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Governing Imbalances in the Economic and Monetary Union. A Political Economy Analysis of the Macroeconomic Imbalance Procedure

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Summary

The topic

Since the euro crisis that erupted in full force in 2010, politicians in the euro area have become considerably more concerned with other Member States' economic policies. The Italian government's announcement to withdraw a pension reform can lead to furious debates in the Dutch parliament. Italian politicians criticize Germany's lack of stimulating fiscal policy, while German politicians closely follow labour market reforms in France. The crisis showed that what happens in our neighbours' economies can spill over to ours. In this thesis, I examine how the EU governs these interdependences.

The pre-crisis framework to govern the euro was relatively simple. Its main elements were: rules for public debt (maximum 60% of GDP), deficits (maximum 3% of GDP), and the 'no bailout rule'. This rule ensures that ultimately every country bears sole responsibility for their public debt and will not receive financial assistance in case of trouble. It was believed that markets would discipline states for unsustainable policies. The crisis showed that this framework was far too simplistic and that interdependence runs much deeper than was previously thought. Markets did not correct the fallout from unsustainable policies, but deepened them. Similarly, the idea that every country has sole responsibility for public debt turned out to be naïve. Greece, Cyprus, Spain, Portugal, and Ireland all received financial assistance, while the European Central Bank had to intervene to prevent further escalation. And – most importantly for this thesis – policymakers learned that countries can run into trouble despite having following the rules on public debt and deficits, because developments elsewhere in the economy spiral out of control. Economic growth in some states turned out to be based on weak fundamentals and macroeconomic imbalances, such as high private debt, lacking demand, eroding competitiveness, etc.. When unaddressed, such imbalances can lead to a loss of market trust and an explosion of public debt as a result. The euro area did not have an effective mechanism to deal with macroeconomic imbalances.

The framework that governs the euro today has been heavily expanded and looks completely different. One of the main new instruments that has been introduced is *the Macroeconomic Imbalance Procedure* (MIP). We can think of the

MIP as a 'health check' for Member States' economies. The Commission makes a yearly scan to check for possible macroeconomic imbalances and if it finds these, the Commission issues Country-Specific Recommendations (CSRs) in which it recommends policy reforms to address them. The MIP is part of the overarching European Semester for fiscal and economic policy coordination. With the MIP, the Commission may recommend structural reforms in tax policies, pension systems, labour market institutions or product and services markets. On paper, the MIP works like an escalation ladder: the more severe the imbalances, the stricter the MIP becomes. Insufficient action on excessive imbalances could potentially lead to financial sanctions for Member States.

The puzzle

The euro is the only significant currency without a state backing it. Rather than a single political centre, the euro area is governed by a much more diffuse power structure where technocratic procedures such as the MIP play a stronger role. The euro is also a relatively young currency and how to govern it effectively is an unresolved question: market participants test its viability, academics question its institutions and policymakers continue to look for the right instruments to stabilise it. The effectiveness of the mechanisms that govern the euro is also unclear. Some believe a viable euro needs more policy discipline of Member States and stronger enforcement mechanisms. Others argue that national sovereignty should be protected and believe that the euro threatens democratic decision-making. The debate on the MIP brings out these considerations very clearly, as it touches upon sensitive policy domains that go to the heart of national decision making. From a legitimacy point of view it would be problematic if the EU started imposing policies on Member States in these domains. At the same time, many champions of the MIP are disappointed in its effectiveness and look for ways to strengthen the procedure.

In this thesis, I analyse this debate and argue that often claims about the MIP's legitimacy, effectiveness and policy content suffer from a lack of empirical backing. Hence in the thesis I aim to fill this empirical deficit underlying the debate on the MIP by studying how this instrument works in practice. For example, claims about the MIP's effectiveness are often based on assessments of annual implementation rates of CSRs. But, implementation rates do not tell us much about the MIPs' effects, as it is not clear whether Member States implemented the policies in response to the CSRs or independently of them. Such assessments can therefore not be taken at face value. This thesis takes as a premise that we should first assess the MIP's effects on domestic policies and the channels and mechanisms through which it operates before making normative claims about (a lack of) effectiveness -- not least because we do not have a clear notion of what to realistically expect from the MIP in terms of results.

The approach

As the MIP may contribute to crisis prevention, it is crucial to investigate its (potential) ***effects.*** But, because of the above considerations, we should also analyse the mechanisms through which the MIP affects Member States. We want to know to what extent the way the MIP affects national democratic decision-making **is *hierarchical***. And finally we should be concerned with the MIP's substantive ***content.*** In other words, what kind of policies does the MIP recommend?

To fill the debate's empirical deficit, this thesis presents an assessment of the first five years of operation of the MIP. The analysis consists of two parts. First, I present an analysis of the origin and evolution of the MIP (chapter 3); a broad analysis of its governance and institutional environment (chapter 4); and an analysis of the scope of issues that fall under the MIP and its policy content (chapter 5). The second part is based on qualitative, contextualised process tracing. It looks at the practical operation of the MIP by tracing the implementation process of five MIP CSRs:

- Wage indexation in Belgium (chapter 6);
- Professional services liberalisation in Italy (chapter 7);
- Labour market segmentation in France (chapter 8);
- The Dutch housing market (chapter 9);
- The German current account surplus (chapter 10).

In all cases I have traced the implementation process over the years to assess whether and how the MIP has affected the domestic reform process. I have examined the MIP's effects by studying the economic, intellectual and political context of each individual CSR, and how this has changed over time. This part of the research draws on extensive documentary analysis and is supported by 76 in-depth interviews with actors who played key roles in the process.

The findings

Most commentators who have analysed the *effects* of the MIP have looked primarily at its impact on policy change. When doing so it is easy to become disappointed by the MIP's results. This thesis brings some nuance to these analyses but does not fundamentally challenge the notion that the MIP's ability to affect policy change directly is quite limited. There are cases to be found where its effect on policy change is clear, but mostly in conjunction with market and domestic political forces. The MIP can be a factor in domestic policymaking, but is not the determinative factor. The analysis also shows that the effects of the procedure primarily emerge within the bureaucratic realm. For national parliaments, it is easier to ignore CSRs as often they do not bring new information and the rationale for EU involvement on domestic policy issues is not always seen as very strong, especially when a country is not in crisis. In the case studies, the effect of the MIP was most pronounced in Belgium where actors claimed that the procedure was a serious factor influencing a reform of their wage indexation mechanism. This was also due to the authority that the European Commission has in the Belgian debate and especially for the Michel government that prided itself on being reformist.

When taking a broader view of the ways in which the MIP affects policymaking more effects emerge. While domestic political factors are mostly decisive for whether a reform gets introduced, the MIP can have an effect on the preceding process: the way the problem is framed and the salience that is given to the issue. When looking at the cases, in four out of five instances the CSR was about problematizing an issue. In the Netherlands, the CSR was meant to convince national politicians that the measures taken were insufficient to address the issue, whereas the government continued to state that it had been dealt with and calm in the housing market was now required. In Germany, it was about breaking national policy myths of defining the current account surplus in terms of being an export champion and ways to address it as an attack on German over-competitiveness. Such domestic policy views can be deeply engrained, as in Belgium where wage indexation is part of the social structure. In Italy, the CSR was about giving salience to an issue that would require political costs in the short term and yield diffuse benefits in the longer term. This meant there were not a lot of incentives for Italian politicians to pick up this issue of liberalisation of professional services. The MIP helped to ensure that they could also not ignore it. Only in France was the issue of labour market reform already firmly on the agenda, because it involved unemployment, which is a relatively obvious problem. But even there the Commission tried to draw attention to particular aspects such as the very short contracts.

The effects of the MIP can therefore also be cognitive: it can help frame policy issues and disseminate a certain reform logic. The fact that the Commission makes a certain analysis, on the basis of a careful procedure and backed up by majority support of all Member States gives authority to the argument. The MIP therefore is about mainstreaming particular policy views. Member States get confronted with a European way of thinking about policy issues. Take Germany: when looking only at the implementation rates, the MIP does not seem to have had much of an effect. Yet over the years, the debate on the current account surplus has changed quite a bit, both in Europe and in Germany. The MIP forced German actors with opposing views to come to a consensus position and engage with the arguments of the Commission. Even when not everyone in Germany agrees with the Commission's arguments and even when the CSRs do not always gain a lot of traction in parliament, almost all interviewees agreed that slowly the policy frame was shifting. Whether cognitive effects translate into a change of policy is dependent on domestic political factors whereby the MIP can be conducive to change when domestic actors actively use it to leverage their agendas. But, in this thesis I argue that cognitive effects are substantive effects in themselves.

Secondly, the analysis of *hierarchy* shows that the MIP does not fundamentally disrupt the democratic accountability links between governments and their electorates. The MIP does not force action and the role of the sanction procedure is not very credible. What the MIP does is to increase the political costs of inaction. It sends a signal that issues should be addressed, but to what extent this is felt as serious pressure depends mostly on domestic political context and market sentiment. Simply put, for some governments a negative judgement from the Commission hurts more than for others and if a country is facing market stress, then any critical comment from an institution with authority is best avoided. But the MIP primarily operates through the 'force of argument'. Procedural aspects such as escalating from 'imbalances' to 'excessive imbalances' do not seem to make much of an impression on domestic actors. The MIP does not operate in a fundamentally different way in Italy as it does in Germany, despite their different positions on the escalation ladder of the MIP.

The non-hierarchical character of the MIP has been shaped by the Commission's deliberate decision to focus on ensuring domestic ownership and making the MIP more interactive. This thesis shows how this decision was also due to forces in the Council that started to push back against a perceived rigid approach at the start. Another key choice that shaped the MIP's character was the Commission's decision to place many Member States under the MIP and to link 81% (own calculations) of their CSRs to the MIP. Because of this wide scope, the MIP has become strongly co-extensive with the Semester at large; their rationale is almost indistinguishable. In theory, a MIP CSR should trigger extra concern amongst Member States as opposed to a normal Semester CSR, but the procedure's political force is diminished if everyone and everything falls under it. Had the Commission chosen to only link a few issues and a few Member States to the MIP, its political force – and hierarchical character – would in all likelihood have been greater.

Third, because the MIP is so extensive in scope, it is very difficult to make judgements on its overall policy content. The MIP does not seem to be driven by a clearly identifiable economic logic. The formulation of CSRs is often dependent on domestic political context and the terminology used in them does not have a univocal meaning. One may identify overarching frames such as the flexicurity frame for labour market CSRs and a trend towards 'socialisation' can be witnessed over the years. But in general, scholars should be careful in making overly deterministic statements about the MIP's overall ideology, such as classifying the procedure as neoliberal.

Reflections

The effects, content and hierarchical character of the MIP differ depending on domestic factors. While the MIP is essentially technocratic, the Commission is constantly faced with political contexts in operating the procedure. Similarly, the thesis shows that there continues to be legitimate and genuine intellectual disagreement about appropriate policies; the pace of their implementation; the use and value of certain indicators; assessments of how much progress has been achieved; and whether there is an EU dimension to issues that some consider purely domestic. Even when the Commission is fully justified in pointing out certain problems, there can be disagreement over whether it is the right actor to be doing so, since its involvement can be politically counterproductive to pro-reform forces. Politicians and other pro-reform forces often deliberately downplay the role of the EU in public debates as it is an easy target for opposition forces or vested interests. The image of 'the policeman' or 'foreign imposer' can be a powerful one.

This does not necessarily speak against the MIP altogether, but should warn against introducing more hierarchy in the procedure. We cannot assume that more pressure automatically leads to greater effects. We can also not assume that the Commission has superior knowledge relative to Member States and that implementation of CSRs is only hindered by classic political economy obstacles, such as vested interests that somehow need to be bought out, persuaded or forced to comply. There is significant strategic uncertainty involved. This thesis not only shows how the MIP is not very hierarchical but also how hierarchy in the procedure can be problematic. This argument is important to bear in mind when discussing effectiveness. Those who argue that the MIP is ineffective often rely on particular views of what a currency union needs in terms of steering on socioeconomic policies. But further tightening of procedures easily runs the risk of leading to legitimacy problems that can in turn weaken effectiveness. The final chapter of the thesis argues that it is anything but clear that a tighter grip on socioeconomic policies in the Member States from the centre is essential. There are other ways of strengthening the Economic and Monetary Union, which also allow for accepting the MIP's inherent limits. If the MIP primarily works through the force of argument than strengthening the force of the latter is perhaps the best way forward.