seems inconsistent in terms of timing (see Figure 7).

[51] A sanction would only be applied when a country does not modify its national strategic documents with regard to cohesion policy. Therefore, a sanction is not applied on the basis of failure to act upon European economic governance recommendations. Yet, the reason for opening the sanction procedure would be directly linked to the preventive European economic governance procedure.

The same problem occurs when an optional suspension procedure is launched while opening the EDP. The suspension procedure could then only result in a sanction shortly before the Council is to make a decision on non-compliance with the EDP. Such a Council decision would be accompanied by thorough sanctions (the mandatory suspension of cohesion policy funding and a fine for eurozone countries). As a consequence, the optional suspension would lose much of its relevance.

Figure 7: Fiscal imbalances and macro-economic conditionalities



Note: The euro symbol refers to steps that apply to eurozone countries only.

Source: Own compilation.

Mandatory suspensions would be enforced in a speedier manner than the optional suspensions, and thus fit in better with the EDP. A first mandatory suspension would be applied when the Council issues a decision on non-compliance. A second mandatory suspension is applied if the Council decides that insufficient action has been taken in response to a formal notice. As the formal notice only applies to eurozone countries, this second mandatory suspension would be limited to members of the eurozone. For these countries, mandatory suspensions would come in both cases in addition to a possible economic governance fine.

In total, the European Commission would be able to suspend cohesion policy funding on four separate occasions during the fiscal surveillance process (comprising both the corrective and the preventive procedures). In practice, the successive possibilities for macro-economic conditionality sanctions would most likely either confirm a previous suspension of cohesion policy funding, or extend its scope.

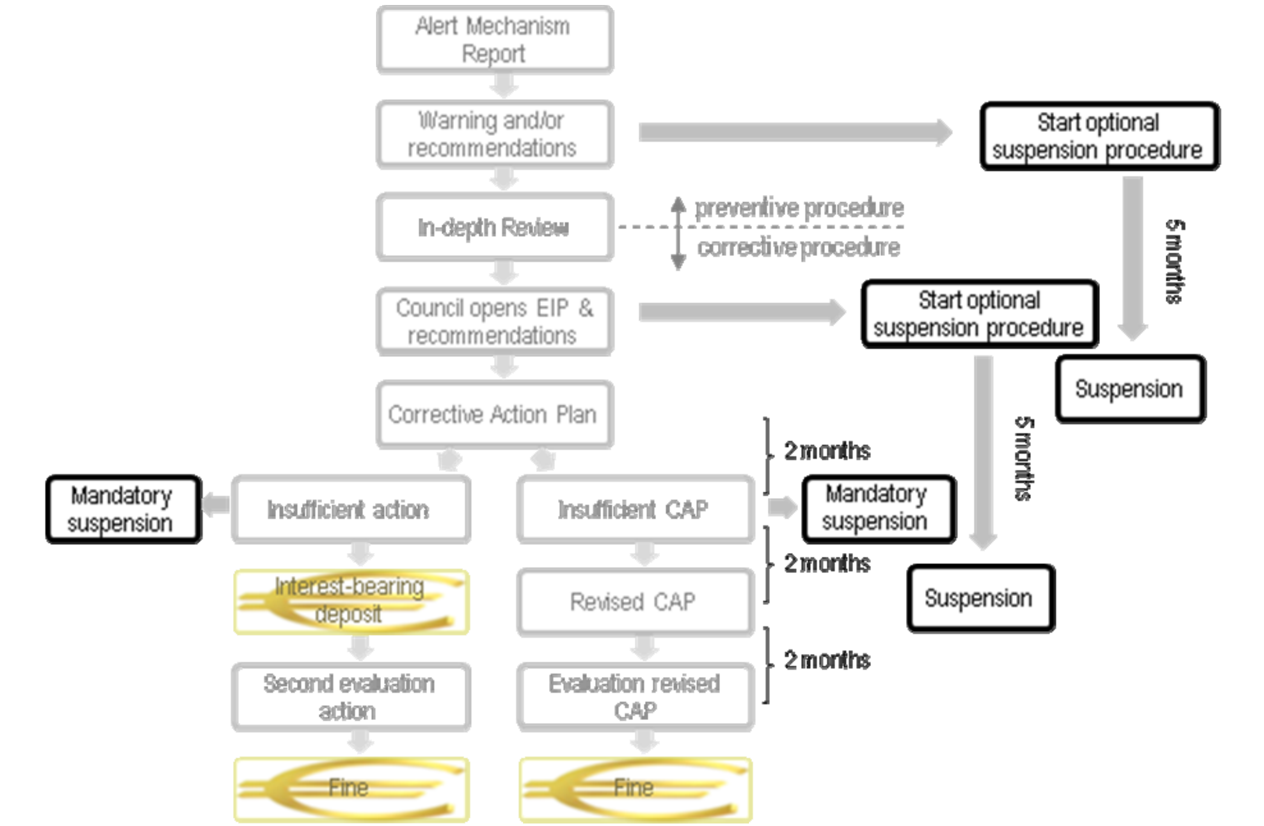
3.2.3. The Excessive Imbalance Procedure

Macro-economic conditionality would have a considerable impact on the corrective procedure for macro-economic imbalances. It would notably allow for more gradual sanctioning. Figure 8 provides an overview of how macro-economic conditionality would relate to the correction of macro-economic imbalances.

Optional suspensions can be launched during the preventive economic governance procedure, as well as when opening the EIP. The optional suspension procedure, again, has difficulties fitting into the governance procedure. Due to the long duration of the procedure, applying optional suspensions would likely suffer from a time lag vis-à-vis the economic governance procedures.

The length of the optional suspension procedure is therefore difficult to integrate with both the EDP and the EIP. Due to the time lag between the cause of an optional suspension and actual suspension, it is questionable whether the threat of the optional suspension sanction will be relevant. Member States would know that by the time the optional suspension actually takes place, the economic governance procedures would have advanced to a stage where mandatory suspension and/or economic governance sanctions is guaranteed. Implementing gradual suspensions of cohesion policy funding (increasing amounts and/or shifting from suspension of commitment to payments) could help overcome this problem, but this has not been foreseen in the European Commission's proposal.

Figure 8: Macro-economic imbalances and macro-economic conditionalities



Note: The euro symbol refers to steps that apply to eurozone countries only.

Source: Own compilation.

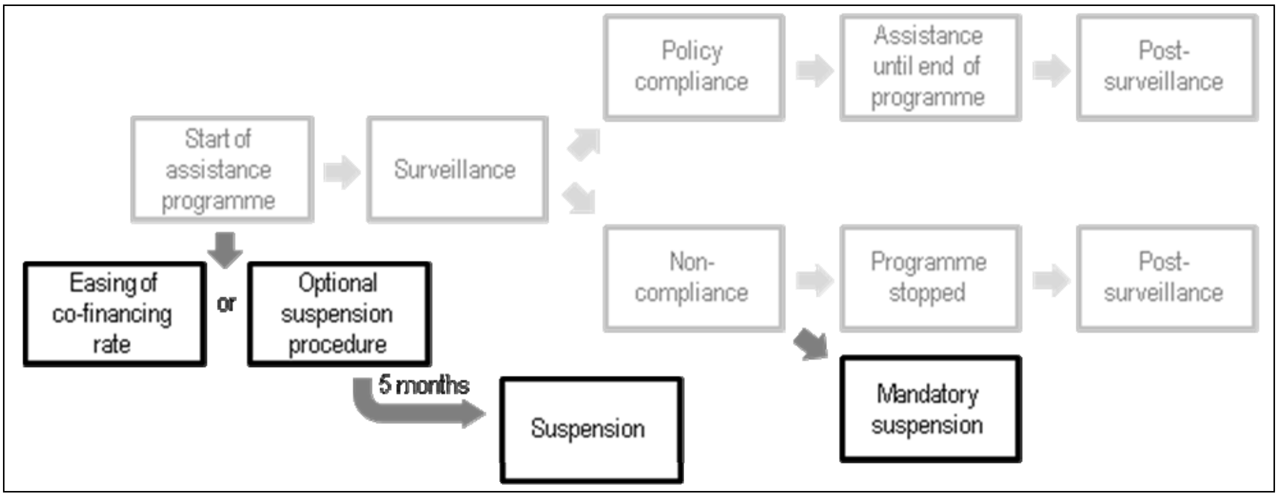
A mandatory suspension of cohesion policy funding would take place if the Council judges a national Corrective Action Plan to be insufficient. Every Member States could thus see its cohesion policy funding suspended following an initial negative evaluation of the CAP. Eurozone countries would then have to pay an additional fine if a second negative evaluation occurs.

A second occasion for the mandatory suspension of cohesion policy funding occurs when a Member State does not take sufficient action to apply its CAP. In that case, the sanction would accompany the interest-bearing deposit that is demanded from eurozone countries. For the latter types of countries, sanctioning would be reinforced after a second negative evaluation of the actions undertaken.

3.2.4. The Financial Assistance Procedure

The interaction between macro-economic conditionality and the financial assistance procedure is different from the other economic governance procedures. Here, macro-economic conditionality can serve as both a sanction and an incentive tool. This way, macro-economic conditionality offers a more balanced way of inducing policy modifications.

Figure 9: Financial assistance and macro-economic conditionalities



Source: Own compilation.

Upon the start of a financial assistance programme, the European Commission would have the choice to either relax co-financing requirements or, on the contrary, launch a suspension procedure. This decision would depend on the Member State's willingness to carry out the necessary reforms.

The mandatory suspension of cohesion policy funding would occur when a Member State fails to comply with the memorandum of understanding it signed with lenders. Besides the suspension of cohesion policy funding, the financial assistance programme would at that point be stopped or at the very least suspended. This would have a significantly larger impact on the Member State, as the country risks having insufficient financial resources to continue its operations. Therefore, when a financial assistance programme is stopped, the mandatory suspension of cohesion policy funding adds little weight.

4. THE CONSEQUENCES OF MACRO-ECONOMIC CONDITIONALITIES

KEY FINDINGS

- Macro-economic conditionality would likely have a beneficial impact in terms of economic governance. It would offer an innovative way of ensuring compliance with the economic governance procedures. This does not necessarily mean that macro-economic conditionality is beneficial in achieving the goals of European Economic Union, which depends on other elements as well.

- With regard to cohesion policy, the consequences of macro-economic conditionality would likely be more negative. While macro-economic conditionality could be a useful instrument in avoiding unproductive spending, it also risks rendering cohesion policy less fair and less reliable.

- Taken together, it is doubtful whether the present design of macro-economic conditionality would help achieve the overarching goals of both policies, i.e. sustainable and balanced growth in Europe.

Macro-economic conditionalities as proposed by the European Commission would have important consequences for both economic governance and cohesion policy. This part of the note discusses the likely consequences of macro-economic conditionality on these policies. The consequences would differ considerably for both policies. Beyond the impact of macro-economic conditionalities on both policies separately, it is important to consider the overall consequences. The latter will determine whether macro-economic conditionalities would be beneficial in achieving the overarching goal of both policies: sustainable and balanced growth in the Monetary Union and the EU.

The actual impact would of course depend on the specific design of macro-economic conditionalities. The proposal by the European Commission serves as the basis for this Chapter. Certain modifications to the European Commission proposal could alter some of the effects of macro-economic conditionalities, although the fundamental consequences are unlikely to change.

4.1. The Consequences for Economic Governance

In terms of economic governance, the potential sanctioning effect of macro-economic conditionality is of prime importance. Such additional sanctioning would be beneficial for compliance with the economic governance rules. It ultimately offers more possibilities for sanctioning, and can increase ownership of the economic governance process along the different levels of government.

4.1.1. A Larger Sanction Toolbox

Macro-economic conditionality would be a new instrument that could stimulate compliance with the economic governance procedures. In this sense, macro-economic conditionality could help achieve the objectives of Economic Union. It would have several advantages over the sanctions available in the economic governance procedures.

Firstly, macro-economic conditionality would introduce a different, innovative kind of sanctioning. The existing sanction toolbox of economic governance consists of deposits and fines. These sanctions entail a financial transfer from a Member State to the European level which results in the direct deterioration of the Member State's budget. This is counterproductive, and renders the enforcement of the sanctions less credible. Non-financial sanctions have been proposed, but it has not proven possible to find an agreement on the issue[52]. Macro-economic conditionality could be a possible compromise, as it imposes a financial sanction (i.e. a possible withholding of EU funding) that does not have a direct negative effect on national budgets. While this is clearly advantageous, macro-economic conditionality is by no means the ultimate solution. The sanction would still have an impact on a Member State's economy and thus its public finances (see infra).

As a second advantage, macro-economic conditionality would offer the possibility of applying sanctions in a more automatic and thus less political manner. Before the sovereign debt crisis, QMV was needed in the Council to apply a sanction. By introducing Reversed QMV as part of the reforms during the sovereign debt crisis, the role of the European Commission in sanctioning has already been strengthened. Macro-economic conditionality would take this shift a step further, as a suspension could be adopted on the grounds of an implementing act.

Thirdly, Member States could be sanctioned throughout the different economic governance procedures. As was previously mentioned, this also applies to the preventive surveillance and coordination procedure, for which the economic governance process itself does virtually not foresee sanctions. Due to the additional sanctioning possibilities, macro-economic conditionality would allow for more gradual sanctioning than is foreseen in the economic governance procedures, especially during the Excessive Imbalance Procedure.

Finally, macro-economic conditionality is valuable because it would increase the geographical scope of the sanction toolbox. While the existing economic governance sanctions only concern the eurozone countries, macro-economic conditionality offers the possibility to sanction any Member State. The benefits of such an increased geographical scope are debateable, as the main goal of the ongoing reforms is to reinforce Economic Union inside the Monetary Union (Van Rompuy, 2012). Sanctions for non-eurozone countries therefore are of secondary importance in the debate on economic governance.

4.1.2. Bottom-up Drive for Upholding Economic Governance Rules

Regions receive most of the EU cohesion policy funding, and thus have the most to lose if these funds are suspended. Respecting the economic governance rules would hence become more important for the regions, which in turn would have two beneficial consequences in terms of economic governance.

As a first advantage, regions would put more pressure on the national level to adhere to the economic governance rules. With regard to the EU-level, local government have particular attention for receiving funding. Due to macro-economic conditionality, they would become more concerned with overall national economic and fiscal performances. This would improve the bottom-up drive to respect the economic governance rules. As a consequence, general ownership of the economic governance procedures would increase. The lack thereof has been a recurrent problem in the past (Verhelst, 2011a).

[52] For example, it has been proposed to suspend voting rights in the Council of countries that do not comply with the economic governance procedures. See: Franco-German Declaration (2010) and ECB (2010).

Secondly, local governments and the regions themselves would be more inclined to avoid deficits and wasteful spending. The importance of regional and local spending is not to be underestimated. In 2010, local government spending in the EU represented on average 23% of total public spending (Gancedo Vallina and Wahrig, 2012). Local governments' deficits are often a non-negligible part of total public deficits. On average, the local level added 0.3 percentage points to Member States' 2010 overall deficit-to-GDP levels[53]. There are even cases where local government deficits reach 1% of GDP or more[54]. In Spain, the 2010 fiscal deficit of the regions (the autonomous communities) was 3.5% of GDP, which means that these regions alone breached the EU's 3% of GDP deficit ceiling[55].

4.2. The Consequences for Cohesion Policy

Macro-economic conditionality would result in an additional step away from the mere re-distributional role of cohesion policy. Such an evolution has its advantages, as it works towards available funds being spent more efficiently. At the same time, macro-economic conditionality has its downsides, as it risks making cohesion policy less fair and less reliable.

4.2.1. Stimulating Efficient Spending

The European Commission's main argument in favour of macro-economic conditionality is that it will improve the effective use of cohesion policy funding. If a country has a fiscal or macro-economic imbalance, this impairs its long-term growth perspectives. The argument states that in such circumstances, the effectiveness of cohesion policy funding is undermined (European Commission, 2010a).

The recent economic crisis has indeed shown that fiscal and macro-economic imbalances can limit the usefulness of cohesion policy. On the one hand, troubled Member States did not take up substantial parts of cohesion policy funding, as they were simply unable to provide the co-financing necessary (Bubbico and De Michelis, 2011). On the other hand, fiscal and macro-economic imbalances in countries like Greece and Spain proved detrimental to their economies, thus limiting the usefulness of the large amounts of cohesion policy funding they received in the past (OECD, 2010; European Commission, 2012). Closer attention to the economic governance rules could prevent some of these difficulties[56].

It would therefore be useful to make cohesion policy funding conditional on respecting the rules of economic governance. If respecting these rules leads to sounder economic policies, it will both decrease the likelihood of profound economic crises and render cohesion policy funding more effective. Furthermore, macro-economic conditionalities offer the European Commission a way to require changes in the Member States' cohesion policy strategic documents.

When cohesion policy is viewed in an international context, macro-economic conditionality is nothing new. Lending by international financial organisations (notably the World Bank

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53 In 2010, the total general government deficit (comprising all levels of government) stood at 6.9% of GDP on average in the EU Member States.

54 In 2010, the Polish local government deficit was 1.2% of GDP, in Slovakia it was 0.9% of GDP and in the Netherlands, Portugal and Hungary local government deficits were 0.8% of GDP.

55 Eurostat database, all figures are for 2010.

56 However, cohesion policy funding can serve as an instrument to counter the consequences of an economic downturn. This calls for sufficient flexibility in using cohesion policy funding during downturns.

and the IMF) has traditionally been accompanied by reform requirements[57]. This is to ensure that assistance can bear fruit. In recent years, international organisations are somewhat shying away from pre-defined macro-economic conditionalities and attach increasing importance to national ownership[58]. Macro-economic conditionality has, despite extensive evaluations, not led to a proven increase in the success of lending programmes[59] (Dreher, 2009).

By introducing macro-economic conditionalities, the EU is arguably heading in the opposite direction of other international organisations. However, it should be clear that international financial organisations most often still impose conditionalities in case of financial assistance (OECD, 2009).

In sum, if they are well designed and take into account the need for national ownership, macro-economic conditionality can be a useful instrument in avoiding wasteful spending of cohesion policy funding. The conditionality provides a) an incentive for the Member States to adopt policies that safeguard the economic returns of cohesion policy spending, and b) an instrument for the European level to reorient the focus of a Member States' cohesion policy planning. This would increase the probability that cohesion policy funding is spent in an efficient manner, which in the end is beneficial to cohesion policy itself.

4.2.2. A Less Fair Cohesion Policy

While the potential beneficial effects of macro-economic conditionality should not be overlooked, there are without a doubt several negative consequences. Due to the design of macro-economic conditionality sanctions, they run the risk of creating a less fair cohesion policy.

Targeting the Wrong Actors

Ideally, those actors who fail to abide by the rules of economic governance should be the ones targeted by sanctions. This corresponds to a core management principle, whereby variable remunerations need to be based on variables that can be influenced by the person receiving that remuneration (Heene and Sanchez, 2003). In linking cohesion policy to economic governance, this principle seems to be partially overlooked.

Generally speaking, it is a Member State's central government that carries responsibilities in terms of economic policy-making, as well as ensuring the respect for the rules of economic governance. In contrast, regions have major responsibilities in carrying out the EU's cohesion policy. These regions often do not play a major role in terms of economic policy-making relevant to the economic governance process. As a result, there is a mismatch between the government level that is for the most part responsible for economic governance (the central government) and the level that would be the prime victim of the macro-economic conditionality sanctions (the regions). The fairness of such an approach is most doubtful (Committee of the Regions, 2012). However, the general mismatch between responsibilities and sanctions must be nuanced, for two key reasons.

Firstly, there is only a partial mismatch between the level of government responsible for economic policy-making and the level executing cohesion policy. On the one hand, the

[57] Such reform requirements include macro-economic policies, as well as structural reforms (e.g. in the labour market).

[58] The IMF, for example, has introduced a financial assistance programme without traditional macro-economic conditionalities (the Flexible Credit Line). In its other programmes, conditionality has often been made more flexible.

[59] Success being seen as a) the likelihood of repayment of financial assistance and b) improvement of the country's policies and institutions.

central government frequently plays a substantial role in cohesion policy, as several of the cohesion policy's operational programmes are centrally managed[60]. On the other hand, some regions have considerable economic policy-making responsibilities, especially in decentralised countries. These responsibilities can then coincide with cohesion policy responsibilities.

A second nuance of the mismatch between sanctions and responsibilities is the local authorities' sizeable role in overall government spending (see above). Therefore, even regions that do not have substantive responsibilities with regard to economic policy-making can influence the Member State's respect for EU fiscal rules. Macro-economic conditionality could be a way to encourage regions to avoid excessive deficits and thus improve the Member State's overall fiscal position.

Despite these nuances, a region could still face sanctions, irrespective of its policies. A macro-economic conditionality sanction might not always be able to target only those actors that have caused the sanction to be imposed. Therefore, a specific region risks being sanctioned for inadequate policies outside of its control (e.g. the failure of central government to take appropriate policy decisions, or large fiscal deficits in other regions). In this sense, macro-economic conditionality can target the wrong actors.

Poorer Regions and Member States Disproportionally Affected

Cohesion policy is mainly aimed at providing assistance to less-prosperous regions and Member States. As a consequence, they receive the majority of cohesion policy funding. Poorer regions and countries are also more economically dependent on Cohesion Policy funding than their wealthier counterparts.

Despite their dependence on cohesion policy, poorer regions and countries would be the prime targets of the proposed conditionality. Therefore, a suspension of cohesion policy funding would most likely have a more adverse effect on them than on richer regions and countries. Table 1 provides an overview of the countries that receive the most and least cohesion policy funding[61].

Table 1: Average yearly pre-allocated cohesion policy funding for the period 2007-13

Top 5

Country	% of GDP
Hungary	3.49%
Lithuania	3.40%
Latvia	3.37%
Estonia	3.20%
Poland	2.65%

Bottom 5

Country	% of GDP
Luxembourg	0.02%
Denmark	0.04%
The Netherlands	0.05%
Austria	0.07%
Ireland	0.08%

Source: (Marzinotto, 2011) and own calculations.

To ensure equal treatment of Member States, the European Commission's proposal tries to factor in poorer regions and countries' dependence on cohesion policy funding. In practice, this implies making the scale of a suspension conditional on the impact it would have in the Member State (see 3.1). Despite this goal, it will prove nearly impossible to prevent the

[60] This tendency is particularly pronounced in less populous Member States, where the regional level often plays only a minor role in cohesion policy. This is notably the case for Cyprus, Estonia, Latvia, Lithuania, Luxemburg and Malta.

[61] Pre-allocated funding in Table 1 includes allocations under the ERDF, the ESF and the Cohesion Fund.

disproportionate adverse effects that suspending cohesion policy funds would have on less prosperous countries. Even if macro-economic conditionality sanctions were to be capped at 0.02% of GDP (which would render the sanction virtually meaningless), they would still have a bigger impact in poorer countries, as their economies are more dependent on EU funding.

As aforementioned, under the 2007-2013 framework macro-economic conditionality only applies to the Cohesion Fund. This fund exclusively targets less prosperous Member States. A system of macro-economic conditionality that applies to rich and poor Member States alike seems fairer. Yet, expanding macro-economic conditionality to other cohesion policy funds would maintain the described discrepancy. Under the European Commissions' 2014-2020 proposal, less prosperous Member States could be sanctioned a great deal more than it is the case under the 2007-2013 rules, while the potential sanctions for rich Member States would remain limited. Considering this, it could be better for poorer Member States to maintain the existing rules than to implement the European Commission's 2014-2020 proposal.

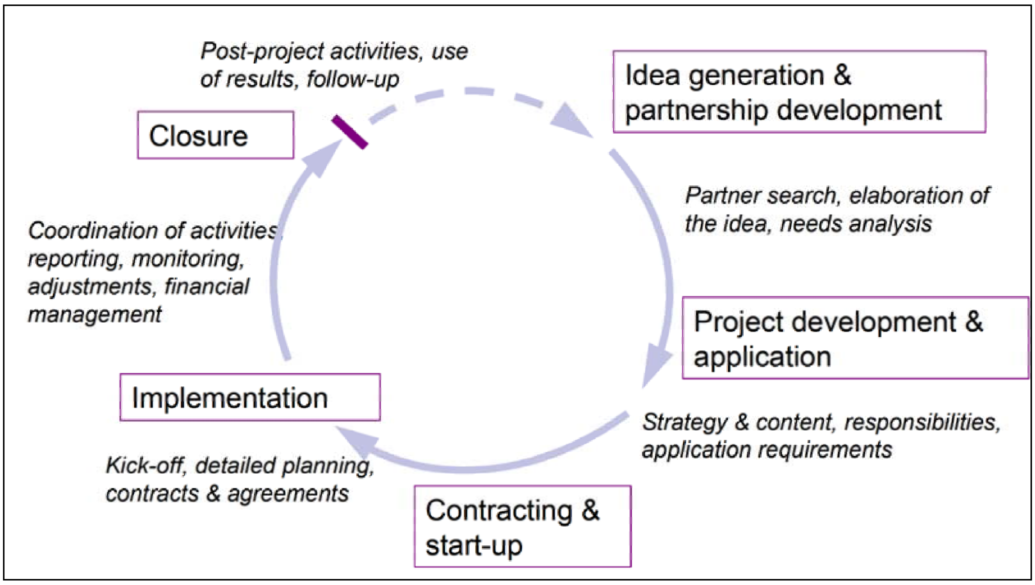
4.2.3. A Less Reliable Cohesion Policy

As well as affecting fairness, macro-economic conditionality is likely to have a negative effect on the perceived reliability of cohesion policy funding. It would result in uncertainty with regard to available European funding when planning individual projects, as well as during the project's execution. This would even be the case when a suspension has not actually taken place.

Uncertainty in Project Planning

Linking cohesion policy funding to economic governance would already result in increased uncertainty in the early stages of the cohesion policy project lifecycle, when partnerships are forged and project ideas are being developed (see Figure 10). Finding the required financing already plays a key role in the early stages of a project, for which cohesion policy is an important pillar. Due to macro-economic conditionality, the availability of cohesion policy funding in the coming years would become less certain, as the Member State in which a project would take place could see its cohesion policy funding cut in the future.

Figure 10: The project lifecycle



Source: Interact (2007).

Because of the increased uncertainty, future project managers might be less inclined to count on EU funding. As a result, projects may be abandoned in the early phases of their lifecycle, despite their existing potential. This would especially be the case in countries where a suspension of cohesion policy funding has already occurred, or risks occurring in the coming years. Yet even in Member States that are perceived as healthy, problems can emerge in the years to come. Therefore, even potential projects in those countries would have to consider a future suspension of cohesion policy funding as a real possibility. This would have an impact on the expected viability of projects across the EU.

Problems for Ongoing Projects

While macro-economic conditionality would already have an impact in the project design phase, its consequences would be even more significant during the project's implementation. A project typically receives its EU funding in periodic payments, which are of major importance to the project's execution. Suspension of cohesion policy funding would therefore jeopardize the completion of these projects.

When considering how macro-economic conditionality will impact on a project, a clear distinction should be made between the suspension of commitments and the suspension of payments. In case of a suspension of future commitments, payments can still occur for two years based on previous commitments. Actual payments would only stop if all the previous commitments have been turned into payments or if, after two years, commitments can no longer be used due to 'decommitment'. At this point, actual projects are likely to suffer from a suspension of commitments. Yet, this stage would only be reached under rare circumstances. It can be expected that by that time, the suspension of commitments would either have been lifted or already been extended to payments.

The suspension of payments would have greater consequences for ongoing projects than the suspension of commitments. In these circumstances, EU payments to the Member States would cease, despite prior commitments. The country would then face two basic options, neither of which is appealing. It could decide to replace EU financing by national financing causing national expenditure to increase, and ultimately worsening its fiscal position. This would make it even more difficult to meet economic governance requirements. Alternatively, projects would simply not receive the financial assistance on which they rely. The latter could result in the termination of projects, even if the suspension is of a temporary nature. The longer the suspension of payments would last, the more detrimental its consequences.

Prior to its proposal on macro-economic conditionality, the European Commission stated that the suspension of cohesion policy funding should not affect the end beneficiaries (European Commission, 2010d). Yet, in light of its actual proposal, the latter cannot be excluded.

CONCLUSION

Macro-economic conditionality is a controversial idea, and is likely to remain so in the future. To a certain extent, macro-economic conditionality would put cohesion policy at the service of economic governance. Macro-economic conditionality would be used mostly as a punitive measure to ensure that the rules of economic governance are upheld. Only in rare cases – when a country is under a European financial assistance programme – would macro-economic conditionality serve as a positive incentive.

Linking cohesion policy to respecting the economic governance process would have mixed consequences. It would most likely lead to better compliance with the economic governance rules. However, for cohesion policy the proposed macro-economic conditionality is much less likely to be beneficial, as it can lead to a less fair and less reliable cohesion policy. Cohesion policy and economic governance both aim to contribute to the sustainable and balanced growth of Europe. It is uncertain whether macro-economic conditionality would help work towards this goal, as its positive effects risk being counterbalanced by the negative impact of potential sanctions.

With regard to sanctioning, macro-economic conditionality faces a catch-22 situation, where all options remain unappealing. Removing the risk of a sanction would render macro-economic conditionality inept, as has been the case with many peer pressure instruments in the past. Yet, sanctioning a Member State based on macro-economic conditionality would disproportionately harm weaker regions. Sanctions could hence actually be even more detrimental to economic growth and convergence than not applying sanctions at all.

There are some available options that would help improve the design of macro-economic conditionality. This note recommends three changes to its design:

- Macro-economic conditionality should take more of a carrot-and-stick approach, instead of predominantly focusing on sanctions. This would make macro-economic conditionality a much more balanced instrument.
- The conditionality should be better aligned with economic governance procedures. Under the optional suspension procedure, a suspension of cohesion policy funding would only occur after several months. As a consequence, the sanction would not be in line with the economic governance process, nor with the potential mandatory suspension of cohesion policy funding.
- A clearer distinction could be made between suspending commitments and suspending payments. In the preventive and early parts of the corrective economic governance procedures, the EU could exclusively foresee the suspension of commitment and not that of payments. Suspending payments would then only be used as a last resort, which would coincide with the fines at the end of the corrective economic governance procedures.

In summary, this note has shown that macro-economic conditionality is in several aspects an attractive idea. It may indeed be instrumental in moving towards a sustainable Economic and Monetary Union. Yet, considering the potential disadvantages, it would prove difficult to turn macro-economic conditionality from an attractive idea into a useful practice.

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ANNEX 1: THE EU INTEGRATED GUIDELINES

The Integrated Guidelines for Growth and Jobs

1) Ensuring the quality and the sustainability of **public finances**;

2) Addressing **macroeconomic imbalances**;

3) Reducing **imbalances in the euro area**;

4) Optimising support for **R&D and innovation**, strengthening the knowledge triangle and unleashing the potential of the digital economy;

5) Improving resource efficiency and **reducing greenhouse gases**;

6) Improving the business and consumer environment and modernising the industrial base in order to ensure the full functioning of the **internal market**;

7) Increasing labour market participation and reducing structural **unemployment**;

8) Developing a **skilled workforce** responding to labour market needs, promoting job quality and lifelong learning;

9) Improving the performance of **education** and training systems at all levels and increasing participation in tertiary education;

10) Promoting **social inclusion** and combating poverty.

Source: Council Recommendation of 13 July 2010 and Council Decision of 21 October 2010.

ANNEX 2: COUNTRIES UNDER THE EXCESSIVE DEFICIT PROCEDURE

Countries under the Excessive Deficit Procedure as of 16 July 2012

Country	Opening of the EDP	Deadline for correction
Austria	2 December 2009	2013
Belgium	2 December 2009	2012
Bulgaria	13 July 2010	2011
Cyprus	13 July 2010	2012
Czech Republic	2 December 2009	2013
Denmark	13 July 2010	2013
France	27 April 2009	2013
Germany	2 December 2009	2013
Greece	27 April 2009	2014
Hungary	5 July 2004	2012
Ireland	27 April 2009	2015
Italy	2 December 2009	2012
Latvia	7 July 2009	2012
Lithuania	7 July 2009	2012
Malta	7 July 2009	2011
The Netherlands	2 December 2009	2013
Poland	7 July 2009	2012
Portugal	2 December 2009	2013
Romania	7 July 2009	2012
Slovakia	2 December 2009	2013
Slovenia	2 December 2009	2013
Spain	27 April 2009	2013
UK	8 July 2008	Financial year 2014/15

Source: European Commission, DG ECFIN.

ANNEX 3: MEMBER STATES RECEIVING EUROPEAN FINANCIAL ASSISTANCE SINCE 2009

International financial assistance to EU Member States since 2009 (in EUR billion)

Country	Assistance by the European financial assistance facilities	Total international financial assistance
Greece[1,6]	144.6	245.5
Hungary[2]	5.5	14.2
Ireland[3,6]	40.2	67.5
Latvia[4]	2.9	4.4
Portugal[6]	52	78
Romania[5]	5	20
Spain[6]	100	100
TOTAL	**350.2**	**529.6**

Source: Own compilation.

Notes:

1) For Greece, EUR 52.9 billion has been provided by eurozone countries on a bilateral basis. This is not included in assistance by the European financial assistance facilities.

2) At the start of the programme, Hungary was to receive EUR 20 billion, of which EUR 6.5 billion from the EU. Due to disagreement on the loan conditions, the programme was not completed. Hungary could possibly enter into a new assistance programme.

3) In addition, EUR 17.5 billion financial assistance is provided by the Irish Treasury and contributions from the Irish National Pensions Reserve Fund.

4) Latvia had originally been provided with a EUR 7.5 billion financial assistance programme. Due to improved conditions, it only borrowed EUR 4.4 billion from the EU, the IMF and the World Bank.

5) An additional EUR 5 billion has been provided on a precautionary basis to Romania (of which EUR 1.4 billion by the EU), but had not been activated at the time of writing.

6) The amount concerns financial assistance that has been committed to the country for an ongoing programme. The amount of financial assistance that will actually be disbursed can differ from the committed amount.

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