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Incentivising Structural Reforms in Europe? A Blueprint for the European Commission's Reform Support Programme

In December 2017, the European Commission proposed a Reform Support Programme in its roadmap for further institutional reforms in the Economic and Monetary Union.[1] Anchored in the upcoming Multiannual Financial Framework (MFF) for the period 2021-2027, the Reform Support Programme would provide financial and technical support for Member States pursuing growth-enhancing structural reforms. The European Commission followed up with a more detailed proposal on the establishment of the Reform Support Programme in June 2018.[2]

This article discusses the rationale and potential adverse effects of the idea to incentivise governments to conduct structural reforms by means of fiscal transfers. We discuss strengths and weaknesses of the reform delivery tool, the key component of the proposed Reform Support Programme, and subsequently present our proposal for 'national convergence roadmaps' which may serve as a blueprint for the tool.[3] Our proposal is driven by the overarching principle that the responsibility for making progress with respect to structural reforms and economic convergence needs to be rebalanced between the Member States and the European Union. Giving the European Commission additional competences in areas where national economic policies generate considerable spillovers can be helpful, but may blur responsibilities and allow national politicians to blame 'Europe' for unsatisfying results, even if these results are primarily caused by shortcomings of national policies and the failure to implement necessary reforms.

We therefore propose strengthening national responsibility for the convergence process by giving Member States the possibility to propose a convergence roadmap in the context of the European Semester. National convergence roadmaps would be assessed by the European Commission, while the Council could approve financial support for structural reforms. In our view, the key rationale for incentivising structural reforms is that some beneficial reforms with positive spillover effects to other Member States and the EU as a whole may not be implemented without incentives. The main difference in our proposed framework to the European Commission's reform delivery tool is that we recommend reallocating existing resources from the European Structural and Investment (ESI) Funds to reform support rather than establishing a separate budget line. This is motivated by empirical evidence pointing to the limited effectiveness of existing Cohesion Funds[4], and by the existence of a significant amount of unused funds in various EU support programmes. As outlined below, we think that it is essential to provide financial incentives in a targeted and efficient way, focusing on those structural reforms that generate spillovers across borders and those that have the highest potential to foster economic convergence in Europe. Granting financial support in one single tranche upon full implementation of the reform package

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1 European Commission: Further Steps towards Completing Europe's Economic and Monetary Union: A Roadmap, COM(2017) 821 final, 2017. European Commission: New Budgetary Instruments for a Stable Euro Area within the Union Framework. COM(2017) 822 final, 2017.

2 European Commission: Proposal for a Regulation of the European Parliament and of the Council on the Establishment of the Reform Support Programme, COM (2018) 391, 2018.

3 This paper refines and extends ideas the authors have developed in a briefing paper requested by the European Parliament's Committee on Economic and Monetary Affairs; M. Dolls, C. Fuest, C. Krolage, F. Neumeier, D. Stöhlker: Convergence in EMU: What and How?, In-depth analysis requested by the ECON committee, European Parliament, 2018, available at http://www.europarl.europa.eu/RegData/etudes/IDAN/2018/614502/IPOL_IDA(2018)614502_EN.pdf.

4 For an overview, see e.g. EEAG Report on the European Economy: What Now, With Whom, Where To – The Future of the EU, Munich 2018, CESifo Group, pp. 1-9.

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and without linking support to the costs of reforms – as foreseen in the current European Commission proposal of the reform delivery tool – may lead to an inefficient use of resources.

The rest of the paper discusses the rationale and potential adverse effects of incentivising structural reforms as well as the European Commission proposal of the Reform Support Programme. We also present our proposal for national convergence roadmaps.

Rationale and potential adverse effects of incentivising structural reforms

Why wouldn't EU Member States pursue reforms that are in their own interest? One main factor that may obstruct the implementation of reforms is the timing and the distribution of costs and benefits. While economic costs may arise immediately, benefits may take longer to materialise as the economy gradually adjusts to the reform.[5] Moreover, gains might be widely distributed across the population, whereas a smaller group may incur significant losses and garner higher visibility than the reform beneficiaries. Another reason why some structural reforms are not pursued is that positive spillover effects to other Member States are not fully internalised by national governments.[6] These short-term economic and political costs and neglect of common European interests are an important explanation for reform fatigue, even though, in principle, efficiency-enhancing structural reforms allow for Pareto improvements by compensating the losers of the reform. Financial incentives could help to overcome these politico-economic impediments.[7]

However, incentive mechanisms may come with unintended side effects that need to be carefully addressed in their design. First, if fiscal transfers are paid as a reward for reforms that would have been implemented anyway, such an instrument would lead to windfall gains, put an unnecessary burden on taxpayers and hence be inefficient. Second, there is concern that financial support for structural reforms could cause moral hazard. This would be the case, for instance, if reform efforts are delayed until governments become eligible for financial support. Third, at the national level, reforms may be more difficult to implement if they are perceived as being imposed from the outside or as giving in to pressure exerted by the EU.

The European Commission's proposal for the Reform Support Programme

The Reform Support Programme comprises three separate but complementary instruments: (i) the reform delivery tool, a financial support instrument for incentivising reforms, (ii) a technical support instrument as a follow up to the Commission's Structural Reform Support Programme, and (iii) a convergence facility to support structural reforms in non-euro area Member States and to prepare them for future membership in the euro area. These instruments shall be established as part of the 2021-2027 MFF and encompass a total volume of 25 billion euro. With an intended volume of 22 billion euro, the reform delivery tool constitutes the largest instrument of the Reform Support Programme.

The reform delivery tool is intended to support reforms that aim at strengthening Member States' economic resilience and that are expected to exert positive spillover effects. Member States can apply for funding by committing to the implementation of structural reforms that address the economic challenges brought forward in the context of the European Semester's policy dialogue. For that purpose, they can propose a multiannual reform commitment package with a detailed set of reform targets and milestones for implementation, together with a timetable for completion within a maximum period of three years. A rating system determines whether the reform package fully meets the Commission's assessment criteria, in which case the full funding is granted, or whether the Commission's targets are only somewhat met, in which case only half of the funding would be made available. If any one of the criteria is not met at all, the proposed reform is not eligible for funding. The implementation of the reform is regularly monitored by the European Commission within the framework of the European Semester.

The amount that a Member State may receive is proportional to population size and is not linked to the costs of the reform. More precisely, each Member State is entitled to a share of the total funds equivalent to the share of its population within the EU-27's total population. The funds are provided at various stages of the programme period. During the first 20 months of the programme, 11 billion euro is made available to Member States and allocated based on their submitted proposals. During the second stage, an additional 11 billion euro is available. If funds

5 A. Banerji, B. Barkbu, J. John, T. Kinda, S. Saksonovs, H. Schoelermann, T. Wu: Building a Better Union: Incentivizing Structural Reforms in the Euro Area, IMF Working Paper No. 15/201, International Monetary Fund, 2015; and P.M. Marrazzo, A. Terzi: Structural reform waves and economic growth, ECB Working Paper No. 2111, European Central Bank, 2017.

6 H.P. Grüner: The Political Economy of Structural Reform and Fiscal Consolidation Revisited, Economic Papers No. 487, European Economy, 2013.

7 Regarding short-termism, one may of course ask why this problem should be less severe at the European level, where financial incentives are set. A possible answer is that the Member States may effectively use EU programs as a commitment device.

remain after these two stages, another call for proposals will go out. The funds are given in a single instalment after the reform has been implemented. This must take place within three years following the adoption decision. If the reform is reversed or if its results are significantly obstructed by other measures within a period of five years following the payment, the Commission might rescind the funds.

Assessment of the reform delivery tool

In many aspects, the reform delivery tool resembles the Convergence and Competitiveness Instrument (CCI) proposed by the European Commission in 2013, which did not garner the necessary political support from the Member States.[8] In our view, it includes several provisions that point in the right direction. First, the reform delivery tool strives to foster national ownership of reforms by making participation voluntary and by inviting Member States to submit their own reform proposals. This is preferable to the inverse approach. Second, Member States are required to lay out implementation milestones as well as a timetable for the completion of their reform commitment packages. These provisions should result in a significant degree of commitment from Member States. Third, reform consultations include a peer review process, enabling Member States to learn from each other.

Yet, some provisions in the Commission's proposal raise scepticism. First, it is questionable whether the reform delivery tool should be equipped with supplementary budgetary resources in addition to the existing European Structural and Investment (ESI) Funds. Evaluations of the effectiveness of the European Union's cohesion policy indicate only a slight contribution to economic convergence and overall growth.[9] Moreover, a substantial fraction of the EU support programme funds has not been retrieved in recent years due to missing co-financing or a lack of suitable projects.[10] Against this background, it would be conceivable to reallocate a share of the 270 billion euro that has not been retrieved from ESI funds to the reform delivery tool.

Second, if the proposed reform complies with the Commission's key criteria, the current proposal allocates funding based on population size, irrespective of the scope and the cost of the reform. In such a setting, populous Member States may receive large financial support for reforms with a comparatively small scope. As structural reforms could be more effective in countries with lower initial productivity levels[11], this allocation key may channel the bulk of funds into the Member States where their effectiveness would be rather low.

Third, it would be advantageous to disperse funds not only on the condition of the implementation of the agreed reforms, but also on the achievement of convergence targets in the medium run. Such a set-up would incentivise governments to consider the reform in isolation as well as to enact general economic, fiscal and social policies that complement the EU-funded convergence strategies. In addition, the current financial governance framework already provides for some inherent flexibility, enabling governments to bear the possible short-term costs of structural reforms. As experience shows, successful but unpopular reform efforts may be reversed later or trigger the implementation of counteracting reforms. In this context, *ex post* conditionality would foster a longer-term commitment to growth enhancing economic policies and structural reforms.

National convergence roadmaps: a blueprint for the Reform Support Programme

Economic and social prosperity as well as fiscal sustainability depend on Member States' policies and can hardly be achieved with the limited set of instruments that are available to the EU. National policymakers, however, occasionally blame the EU for unsatisfactory economic developments at the national level. In an attempt to divert attention away from their own policy shortcomings, the EU is frequently accused of 'prescribing' the wrong policies or breaking its convergence promises. We think that the EU's dilemma can only be overcome by rebalancing between the Member States and the EU the responsibility for achieving progress with respect to key convergence targets. We propose a framework where Member States agree on convergence targets laid out in what we call 'convergence roadmaps' that also specify how and in what timeframe these jointly agreed targets should be achieved. A main goal of our proposal is to strengthen national ownership of structural reforms that help governments to achieve economic convergence targets.

8 European Commission: Towards a Deep and Genuine Economic and Monetary Union – The Introduction of a Convergence and Competitiveness Instrument, COM(2013) 165 final, 2013; and A. Steinbach: Structural Reforms in EU Member States: Exploring Sanction-based and Reward-based Mechanisms, in: European Journal of Legal Studies, Vol. 8, No. 1, 2016, pp. 173-210.

9 EEAG Report on the European Economy, op. cit.

10 Court of Auditors of the European Union: Annual Report on the Implementation of the Budget, in: Official Journal of the European Union, C 357, 2018.

11 A. Banerji, C. Ebeke, K. Koloskova, H. Schoelermann, J. Siminitz: Can Structural Reforms Foster Real Convergence in the Euro Area?, in: International Monetary Fund: Euro Area Policies – Selected Issues, IMF Country Report No. 17/236, 2017.

Convergence targets

The EU is currently proposing a multitude of indicators for measuring convergence in its various stability and convergence-related programmes. For more effective policy-targeting, we propose restricting the list of targets. First, focussing on a small set of indicators ensures that their meaning is not blurred by the multitude of indicators and allows for more effective policy-targeting. Second, by restricting the list to output instead of input-related goals, Member States gain more flexibility with respect to achieving goals that are in line with national policy preferences as well as country-specific economic circumstances.

We propose to focus on two real convergence indicators which are of the utmost importance for the economy as a whole: per capita income and unemployment rates. Both indicators reflect the widely accepted concept of β-convergence where initially less prosperous countries are growing faster than more developed countries.[12] In its convergence roadmap, each Member State applying for EU support would be required to provide a sound economic *ex ante* assessment of each reform's potential for raising output, per capita income and reducing unemployment.[13] We suggest focusing on structural components of per capita output and unemployment in order to sort out short-run business cycle dynamics and transitory expansions, e.g. through temporary fiscal policy interventions.[14]

Assessment and approval of national convergence roadmaps

National convergence roadmaps would be presented by the Member States in the context of the European Semester, thereby benefitting from the existing platform. Once convergence targets are agreed upon, the countries are asked to propose concrete reform initiatives whose targets and intermediate objectives they consider reachable while simultaneously meeting country-specific preferences and aligning with economic circumstances. Continuous dialogue with the European Commission and exchange with other Member States would help identify reforms with positive externalities.

The proposed roadmap would then be reviewed and assessed by the European Commission before being sent for approval by the European Council for unlocking financial support.[15] Giving the Council the ultimate decision-making power is coherent as the financial support for structural reforms would be conditional on positive spillovers.

Countries could fail to reach targeted convergence outcomes. In the event that this is due to circumstances beyond the control of the Member State, the Council could grant an extension after the Member State has explained why those targets were not met.[16] If failure to reach the targets is due to a partial or complete lack of implementation of the reform roadmaps or due to the implementation of counterproductive reforms, the EU could deny financial support.

Financial resources, conditions for financial support and programme eligibility

In our view, sufficient resources for financing the proposed incentive scheme are already available, most prominently in the European Structural and Investment Funds. A substantial share of ESI resources remains unused every year, partly because Member States cannot or do not want to deliver the required self-financing ratios (see above). We think that these resources could be more efficiently used for reform support.

Financial support should be conditional on the potential for positive spillovers across country borders, continuous implementation of the reform package and the achievement of the convergence targets. This implies that only those structural reforms that are expected to have a direct and measurable impact on the two convergence indicators specified above would qualify for financial sup-

12 Some contributions have found that income gaps between high- and low-income countries shrink by two percent per year on average (e.g., X.X. Sala-i-Martin: The Classical Approach to Convergence Analysis, in: The Economic Journal, Vol. 106, No. 4, 1996, pp. 1019-1036). However, the academic literature has not reached a consensus on structural parameters such as the rate of convergence (N. Islam: What have we learnt from the convergence debate?, in: Journal of Economic Surveys, Vol. 17, No. 3, 2003, pp. 309-362).

13 See e.g. Barrios et al. who develop a dynamic scoring framework for ex-ante evaluations of tax reforms in the EU; S. Barrios, M. Dolls, A. Maftei, A. Peichl, S. Riscado, J. Varga, C. Wittneben: Dynamic scoring of tax reforms in the EU, ifo Working Paper No. 251, ifo Institute, 2018; will be published in: Journal of Policy Analysis and Management, forthcoming.

14 The estimation of structural income per capita and unemployment could be based on the ECOFIN's 'approved production function methodology' as well as the corresponding estimates and forecasts of the non-accelerating wage rate of unemployment (NAWRU).

15 See the Commission proposal on the Convergence and Competitiveness Instrument which also includes an obligatory approval of the Council (European Commission: Towards a Deep and Genuine Economic and Monetary Union…, op. cit.).

16 The Brexit and its expected adverse impact on the Irish economy might serve as an example for such an event which is beyond the control of a Member State.

port.[17] More specifically, we propose that funds should be paid in several tranches after important milestones have been achieved in order to incentivise Member States to fully implement their convergence roadmaps.

Substantial reform interventions that have the potential to improve economic prosperity and resilience in the long-run may come with rather pronounced negative effects for production and employment during the transition phase. For this reason, we propose making the amount of financial support proportional for the short-term costs of the reform. Furthermore, by restricting programme eligibility to Member States with below average per capita income that are not participating in other programmes such as the European Stability Mechanism (ESM), resources are effectively channelled towards those countries with the greatest need to catch up.

Yet, it remains a challenge to put a price tag on the short-run costs, which would determine the initial support tranches. There may be substantial losses in production and employment following both product and labour market reforms before a noticeable pay-off in the medium and longer run. For instance, benefits of the reform through new firm entry and increased hiring often occur gradually while reform-driven layoffs may be immediate.[18] One option for governments could be to respond with expansionary fiscal policy to counteract the transitory dip in output and employment. Estimates of the extent of extra fiscal spending that would be necessary for maintaining the pre-reform output level can be found, for example, in Sajedi who simulates reductions in product and labour market mark-ups under active fiscal policy regimes.[19] When calibrated to the Eurozone as a whole, the drop in production following a reduction in mark-ups of one percent can be offset by additional government spending during the transition period (not higher than 0.85% of GDP over the whole period) and is quickly repaid after only four years following the reform.

17 Arguably, in an economically-integrated currency area such as the euro area any growth-stimulating structural reforms should have positive spillovers to other Member States. Conversely, reforms without quantifiable spillover effects, for example judiciary reforms, would not qualify for financial support.

18 See for example M. Cacciatore, R. Duval, G. Fiori, F. Ghironi: Short-term pain for long-term gain: Market deregulation and monetary policy in small open economies, in: Journal of International Money and Finance, Vol. 68, 2016, pp. 358-385.

19 R. Sajedi: Fiscal consequences of structural reform under constrained monetary policy, in: Journal of Economic Dynamics and Control, Vol. 93, Issue C, 2018, pp. 22-38.

Conclusion

Convergence is one of the key objectives of the European Union and has taken centre stage in many recent debates. In an attempt to overcome existing reform fatigue among EU Member States and to revamp the convergence process, the European Commission has proposed a Reform Support Programme as part of the 2021-2027 MFF equipped with a separate budget of 25 billion euro. Its key pillar, the 'Reform Delivery Tool', intends to support reforms that aim at strengthening the economic resilience of Member States, and in turn have positive effects on other Member States as well. Funding can be applied for by committing to the implementation of structural reforms that have been identified in the context of the European Semester's cycle and laying out a detailed set of reform targets and intermediate milestones. Available funds are proportional to each Member State's population size and are paid out as a single instalment upon full implementation of the agreed reform package.

Despite being an improvement to the current top-down approach of the European Semester, some key features of the proposed programme are likely to considerably constrain the success of the programme. We therefore propose an alternative framework where Member States agree on convergence targets laid out in what we call 'convergence roadmaps' that also specify how and over what time horizon these jointly agreed targets should be achieved. A key goal of our proposal is to strengthen national ownership of structural reforms that help governments to achieve economic convergence targets. We propose to restrict the target indicators to a small set of structural outcome variables such as per capita income and the unemployment rate. This not only allows for better policy targeting but also for more flexibility to reach these targets. The countries themselves are asked to propose concrete reform initiatives that they think are best suited to reach those targets and align with national political preferences and economic circumstances at the same time. Integrating the process in the context of the European Semester facilitates effective interaction between the Member States and the European Commission. Furthermore, financial support should not be a one-time pay-out but should be split in different tranches taking into account the potential for positive spillovers, continuous reform implementation and achievement of convergence targets. Programme eligibility needs to be restricted to countries with below average per capita income levels – independent of population size – in order to channel available resources to those countries with the greatest need to catch up. Last, resources for financing the incentive scheme are already available, for example in the European Structural and Investment Fund where a large share of funds go unused every year and effectiveness has proven to be limited.