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Thinking ahead for Europe

Enhancing the Legitimacy of EMU Governance

Cinzia Alcidi, Alessandro Giovannini and Sonia Piedrafita

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Abstract

This CEPS Special Report investigates ways to enhance the legitimacy of economic governance in the Economic and Monetary Union (EMU) without introducing Treaty changes. It suggests changes in the governance framework at both the institutional and economic level. Input-oriented legitimacy can be improved by increasing parliamentary oversight on decisions related to EMU and increasing the accountability of the Eurogroup. Output-oriented legitimacy can be improved by strengthening the ability of EMU to reduce the emergence of negative externalities and to mitigate their impact, through market and fiscal risk-sharing mechanisms.

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List of Abbreviations

AGS	Annual Growth Survey
ECB	Euroepean Central Bank
EFSF	European Financial Stability Facility
ECCL	Enhanced Conditions Credit Line
EMU	Economic and Monetary Union
EDP	Excessive Deficit Procedure
EP	European Parliament
ESA	European Supervisory Authority
ESM	European Stability Mechanism
FDIC	Federal Deposit Insurance Corporation
GSEs	Government-Sponsored Enterprises
IDRs	In-depth Reviews
IMF	International Monetary Fund
LTRO	Long-Term Refinancing Operations
MIP	Macroeconomic Imbalance Procedure
MTOs	Medium-Term Objectives
OMTs	Outright Monetary Transactions
QMV	Qualified Majority Voting
PCCL	Precautionary Conditioned Credit Line
SGP	Stability and Growth Pact
TEU	Treaty on European Union
TSCG	Treaty on Stability, Coordination and Governance

EU Member States Abbreviations

AT	Austria
BE	Belgium
BG	Bulgaria
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EE	Estonia
EL	Greece
ES	Spain
FI	Finland
FR	France
HR	Croatia
HU	Hungary
IE	Ireland
IT	Italy
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
PL	Poland
PT	Portugal
RO	Romania
SE	Sweden
SI	Slovenia
SK	Slovakia
UK	United Kingdom

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Enhancing the Legitimacy of EMU Governance

Cinzia Alcidi, Alessandro Giovannini and Sonia Piedrafita*

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Executive Summary

The **democratic legitimacy** of a polity, institution or policy decision refers to its conformity not only to the law in the narrow sense but also to democratic principles and common values. The participation of citizens, mainly but not exclusively, through the election of their representatives and their ability to hold those elected official accountable lie at the core of the concept. Yet, democratic legitimacy is not just about giving a voice to the people, it is also about responsiveness. It ultimately depends on the extent to which citizens feel as part of the polity under which they live, accept its institutions and support the decisions it takes. Therefore, not only 'input' but also 'output' considerations of the institutions or policy decisions under assessment are important. Output legitimacy rests on the ability of institutions to deliver results and solve the problems for which they are responsible. For the Economic and Monetary Union (EMU), this relates to the ability to avoid or deal with negative externalities emerging from shocks in individual countries.

The crisis in the euro area has exposed serious shortcomings in the **output legitimacy** of EMU, which has always been its main source of legitimacy. The idea that a successful EMU is sufficient to ensure its full legitimacy relies on the very assumption that 'output legitimacy' can compensate for any lack of 'input legitimacy'. This worked until 2009, but then it failed as this system contains an inherent weakness. Every time there is a crisis, the output legitimacy deteriorates by definition, making the system vulnerable to a decline in citizens' support. This translates into questions about membership of EMU and the rationale for having a monetary union instead of questioning specific policies and actions (the government), as would be the case in a nation state.

Weak **input legitimacy** has always been a feature of the EMU project as it gave priority to the delivery of results over its democratic representativeness. The management of the crisis and the creation of a new system of governance that privileged quick fixes and ad hoc solutions, but did not aspire to make the process more democratic and fully accountable, exacerbated this weakness. The transfer of executive powers to the EU level with the objective of solving the euro-area crisis speedily has reduced Member States' discretion in key policy areas and has not been accompanied by the creation of corresponding mechanisms to ensure political accountability at EU level. As a result, the democratic credentials of the economic governance of EMU have been called into question and citizens' disaffection with the EU has increased.

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The combination of low input legitimacy and low output legitimacy is jeopardising support for the EU project.

A fully-fledged political union with fiscal capacity would help to overcome these two sets of shortcomings and would also reduce the system's vulnerability to citizens' disapproval. It is highly unlikely, however, that EMU will become a federal system any time in the near future, and even if it did, it is highly uncertain that such a solution would receive the political support needed from EU citizens.

With these caveats in mind, this study examines the main **shortcomings in terms of both input and output legitimacy** of the current EMU governance and proposes **recommendations to improve its political accountability** and a set of **conditions to reduce negative externalities** so as to address citizens' increasing dissatisfaction and detachment.

Assessing the legitimacy of the current EMU governance system

The design of the system of governance since the inception of EMU, either implicitly or explicitly, relied on two tightly interlinked fundamental assumptions: the success of EMU is a sufficient condition to ensure its legitimacy and rules must be at the core of governance.

The creation of a **rule-based system of governance** for EMU can be seen as an attempt to replicate the logic of the EU single market regulation. One of its main advantages is the de-politicisation of the system: the same rules are agreed and applied to all countries, and mechanisms for correction are made as automatic as possible. This eliminates (or at least reduces) the need for political decisions at EU level, where political power is dispersed and national interests weigh heavily. Political decisions are left at the national level where governments have to choose the policies to meet the targets and satisfy the thresholds.

The most recent changes in European economic governance assume that fiscal and macroeconomic matters can be depoliticised. Indeed, they mainly have implied stricter rules and procedures which attribute tasks and decision powers to executive bodies justified by exceptional circumstances and the need to react quickly. But this in turn has contributed to the political crisis. While this dichotomy reflects an approach that is often applied and usually accepted at the level of nation states, it raises important legitimacy problems at the EU level, where the executive is not accountable to the elected body in the same way as national governments are to their respective parliaments.

More specifically within this process, the **Commission has been assigned a central role** in the assessment of Member States' performance, the ex-ante surveillance of national policies (before approval by the parliaments) and the establishment of corrective actions, all of which usually require the involvement and/or the approval of the Council. Given the limited role of both the European Parliament (EP) and national parliaments and the diffuse responsibility of representatives in the Council vis-à-vis the citizens, this approach magnifies the existing limits to EMU input legitimacy.

It is unclear whether EMU has managed to compensate for such shortcomings with output legitimacy. There is no unambiguous evidence of an improved ability of EMU to deal with the negative effects of a shock originating in a single country under any of the specific circumstances that could arise within the new governance system. Admittedly, this may be due to the fact that the crisis is not yet over and the current subdued level of economic activity inevitably weighs on this judgement. Moreover, a key purpose of EMU, i.e. its ability to reduce the likelihood of future crises, cannot yet be tested.

With this caveat in mind, we proceed to assess the legitimacy of the new system of governance on the basis of different typologies of legitimacy relationships between the EU

and the Member States. We employ two dimensions: the degree of EU constraints faced by national governments when setting policies that fall under national sovereignty, as this is informative about input legitimacy, and the risk of negative spillovers, which is related to the degree of output legitimacy. This approach allows us to identify **four categories of relationship between the Member States and the EU**, ranging from the lower to the higher level of discretion and from higher to lower risk of negative spill-overs, i) countries under a macroeconomic adjustment programme, ii) countries under enhanced budgetary surveillance, iii) countries under an excessive deficit procedure (EDP) or excessive imbalance procedure (EIP) and iv) countries subject to regular coordination of macroeconomic policies.

Each category corresponds to one of the procedures foreseen in the new system of governance and to different levels of obligations that Member States are currently or can be subject to.

As long as the increased EU executive powers are not accompanied by the corresponding mechanisms of political accountability, the stricter the EU interference is, the higher the cost in terms of democratic legitimacy. The risk that a country falls into a situation of crisis and hence that an idiosyncratic shock generates negative spillover effects on other countries or EMU as a whole is the benchmark against which output legitimacy is assessed. This implies that the cost of a failure in output legitimacy is larger as the risk of large spillovers is higher.

Overall the main finding of the exercise is that EU constraints on national discretion increase as the risk of (larger) spillovers grows. Put simply, when such risk increases, the EU intrusion increases and input legitimacy tends to be weakened. The second finding is that a lower input legitimacy is not necessarily offset by higher output legitimacy. The idea that a stricter intrusion at EU level should lead to better capacity to deal with externalities is not yet backed by robust evidence.

The exercise also helps to understand the **limits of the rule-based system and the idea of de-politicisation of EU decisions**. It suggests that when an economy moves into circumstances of stress and crisis due to the failure of the rule-based system in achieving its objective to prevent externalities from happening, decisions of a political nature become unavoidable. And for those decisions, due accountability must be ensured.

More specifically, in the case of **countries under a macroeconomic adjustment programme**, the assessment suggests that input legitimacy may suffer from serious shortcomings. The study argues that shortcomings in input legitimacy have not been compensated for by clear progress in output legitimacy. Indeed, the outcome of the macroeconomic adjustment programmes adopted in different countries has been, at best, mixed: at aggregate level, the real economy in most cases has recovered, but it remains weak. It is difficult to disentangle how much of the affected countries' ability to avoid the worst-case scenario should be attributed to the programmes and how much to other tools, such as the intervention of the European Central Bank (ECB).

For **countries under enhanced budgetary surveillance**, the prominent role played by the European Commission limits national governments' capacity to take decisions and poses some concerns in terms of political accountability, thereby affecting the degree of input legitimacy. It may be still too early to assess whether enhanced budgetary surveillance has been effective in preventing the crisis in one country from spilling over to other countries. The expectation, of course, is that it should at least contribute to reduce such a risk.

Input legitimacy is at stake also in the case of the procedures for redressing **excessive deficits and macroeconomic imbalances**, as the powers of the Commission and of the Council (admittedly more limited), in terms of the enforcement of corrective measures,

reduce the policy discretion of national governments. Even though the rationale for such procedures may be justified in terms of output legitimacy, doubts remain on the ability of the Macroeconomic Imbalance Procedure (MIP) to prevent negative externalities, as some of the scoreboard indicators suffer from serious drawbacks and there is a problem of potential enforcement as the procedure is very broad and intrusive, if fully used.

Input legitimacy is less of an issue in the case of the **regular coordination of macroeconomic policies**, as policy decisions reside by and large in the hands of national governments, with the EU mainly exerting peer pressure and suggesting (non-binding) recommendations. While policy coordination appears to be fully justified in this case, it has nevertheless proven difficult to find supporting empirical evidence in favour of increased output legitimacy.

Against this background, the study explores potential improvements in the economic governance framework of EMU and suggests policy changes both at the institutional and economic levels.

Improving input legitimacy

The input-oriented legitimacy of EMU can be improved by **strengthening the involvement of the EP** in the European Semester, in the scrutiny of the macroeconomic adjustment programmes as well as by enhancing the Parliament's oversight of the European Council, the Eurogroup and, where appropriate, the ECB.

In the context of the European Semester, the EP should exert a stronger role in establishing the EU's economic priorities and in the **parliamentary oversight of the country-specific recommendations**, in particular their implementation phase. The so-called 'troika' model, assuming it will be maintained, has to be adapted to the new provisions in the six- and the two-pack. The Commission should make an (ex-post) assessment not only of the implementation of its policy recommendations, but also of whether they effectively promoted the return of the economy to a sustainable path. The involvement and responsibilities of the Eurogroup and the ECB should be spelled out more clearly.

The parliamentary oversight of the European Council and the Eurogroup can be improved through better use of the **economic dialogues** with their Presidents on EMU decisions and policy actions. An exchange of views with the President of the Eurogroup and the Managing Director of the European Stability Mechanism (ESM) could improve the political accountability of this body. The agreed mechanisms for the oversight of the ECB's supervisory powers and the Resolution Board should be used to their full potential.

In order to perform these tasks satisfactorily, the EP needs to be endowed with the necessary resources and its organisational structures upgraded. The creation of a **subcommittee of the European Parliament's Economic and Monetary Affairs Committee** for the scrutiny of EMU with MEPs from the euro area would facilitate the performance of all these tasks. It would also allow for a more effective format of inter-parliamentary cooperation with (and among) the national parliaments of euro-area countries.

Finally the **selection of the President of the Commission** through the European elections could increase the political capital of the EP and citizens' interest in the elections and support for the EU. The limited impact of the initiative in this year's elections, however, has exposed some shortcomings such as whether the top candidates of the European political groups can convince and mobilise citizens without a clear political programme that they can later implement, or without the full support of the leaders of the national parties.

Improving output legitimacy

The output-oriented legitimacy can be improved by **strengthening the ability of EMU to dampen the adverse effects of (negative) externalities**, largely stemming from country-specific idiosyncratic shocks. For this purpose, enhanced financial integration can serve as an important tool for sharing market risk. Endowing EMU with a fiscal capacity would help to stabilise macroeconomic fluctuations.

Regarding financial integration, the debate so far has mainly focused on the volume of cross-border financial flows, regardless of their nature, and on key elements of a banking union. The main purpose of the latter is to make a firm break in the linkages between the sovereigns and the banks. But for the purpose of sharing market risks, the 'quantity' of financial integration is likely to be less important than its 'quality'. Indeed, if risks materialise, **equity market integration** entails a different capacity of absorbing losses than debt-financing through bank intermediation. Well-functioning risk-sharing mechanisms should be complemented by common fiscal instruments to absorb and mitigate the effects of negative externalities. A common EMU insurance scheme to counter idiosyncratic shocks can represent the starting point for more complex policy instruments, which have proved successful in other monetary unions.

Financial and **fiscal mechanisms of risk-sharing** can reduce the risk that a shock originating in one sector or country triggers a cascade of adverse effects in other countries and/or sectors, eventually leading to a euro-area crisis and challenging the output-oriented legitimacy of EMU. This aspect is particularly relevant in the absence of a political (and fiscal) union, although not only in that context. All successful federations usually have both kinds of mechanisms in place.

One solution is to undertake institutional reforms aimed at reducing the risk that an idiosyncratic shock turns into a systemic shock. This could be achieved through the creation of a **fully-fledged banking union** and the development of more effective market-based systems of risk-sharing.

A second avenue, which implies deeper changes, considers the option of equipping EMU with additional institutions in charge of tackling negative externalities associated with idiosyncratic shocks that could hamper the smooth functioning of the monetary union. This could be achieved by endowing EMU with a **proper fiscal capacity**, e.g. through the establishment of a European unemployment insurance scheme.

Conclusions

Overall, under the assumption that a political union is not a viable solution in the near term to solve legitimacy issues of EMU institutions, there can and should be room to improve on specific aspects of EMU legitimacy. While this may not be the optimal solution, the recommended improvements would represent a step towards more democratic and effective governance of EMU and one that is likely to enhance citizens' support, the latter of which remains a precondition of a successful monetary union. The suggested improvements would also facilitate the introduction of any further substantial changes at the institutional level, including a political and fiscal union.

1. Introduction

The unprecedented financial crisis of 2008 and the subsequent sovereign debt crisis and economic recession have represented a severe test for the entire architecture of the Economic and Monetary Union (EMU).[1] This was not the first time that strong tensions had shaken the EU architecture and its economy. The Werner Plan[2] and the 'snake in the tunnel'[3] offered earlier examples of failed attempts to create a monetary union in the 1970s. Although the lack of success was later explained by the exclusive reliance on monetary mechanisms and the absence of an adequate fiscal regime, the preparations to create the euro in the 1990s followed exactly the same approach. The conviction that the rule-based constraints, built into national budgets by the Stability and Growth Pact (SGP), were sufficient to prevent fiscal deficits from undermining the stability of EMU dominated opposite views. Proponents of the euro largely disregarded the fact that monetary unions of existing advanced federations were buttressed by federal budgets on the order of 20-25% of GDP, complemented by fully-fledged banking unions.[4]

The financial and economic crisis unveiled the main flaws of the existing governance system[5], the lack of common resources and macroeconomic stabilisation mechanisms like inter-state redistribution functions and effective risk-sharing mechanisms typical of successful federations.

As the severity of the crisis unfolded, exceptional and unprecedented measures had therefore to be taken. These ranged from enhancing the coordination of macroeconomic policy of the Member States, to the establishment of financial assistance mechanisms, to European Central Bank's (ECB) interventions to support distressed banks and to the

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1 The Economic and Monetary Union (EMU) refers to the coordination of economic policies and the adoption of a common monetary policy and, eventually, the euro by EU Member States. Both the (current) 18 euro area Member States and the 10 non-euro Member States are members of EMU. A Member State, however, needs to comply and be a part of the "third EMU stage", before being able to adopt the euro. All Member States of the European Union, except Denmark and the United Kingdom, have committed themselves by treaty to join the "third EMU stage".

2 The Werner group submitted its final report in October 1970, setting out a three-stage process to achieve EMU within a 10-year period. The final objective was the irreversible convertibility of currencies, free movement of capital and the permanent locking of exchange rates – or possibly a single currency. To achieve this, the report called for closer economic policy coordination, with interest rates and management of reserves decided at Community level, as well as agreed frameworks for national budgetary policies. For details, see http://aei.pitt.edu/1002/1/monetary_werner_final.pdf.

3 In March 1972, the Member States created the 'snake in the tunnel'. This was a mechanism for managing fluctuations of their currencies (the snake) inside narrow limits against the dollar (the tunnel). Hit by oil crises, policy divergences and dollar weakness, within two years the snake had lost many of its component parts and was little more than a German-mark zone comprising Germany, Denmark and the Benelux countries.

4 As early as 1977, the MacDougall Report (European Commission, 1977) had pointed out that federal budgets in Germany and the US were of a comparable size and that a Federation in Europe should have a common budget of a similar magnitude. However, in the early stages of the Federation, public expenditure was conceived at Community level at about 5-7% of GDP (and around 10% if defence were to be included) of GDP and in the pre-federal period at 2-4%.

5 It should however be recognised that despite its deepest crisis in post-war times, none of the worst-case scenarios predicted for the euro area has materialised. In fact, EMU even managed to add a new member, Latvia, in 2014.

redesign of financial markets regulation. The pressure exerted on policy-makers by the size and depth of the crisis resulted in the complete overhaul of EU economic governance hardly conceivable few years before. Member States reached an agreement on pooling public resources to assist governments at risk of default, on the establishment of the Single Supervisory Mechanism (SSM) for financial institutions and the Single Resolution Mechanism (SRM) for banks setting up the main pillars of a banking union.

However, serious challenges remain on both the economic and the institutional front. The governance system in place since the inception of EMU, implicitly or explicitly, relied on two tightly interlinked fundamental principles: the creation of a rule-based system of governance and the assumption that the success of EMU will be sufficient to ensure its legitimacy.

The creation of a rule-based system of governance for EMU can be seen as an attempt to replicate the logic of the EU single market regulation. The latter has successfully worked over time fostering economic integration and creating conditions for a level playing field across countries. One of the main advantages of a rule-based system is the de-politicisation of decisions. The same rules, with targets and thresholds, are agreed and applied to all countries and mechanisms for correction are made as automatic as possible. This eliminates (or at least reduces) the need for political interference from the EU level, where political power is dispersed and national interests weigh heavily. Political decisions are left in the hands of the national governments, which have the political responsibility to choose the policies to meet the requested targets and satisfy the thresholds.

The question is whether fiscal and more in general macroeconomic matters can really be depoliticised. The recent history of EU governance suggests that this is the case. Indeed coordination of macro-fiscal policies has largely implied sharing common rules, most of the time, stricter rules. The problem is that the duration of the crisis and depth of the recession are severely putting into question the desirability and the benefits of such common rules. This is contributing to shift the debate from sharing rules towards the creation of common tools to mitigate the effects of shocks.

The creation of the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM), the debate about the fiscal capacity of the Union and the resolution mechanism and fund for banks represent deviations from this idea of having a rule-based system in favour of a governance framework where the optimal sharing of risks is key and may also entail sharing resources.

While sharing rules have been accepted, on the front of sharing public resources, compromises have dominated over success. Indeed, both the EFSF and the ESM are mechanisms designed to share risks, but not resources. EFSF and ESM resources are meant to grant loans later to be repaid by the borrowers. Sharing resources without a central fiscal authority in charge of taxation and redistribution remains unacceptable to several Member States as the solution is perceived as a way to de facto transform EMU into a transfer Union.

Yet, the severity of the crisis and the need to avert the failure of EMU called for a shift of the traditional approach based only on rules. This last point brings into the picture the issue of legitimacy of EMU governance, namely the idea that a successful EMU is sufficient to ensure its legitimacy to the extent that the delivery in terms of 'output legitimacy' can compensate for the deficiency in terms of 'input legitimacy'. While this governance framework seemed to work until 2009, it features a built-in weakness: with the deepening of a crisis, output legitimacy deteriorates almost by definition, making the system vulnerable to changes in citizens' support. If poor delivery of outcomes persists, the very benefits of EMU membership and its rationale may be questioned rather than the lack of effectiveness of specific policies and government actions, as would be the case at the national level.

The overhaul of EU governance and the steps taken so far towards a banking union may still fall short of creating an economic and monetary union endowed with the minimum institutional and democratic standards to ensure its long-term well-functioning. Already the "Blueprint for a Deep and Genuine Economic and Monetary Union",[6] recognised that further work was needed to strengthen the democratic legitimacy, accountability and scrutiny of the EMU project.

Overall, the new economic governance has resulted in a shift of powers from the Member States to the EU level. This has not been accompanied, by an adequate re-allocation of competences between the key EU institutions (the Commission, the Council and the European Parliament),[7] partly because inter-governmentalism has prevailed over the community method[8] in the design of the reform of EU governance.

Most of the changes in the EU governance framework have been characterised by a 'disconnect' with the electorate. This disconnect attracted a great deal of attention in the aftermath of the crisis and is, de facto, an old, basic feature of the original EMU project. EMU was originally presented to the European citizens both as a highly technical project best dealt with by technocrats (the ECB is the main product of this approach[9]) and the most important political project to secure Europe's future.[10] This dual nature of the EMU project was in practice reflected in the net separation between monetary and fiscal policy: monetary policy was assigned to the technocrats and centralised in the ECB, whereas fiscal policy, where the political dimension is key, remained close to the electorate, hence a task for national governments. This design was consistent with the absence of a central political power.

Strict separation between monetary and fiscal policy may work well in 'normal' times. In times of severe crisis, however, that separation may become artificial and blurred. Indeed, even a strongly independent central bank may be forced to take decisions that have fiscal or

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6 European Commission (2012). The report points to a stable architecture of EMU in the "financial, fiscal, economic and political domains", yet notes that the most critical concepts remain vague.

7 The Lisbon Treaty was supposed to deal with the issue of the democratic deficit intrinsic in the Maastricht Treaty by conferring larger competences to the European Parliament. While this has certainly happened, the new system of economic governance that emerged from the six-pack and two-pack legislation has seen executive powers (Commission) increasing their competences well beyond what was originally foreseen in the new Treaty and without a corresponding increase in the accountability, in particular towards national and European parliaments.

8 The community method is based on the premise that the Commission proposes, the European Parliament co-legislates with the Council and the Court of Justice ensures a common interpretation of EU law. The inter-governmental method refers to the process where the decisions are basically taken by the member governments represented in the Council or the European Council.

9 A fully technocratic central bank was justified by the need to ensure policy independence (so-called 'monetary dominance' over fiscal policy). This was considered a crucial condition (for Germany) in order to reach an agreement on EMU, to minimise the risk of monetisation of national governments' debt (see for instance Sargent and Wallace, 1981) as well as to force the fiscal authorities to adjust their balance sheet rather than rely on inflation. It was never explicitly recognised until the crisis hit (in fact it was denied), but under this framework countries can default. The combination of the no bail-out clause and monetary independence of the central bank under a fixed exchange rate regime implies that while the risk of inflation is minimised, the risk of liquidity is high and can turn into insolvency if there is no lender of last resort. See De Grauwe (2012) on this point.

10 The political project argument was often used in response to those (especially US economists) pointing to the failure of EMU to meet the economic criteria for being an optimum currency area.

quasi-fiscal implications without being accountable to any democratic institution. Many observers[11] claim that a full fiscal and political union is needed exactly to avoid the occurrence of such circumstances. Only if citizens have a say in the formulation of policies to which they are subject can EMU succeed and prosper.

The problem is that while a fiscal and political union must be seen by many as "the" desirable policy option, it is unlikely to be a realistic option any time soon, awkwardly enough, also because European citizens do not show much appetite for it. The lack of will at the level of national governments mirrors adverse feeling of the European electorate, who does not appear to be in favour of giving up national sovereignty to overcome the existing disconnect between the European and national level. This may be especially true in the current situation, as the persisting subdued level of economic activity has further weakened an already-feeble motivation among EU citizens to move towards the United States of Europe. National electorates may find it even more difficult to vote for representatives whose role in the decision-making process they do not fully understand. Moreover, the division between creditor and debtor countries brought about by the sovereign debt crisis may have undermined the belief that a common European interest really exists in key domains of public policy and that specific interests of debtors and creditors can actually be reconciled. The outcome of the 2014 European elections seems to point exactly in this direction.

Hence a first question is: How can the democratic accountability of EU institutions (i.e. the input legitimacy of EMU governance) be enhanced in the medium term, under the assumption that a political union is not a feasible option in the near future?

To answer this question, this study intentionally avoids discussing federal solutions for EMU, as suggested for example in the proposals made by the Padoa-Schioppa Group (2012), the Glienicker Group (2013) or the Group Eiffel Europe (2014), albeit with important differences. By contrast, it considers a more partial and feasible solution, focusing on policy mechanisms and institutions (but not necessarily fiscal ones) that share two key features: i) they must promote a better functioning of EMU and ii) they must ensure the highest degree of legitimacy in the existing Treaty framework.

The reports starts from the conviction that a well-functioning EMU must deliver results that meet the expectations of citizens and receive the support of the Member States. This conviction is naturally and deeply intertwined with the objective of building an EMU endowed with legitimacy. And the issue of EMU legitimacy has been hardly questioned since the outbreak of the crisis.

As mentioned above, the attempt to fix the weaknesses of EMU governance highlighted by the crisis has revived concerns about the democratic deficit of EU institutions. The deficit of EMU in terms input legitimacy has been reinforced by its low level of output legitimacy, with doubts mounting about whether EMU is able to deliver good outcomes for its citizens.

In order to answer the question above, the study examines the constraints that the new regulatory framework imposes on national governments' discretion and the role and political accountability of EU institutions (e.g. the Commission and the ECB) and related bodies (e.g. the Eurogroup and the Troika[12]).

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[11] See for instance De Grauwe (2013) among others.

[12] The cooperation between the IMF, the European Commission and the ECB in the context of adjustment programmes for troubled euro-area Member States has become known as the 'Troika'.

The need for EMU to deliver results has become even more compelling in recent years because the low level of input legitimacy calls for stronger output legitimacy. Therefore, a second question is: How can the delivery of policy outcomes by EU institutions (i.e. the output legitimacy of EMU governance) be enhanced in the medium term in a context of limited democratic accountability?

Addressing the second question requires an analysis of risk-sharing mechanisms for an economic and monetary union and how they can be best designed. The key point is that strong economic and financial integration especially among countries sharing a single currency and a single monetary policy is a source of externalities: the effects of a shock occurring in a certain country/sector (also as a result of a policy decision) can propagate beyond national borders or sectors. As policies are either a source of a shock or a response to a shock, in the current institutional set-up, national governments must be held responsible also towards the rest of the Union. Only the delicate balance of managing national and EU responsibilities can ensure the smooth functioning of EMU. The crisis has proved that such equilibrium may be very unstable. The presence of externalities is the main rationale for the coordination of economic policies and sharing financial resources. If a fiscal union is not a viable solution, the way forward requires the setting up of an institutional framework that reduces the likelihood of externalities and at the same time allows for a common safety net that is able to mitigate the effect of those externalities. The latter has to be designed in a manner that does not lead to systematic transfers of resources.

The rest of this study is organised as follows. The next section presents the multiple layers of the new EMU governance framework, according to taxonomy and an assessment of legitimacy relationships between Member States and the EU. It then examines the role of the main decision-makers and assesses whether a low degree of input legitimacy can be compensated by relatively high level of output legitimacy. Section 3 examines ways to improve the input legitimacy of EMU governance in view of these findings and, in particular, how to strengthen the accountability role of the EP. Section 4 assesses different options to overcome the flaws in the functioning of EMU governance and improve its ability to deliver the expected policy outcomes, essentially by internalising and mitigating the adverse effects of negative asymmetric shocks. The concluding section provides a summary of the main arguments and offers some policy recommendations.

2. Legitimacy assessment of the current economic governance of EMU

KEY FINDINGS

- The establishment of the new system of EMU governance has affected the relationship between the Member States and the EU and raised questions in terms of legitimacy.
- Four typologies of such relationship can be distinguished. Countries under: i) macroeconomic adjustment programmes, ii) enhanced budgetary surveillance, iii) excessive deficit procedure or excessive imbalance procedure and, iv) regular coordination of macroeconomic policies.
- Overall, regarding input-oriented legitimacy, political accountability is weaker and policy discretion at Member State level is lower, the closer to circumstances of crisis. By contrast, in normal times, EU constraints on matters of national sovereignty are limited. As regards the output legitimacy, the results are mixed and there is no strong evidence so far that EMU has improved its ability to deal with spillovers under any of the specific circumstances.
- In the case of countries under a macroeconomic adjustment programme, responsibilities in the Troika are not clear-cut and those taking decisions are not accountable for their actions. Such shortcomings have not been fully compensated for by clear progress in terms of output legitimacy.
- The Commission's prominent role in assessing and deciding whether to open an enhanced budgetary surveillance procedure, which imposes significant constraints on a Member State's range of policy discretion, can lead to serious legitimacy issues. In terms of output legitimacy, the procedure should reduce the risk of crisis spreading to other Member States, although it is still too early to judge with any certainty.
- The heavy role of the Commission and the limited capacity of the Council to reverse its decisions in the excessive deficit procedure and the excessive imbalance procedure diminish the input legitimacy in view of the subsequent obligations imposed on Member States. In terms of output legitimacy, while the rationale for such procedures is not questioned, it is doubtful that an MIP can prevent negative externalities.
- In the case of regular coordination and surveillance of macroeconomic policies, the Commission's role is limited to monitoring, and Member State governments enjoy high discretion. In terms of output legitimacy, while coordination is in theory fully justified, positive results are still lacking.

When the global financial crisis turned into the sovereign debt crisis at the beginning of 2010, the EU's policy response was largely based on three pillars: i) providing financial assistance to countries in crisis (Greece, Ireland, Portugal, Cyprus), ii) strengthening controls over member countries' economic policies and iii) stabilising monetary and financial market conditions. The design of a policy response for the first two was mainly assigned to the European Commission, the Council and the European Council (therefore with the

involvement of national governments). The design of a policy response for the third fell largely under the responsibility of the European Central Bank.[13]

Large economic crises usually cause large losses in countries' income and citizens' welfare. But they also offer the opportunity to promote reforms otherwise considered politically infeasible. The EMU crisis was not an exception in this respect. In the wake of the crisis, European institutions and national governments hastened to introduce changes aiming, on the one hand, to manage the crisis and, on the other hand, to establish a new system of governance that would prevent other crises from occurring.

Some problems quickly arose, however. First, the need to clearly separate competencies and to define the terms of interaction of the different institutional players, EU bodies and national governments, which often proved to be in tension. Second, while most decisions were driven by the urgency to fix compelling problems, issues of legitimacy,[14] a hallmark of democratic institutions, cannot any longer be ignored.

The focus of this section is to examine how recent developments in EMU governance affected the relationship between the EU/EMU levels and Member States through the lens of the input/output legitimacy. Indeed while literature on the new system of the governance has flourished in the recent times, the legitimacy issues it entails have not been fully investigated. For this purpose, the concepts of legitimacy and accountability are shortly reviewed beforehand and the description of the main developments of the EMU governance system is also presented.

2.1 New balances and legitimacy challenges in the development of the current EMU governance

Since the EU is a political and economic 'experiment' without historical precedents, the construction of a common governance framework has not always followed a straight line. The resulting current governance framework is a complex institutional architecture, which at times experiences political paralysis largely stemming from tensions between different institutional levels and polarisation of national interests over the common interest.

As a response to the economic and financial crisis, the structure of EU economic governance has been strengthened and has become more complex. Soon after the entry into force of the

[13] In this third line of action, two decisions in particular were key: i) the decision to create an integrated system of banking supervision at the European level (the Single Supervisory Mechanism, SSM) and the common European framework for bank resolution (the Single Resolution Mechanism, SRM), as two steps towards the realisation of a banking union; and ii) the decision of the ECB to undertake Outright Monetary Transactions (OMTs) to stabilise the financial markets and to ensure the functioning of the transmission mechanism of the single monetary policy. Despite the crucial importance of these policies, most notably the creation of the banking union, this section does not intend to deal specifically with these aspects of governance. They are addressed more specifically in sections 3 and 4, both in terms of institutional and economic analysis.

[14] In assessing the legitimacy in the framework of the EMU governance system, three dimensions should be considered: institutional, economic and legal. This report focuses only on the first two. In particular, developments on the judicial review of EMU mechanisms and how they are challenged by constitutional courts (and especially the German Court) are not addressed here. Nor do we consider the issue of whether the possibility to hold a judicial review would be sufficient to balance the absence of effective political accountability. For a review of these aspects, see Fabrini (2013), Pernice (2014) and Bardutzky and Fahey (2014).

Lisbon Treaty in 2009, the severity of the recession and the need to act quickly required to resort tools and policy instruments not yet envisaged by the Treaties.

It was evident that the optimal solution to the crisis – a full fiscal and political union to complement the monetary union – would not have materialised quickly. Therefore, the resulting strategy consisted in strengthening of the current governance framework to better ensure the soundness and coherence of Member States' fiscal and macroeconomic policies. In particular, the reforms of EMU governance focused on enforcing both the preventive and corrective arms of the Stability and Growth Pact (SGP) to safeguard fiscal discipline as well as complementing it with the excessive imbalances procedure (EIP) to prevent the emergency and persistence of macroeconomic imbalances and divergent competitiveness trends. In broad terms, this approach reaffirmed the design of EMU economic governance according to a rule-based system, aiming at reducing the risk of idiosyncratic shocks.

It is worth noting that the suggested changes in the governance framework for EMU have been triggered as a response to the euro area (not EU) crisis as the lack of the exchange rate as a policy instrument amplifies the adverse effects of negative externalities. However the EMU does not have "its own institutions", EU institutions are EMU institutions. The new framework is therefore a very complex system of EU governance with different layers of legislation, including the six-pack, the two-pack, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) and an overlapping of competences at EU and euro-area level, often difficult to disentangle.

In what follows we briefly review the main features of this governance framework. Table 1 presents a snapshot of the main elements of the emerging system of EU economic governance, highlighting their different characteristics. Table 2 lists the legislative acts that comprise the six and the two-packs.

The six-pack consists of five regulations and one directive (see Table 2). It reinforces both fiscal and macroeconomic surveillance by setting up the European Semester for Economic Policy Coordination under which budget plans and reform programmes are scrutinised ex-ante by the Commission to make sure that fiscal targets are not jeopardised and excessive macroeconomic imbalances are prevented. The six-pack applies to all EU Member States, with specific provisions regarding the macroeconomic indicators and the financial sanctions for the euro-area Member States. Building on the Treaties, the two-pack further enhances the control and coordination of the budgetary policies of the euro area and streamlines the surveillance procedures of those member countries facing severe financial difficulties. The TSCG[15] requires signatory states to implement a balanced budget rule in their national legislation through permanent, binding provisions, preferably of a constitutional character.[16] As regards non-euro area members, Denmark and Romania are bound by the fiscal provisions, while these provisions will only apply to the remaining non-euro area states when they adopt the euro. Conversely the Euro-Plus Pact agreed in 2011 is just a commitment of signatories (all euro-area Member States plus Bulgaria, Denmark, Lithuania, Poland and Romania) to stronger economic coordination.

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[15] TSCG was signed by all Member States at that time, except the Czech Republic and the United Kingdom.

[16] The 'balanced budget rule' obliges the general state budget to be balanced or in surplus, that is, that the annual structural deficit does not exceed the 0.5% of the GDP, or the 1% when debt levels are significantly below 60%. The 'debt brake rule' establishes specific obligations and timing to reduce the ratio of government debt-to-GDP when this exceeds the 60% limit.

Table 1. Summary of the system of economic governance

LEGISLATIVE TOOL	LEGISLATIVE STRENGTH	CONTENT	TO WHOM IT APPLIES	ENFORCEMENT
Stability and Growth Pact	Primary legislation + Secondary legislation	Framework for the coordination of national fiscal policies. It has the objective to safeguard sound public finances, on the principle that economic policies are a matter of shared concern for all Member States.	28 EU countries	Non-compliance with either the preventive or corrective arms can lead to the imposition of sanctions for euro area Member States. In the case of the corrective arm, this can involve annual fines for euro area Member States and, for all countries, possible suspension of Cohesion Fund financing until the excessive is corrected.
Six-Pack: MIP	Secondary legislation	i) Enforcement measures to correct excessive macroeconomic imbalances in the euro are; and ii) Prevention and correction of macroeconomic imbalances	EU 28 + euro area specific provisions	
Six-Pack: Revised SGP	Secondary legislation	i) Enforcement of budgetary surveillance in the euro area; ii) strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies; iii) Speeding up and clarifying the implementation of the excessive deficit procedure; and iv) Requirements for budgetary frameworks	EU 28 + euro area specific provisions	
Two-Pack	Secondary legislation	i) Strengthen of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability; and ii) Common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area	Euro area Member States	
TSCG (Fiscal Compact)	Inter-governmental Treaty	It requires Member States to enshrine in national law a balanced budget rule with a lower limit of a structural deficit of 0.5% GDP, centred on the concept of the country-specific medium-term objective. It increases the role of independent bodies to monitor compliance with the national fiscal rules.	25 EU Member States (no UK and CZ)	Maximum once the principle is part of national constitutions
Euro plus Pact (2011)	Statement	Commitment to stronger economic coordination for competitiveness and convergence, also in areas of national competence, with concrete goals agreed on and reviewed on a yearly basis by Heads of State or Government. The Euro Plus Pact is integrated into the European semester and the Commission monitors implementation of the commitments.	euro area Member States + BG, DK, LT, PO and RO	Non-binding

Source: Authors' elaboration.

Table 2. The six-pack and the two-pack in a nutshell

LEGISLATIVE ACT	DATE	TITLE	LEGAL BASIS
SIX-PACK			
Regulation (EU) No 1173/2011 of the European Parliament and the Council	16/11/ 2011	On the effective enforcement of budgetary surveillance in the euro area	Art. 121.6 TFEU
Regulation (EU) No 1174/2011 of the European Parliament and the Council	16/11/2011	On enforcement measures to correct excessive macroeconomic imbalances in the euro area	Art. 121.6 TFEU
Regulation (EU) No 1175/2011 of the European Parliament and the Council	16/11/2011	Amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies	Art. 121.6 TFEU
Regulation (EU) No 1176/2011 of the European Parliament and the Council	16/11/2011	On the prevention and correction of macroeconomic imbalances	Art. 121.6 TFEU
Council Regulation (EU) No 1177/2011	08/11/2011	Amending Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure	Art. 126.14 TFEU
Council Directive 2011/85/EU	08/11/2011	On requirements for budgetary frameworks of the Member States	Art. 126.14 TFEU
TWO-PACK			
Regulation (EU) No 472/2013 of the European Parliament and the Council	21/05/2013	On the strengthening of economic and budgetary surveillance of EU Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability	Art. 136 and 121.6 TFEU
Regulation (EU) No 473/2013 of the European Parliament and the Council	21/05/2013	On common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the EU Member States in the euro area	Art. 136 and 121.6 TFEU

Source: Authors' elaboration.

This complex interconnection of primary and secondary EU legislation combined with intergovernmental treaties has the common objective to strengthen the economic coordination and fiscal discipline, particularly for the Member States sharing the single currency, either by increasing the constraint that the European Commission can impose on the budgetary powers of the national governments or by ensuring that Member States commit in the strongest manner, i.e. with commitments in their national constitutional law.

This new integrated system of rules (introduced by the three pieces of legislation above) is grounded in the European Semester, which sets the timeline for policy coordination in the EU.

The European Semester assigns different tasks to different European institutions. The European Commission plays a key role by providing background information for the

assessment of the countries' economic situation and policies at the start of the cycle and by drafting the country-specific recommendations. The role of the European Council is first to provide policy orientation and then to formally adopt final country-specific recommendations. The EP has a rather marginal role in the process, chiefly that of formulating an opinion on the Annual Growth Survey (AGS). Meetings between the EP and national parliaments can take place both in the pre-spring Council (of the ECON, EMPL & BUDG Committees) and the ECON meetings in September, but the aim is only to discuss national policies under the Semester Cycle. In the framework of the European semester, euro area Member States also have to submit to the Commission their draft budgetary plans (in October before submitting them to national parliaments) to assess whether they are in line with the recommendations of the European Semester.[17] The Commission's assessment is then discussed by the Eurogroup. In the various phases of the process, different sanctions for non-compliant Member States are envisaged, which are proposed by the Commission and adopted by the Council.

There is little doubt that in terms of staff and technical competences, the European Commission is best placed for the monitoring and surveillance of Member States' economic situation and policies. Moreover its status as an independent body that acts in the general interest of the Union with complete independence from national governments (Art. 17 Treaty of European Union (TEU)) should ensure that such a process is carried out in effective fashion. Monitoring and assessing an economy under adverse economic conditions may, however, be less objective and more complicated than one would expect. Even quantitative indicators, like those included in the MIP, are seldom as clear-cut as they might seem at first glance. The assessment exercise may therefore implicitly incorporate a political dimension and raise key legitimacy issues, if accountability is not ensured. In a situation of increasing constraints for national budgetary policies and policy-making discretion, the strong powers of the (European) Council and the relatively weak role of the EP make these legitimacy issues of particular concern.

The recent changes in the governance framework of EMU have affected significantly the relationship between the EU and its Member States and raise the issue of whether suggested policy decisions fulfil the principle of democratic legitimacy. This issue is examined in section 0, which considers the main procedures foreseen in the framework of the current governance and tries to assess the degree of legitimacy associated with each of them. Before moving to this discussion, section 2.2 briefly explains the concepts of legitimacy and accountability.

2.2 Input legitimacy, output legitimacy and accountability

When discussing the issue of legitimacy, it is first necessary to explain the concept. Suchman (1995) defined democratic legitimacy as "the assumption that the actions of an entity are desirable and fit within a structured system of social norms, values, beliefs and thoughts". Beetham (1991) distinguished three standards of legitimacy that apply to liberal democracies: output legitimacy, that is, their capacity to deliver results and improve citizens' welfare; substantial legitimacy, that is, the protection and promotion of collective values and common identity; and procedural legitimacy, that is, respect for the democratic principles of representation and checks-and-balances. Scharpf (1999) approached EU legitimacy by collapsing the three previous standards into two dimensions, namely input and output legitimacy. In order to be legitimate, the EU political system, institutions and decision-

[17] http://ec.europa.eu/economy_finance/economic_governance/images/european_semester_en.htm

making process should be democratic and effective, i.e. shall reflect the will of the people ('government by the people' or input legitimacy) and promote the common welfare ('government for the people' or output legitimacy).

In a nutshell, input legitimacy rests on the participation of citizens to the decision process, mainly but not exclusively, through the election of their representatives and their capacity to hold them accountable. Output legitimacy rests on the ability of institutions and executive bodies to deliver the expected results. In a liberal democracy, political parties formulate policy programmes on behalf of the electorate, which in turn delivers a mandate to form the national government.

In the EU context, citizens elect their representatives in the EP in direct elections and are also indirectly represented in the Council and the European Council through their national governments. The EP and the Council exercise equal powers in the ordinary legislative procedure, which applies to most EU legislation since the Lisbon Treaty. In the EU, the governments represented in the European Council and the Council are politically accountable to their national parliaments and citizens. The EP also exercises functions of political control as laid down in the Treaties (Art. 14.1 TEU). In particular, the Commission is responsible to the EP, which may force the Commission as a body to resign through a motion of censure (Art. 17 TEU).

Yet, democratic legitimacy is not just about giving a voice to the people but also about responsiveness. Overall, democratic legitimacy depends ultimately on the extent to which citizens feel to be part of the polity in which they live and accept its institutions.

All political systems rely on a mixture of input- and output-oriented legitimacy, but the institutional architecture of the EU has traditionally prioritised the output legitimacy. While the transfer of additional powers to the EU has always sparked demands for enhancing input legitimacy and democratic accountability of EU institutions, these demands emerge strongly in times of crisis as citizens perceive more neatly that EU institutions are not delivering the expected outcomes.

The management of the economic and financial crisis has revealed shortcomings both as regards the output and the input legitimacy of EU governance. The new governance system has conferred additional powers on the European Commission and the decision-making has privileged the intergovernmental approach over the community method, raising questions on the representativeness and accountability of the decision-making process. The Commission is not a democratically elected body or fully accountable to the EP in the way national governments are vis-á-vis their respective legislative bodies. Governments represented in the Council and the European Council certainly enjoy the democratic legitimacy conferred to them by the national democratic system and each country, through the Treaties, is committed to accept decisions taken at EU level. The presumption is that the decisions are taken in a collective fashion and all countries are equally affected by them.

The changes in the new governance system have enlarged the competences of the executive powers, conferring upon them the authority to take decisions that might affect specific areas of national sovereignty and countries unevenly. While this is justified by the existence of specific circumstances, such decisions should be accompanied by the appropriate involvement of parliaments (national and European) to better legitimise those decisions or at least to improve their accountability.

The next section makes an assessment of the degree of legitimacy of the policy decisions taken (or to be taken) in the framework of the new system of EU governance.

Input legitimacy is a non-observable variable, but it can be assessed by examining the underlying decision-making processes and, more specifically, the rules and procedures that regulate the participation of the different EU and national institutions.

Similarly, output legitimacy cannot be measured directly. The simplest way to assess it is to focus on macro indicators of economic performance that are informative on the ability of institutions to deliver results. In the case of the EMU, a more appropriate way to assess output legitimacy is to focus on the performance in its specific area of responsibility, namely preventing the emergence of negative externalities or mitigating their adverse effects. This is indeed the approach followed in the next section. Yet, it should be recognized that because of its nature and because the electorate is the ultimate source of legitimacy, in the assessment of output legitimacy citizens' perception matters. When this is taken into account, the degree of EMU legitimacy varies widely across countries. In some of the Member States hardest hit by the crisis but also in some of those at risk of having to pay the largest share to assist countries in difficulty, the perceived output legitimacy of the EMU has declined since the crisis. Box 1 presents some evidence of this phenomenon on the basis of opinion surveys about citizens' support and confidence in the EU institutions as well as democratic accountability of their decisions bodies. Interestingly, the Box also highlights that this trend is also a feature of national institutions.

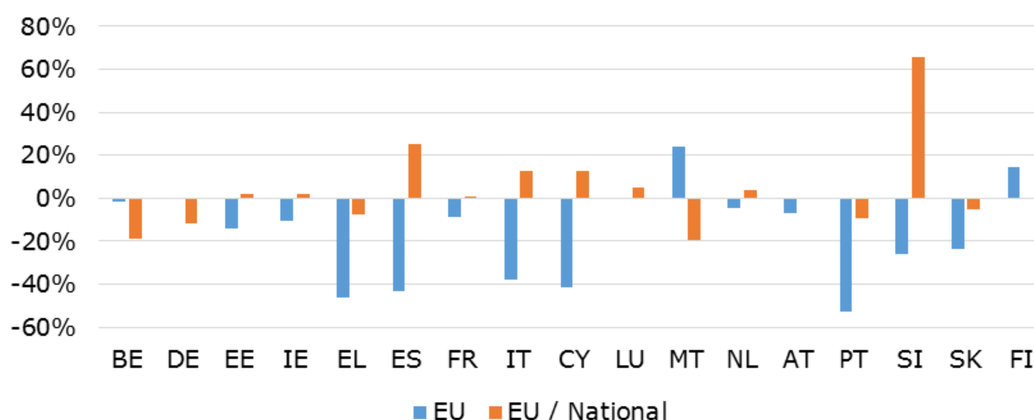
Box 1. Input and output legitimacy: An assessment based on Eurobarometer data

Assessing legitimacy has always represented a challenge for political scientists, and this task is even more challenging in the case of the EU. One of the main problems arises from the difficulty in correctly measuring the support that the EU enjoys from its citizens. There are various ways to do this, the most common being to examine the results of referenda and the turnout at European elections. The latter has often been the subject of discussion, especially recently, as European elections have tended to be characterised by a very low turnout compared to national elections.

Attitudes of European citizens towards Europe can also be 'measured' using opinion polls. This is certainly not to say that EU democratic legitimacy can be reduced to shifts in opinion about the EU as captured in public surveys. Opinion polls, however, do provide an indication of the support and approval by citizens of their political institutions and the decisions they take, and this usually positively correlates with the consent of citizens, which emerges from elections, and forms the basis of democratic legitimacy.

This box focuses on what can be inferred about legitimacy from opinion polls. In this respect, one of the most frequently used indicators of the degree of citizens' satisfaction with the performance of the European Union is a broad public opinion survey conducted two to five times a year across all Member States by Eurobarometer, on behalf of the European Commission. Each survey consists of approximately 1,000 face-to-face interviews per Member State. Having operated since the 1970s, Eurobarometer thus provides comparable data over a long time span. Among the questions of the survey, one in particular captures well the concept of input legitimacy: "*On the whole, are you very satisfied, fairly satisfied, not very satisfied or not at all satisfied with the way democracy works in the EU?*". Looking at changes in the responses to this question over time can help us measure how citizens have perceived changes in input legitimacy. The blue bars in the figure below show how the percentage of people satisfied have changed between 2010 and 2013 in the different Member States.

Figure 1. Input legitimacy: Citizens' satisfaction with the way democracy works in the EU, absolute and relative indicators 2010-2013



Source: Authors' elaboration on Eurobarometer data, 2010 and 2013.

This indicator reveals an emerging and increasing dissatisfaction by citizens towards the democratic level and quality of the functioning of the EU. This is particularly true for those peripheral euro-area countries hardest hit by the sovereign debt crisis, like Portugal (where the number of satisfied respondents dropped by 53%), Greece (a reduction of 46%), Spain (43%), Cyprus (42%) and Italy (38%). These results seem to suggest a strong lack of input legitimacy in the European Union and highlight how the problem has been severely aggravated in recent years. However, a closer analysis of the data shows that this interpretation is not necessarily correct, as the democratic deficit is not necessarily a specific issue of the European Union.

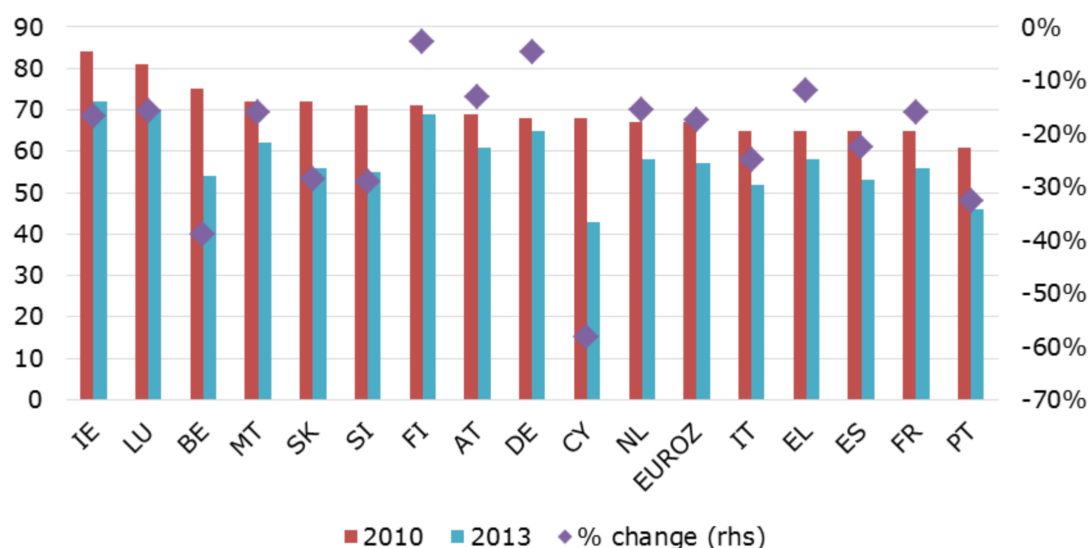
An additional question posed in the Eurobarometer survey is the following: "*On the whole, are you very satisfied, fairly satisfied, not very satisfied or not at all satisfied with the way democracy works in your country*?" It is thus possible to compute the satisfaction with the national and EU democracies and see how they have evolved over time and in relative terms. In 2010, on average, the level of satisfaction with the way in which democracy worked in the EU was perceived exactly the same as at the national level. But in general, citizens of the 'core' countries like Germany, France, the Netherlands, Austria, Luxembourg and Finland were relatively less satisfied with the degree of democracy at EU level than citizens in peripheral countries.

The ratio between satisfied with EU and national democracy, suggests that in relative terms the level of satisfaction has not severely deteriorated between 2010 and 2013. On the contrary, as shown by the orange bars of Figure 1, it has even improved in some peripheral countries like Spain (+25%), Cyprus and Italy (+13%) and slightly deteriorated (but not to the levels of the indicator seen previously) in Greece (-8%) and Portugal (-9%). This result hides a fall in satisfaction at both level, but with a large drop at national level. In other words, dissatisfaction with the actual functioning of democracy has increased at both national and EU level and a lower support for political institutions is a general trend that is not EU specific.

Assessing output legitimacy of the euro area through the Eurobarometer data is extremely difficult, as this concept depends on the euro area's performance in meeting the needs and values of citizens, which are difficult to define in a standardised way for all the population. Moreover, the introduction of the euro has been not only a monetary decision, but also a more powerful and broad action. The crisis has shown how EMU membership is not simply a matter of a common monetary policy, but a step that influences all aspects of the economic policy of a country. As concisely expressed in 1994 by Hans Tietmeyer, the President of the Bundesbank, the euro "*will lead to member nations transferring their sovereignty over financial and wage policies, losing gradually their autonomy over taxation policies*". Therefore, measuring the output legitimacy only on the ability of the ECB to achieve the goal of a stable rate of inflation is extremely simplistic.

One of the questions asked of respondents by the Eurobarometer that would better capture this multi-dimensionality of EMU's output legitimacy is the following: "*Generally speaking, do you think that having the euro is a good or a bad thing for your country*?" Figure 2 reports the percentage of respondents who answered positively in 2010 and 2013 and the change that occurred over time. There has been a general reduction in all the euro-area countries, almost 20% on average. Interestingly, one of the largest reductions did not occur in a peripheral country like Greece (-12%) or Spain (-23%), but rather in Belgium (-40%), which was surpassed only by Cyprus (-58%).

Figure 2. Output legitimacy: "Having the euro is a good thing for the country", level of satisfaction and change, 2010-2013



Source: Authors' elaboration on Eurobarometer data, 2010 and 2013.

2.3 A multi-layered economic governance for EMU: An assessment of the legitimacy relationship between Member States and the EU

The balance of powers, between the EU and its Member States, emerging from the new system of governance has raised legitimacy concerns that deserve careful assessment.[18] This sub-section addresses them by analysing both the democratic aspects of the creation and functioning of the new institutional framework (input legitimacy) and, as explained above, its ability to protect against externalities (output legitimacy).

If one were to find a common thread in the institutional changes of the EMU economic governance in response to the crisis in the euro area, this would certainly be the attempt to strengthen EU supervision on economic matters.

[18] In looking at this issue, the literature on European studies usually distinguishes two lines of research, one exploring the role of the EU Member States in the institution-building process and the other analysing the effect of the evolving EU system of governance on the Member States (Marks, Hooghe and Blank, 1996; Cowles, Caporaso and Risse, 2001; Goetz and Hix, 2000). A comprehensive understanding of the relationship between the Member States and the European Union requires the systematic integration of the two dimensions. For the purposes of this section, however, the second dimension will be examined more fully.

The various components of the new system of governance described in the previous section imply different degrees of EU intrusion in the definition of national economic policies according to different situations. Within the European Semester, the Council and the European Commission can play a central role in influencing the general principles of fiscal policies at national level with the EP or national parliaments playing limited, if any, role. This can result in situations where the decisions taken are characterised by a low degree of input legitimacy.

To better understand the different typologies of legitimacy relationships that exist between the EU and the Member States, it is helpful to characterize them according to two dimensions. The degree of EU constraints faced by national governments when setting polices that fall under national sovereignty, as this is informative about input legitimacy, and the risk of negative spill-overs, which is related to the degree of output legitimacy.

As illustrated in Figure 3, we consider four different categories[19] (the blue boxes), namely macroeconomic adjustment programs, enhanced surveillance of countries under financial difficulties, corrective actions for excessive defect and imbalances and coordination and surveillance of fiscal and macroeconomic policies. Each of them corresponds to one of the procedures foreseen in the new system of governance and to different levels of obligations (measured along the vertical axes) Member States are or can be subject to.

As long as the increased EU executive powers are not accompanied by the corresponding mechanisms of political accountability, the stricter the EU interference is, the higher the cost in terms of democratic legitimacy.

The horizontal axes measures the risk that a country falls in a situation of crisis and hence that an idiosyncratic shock generates negative spill-overs on other countries or the EMU as whole. While this is not a direct proxy for output legitimacy, it is the benchmark against which output legitimacy should be assessed. When moving rightwards, the cost of a failure in output legitimacy is larger as the risk of large spill-overs is higher.

The position of the blue boxes in Figure 3 summarizes the result of the exercise; a detailed assessment of the different typology of relations is described in the following sub-sections.

Overall the main finding of the exercise is that EU constraints on national discretion increase with the risk of (larger) spill-overs. Put is simply, when such risk increases, the EU intrusion increases and input legitimacy weakens (see arrow pointing to the origin of axes).

The second finding is that a lower input legitimacy is not necessarily offset by higher output legitimacy (see arrow with two directions). The idea that a stricter intrusion should lead to better capacity to deal with externalities does not seem yet backed by robust evidence.

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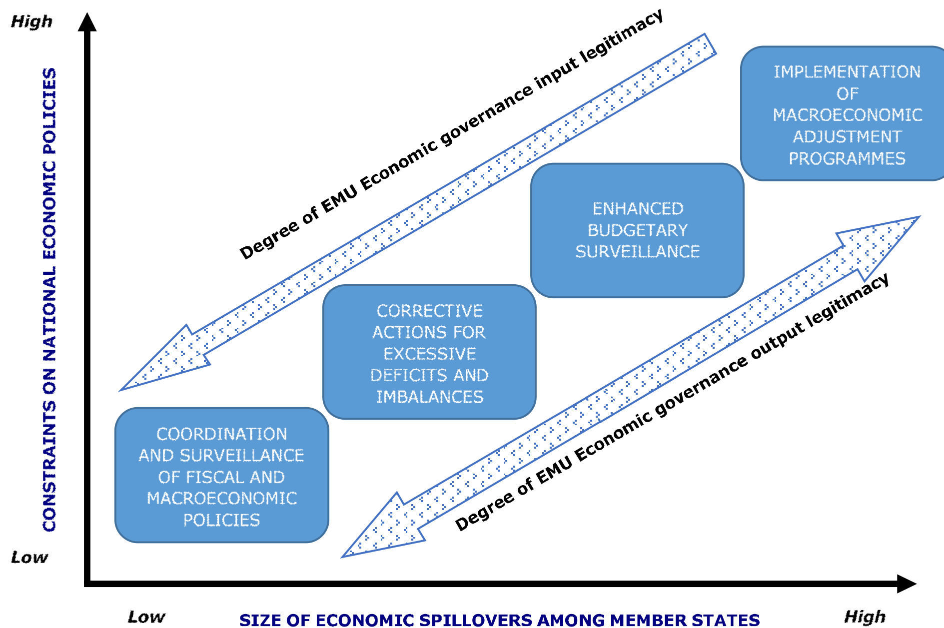
[19] A fifth category including "contractual arrangements", i.e. countries benefitting from financial incentives under the contractual commitment to undertake and complete specific structural reforms, could be added. However, given that the conditions triggering the procedure have not yet been agreed upon, we are unable to place them in the chart. Indeed, according to the European Commission proposal, they could be either voluntary (thus defining a new category) or triggered by the macroeconomic imbalances procedure or the excessive imbalance procedure. In the latter case, the procedure would not necessarily define a separate category. The taxonomy could be further enlarged to also include the peer-review processes defined in the framework of Lisbon 2020 strategy (e.g. 3% GDP expenditure in R&D). In these cases, the EU may ask Member States for greater efforts, but since compliance remains with Member States as the EU has no real powers, this case is not included.

Figure 3 also helps understanding the limits of the rule-based system and the idea of de-politicisation of EU decisions presented in the introduction. This exercise suggests that when moving away from the axes' origin, the rule base-system is failing and decisions of political nature become inevitable. For those decisions due accountability must be ensured.

Figure 3. Input and output legitimacy under the new system of governance



Source: Authors' own elaboration.

The rest of the section is devoted to assess the input and output legitimacy issues associated with each of the 4 procedure of the new system of governance.

2.3.1 *Implementation of macroeconomic adjustment programmes*

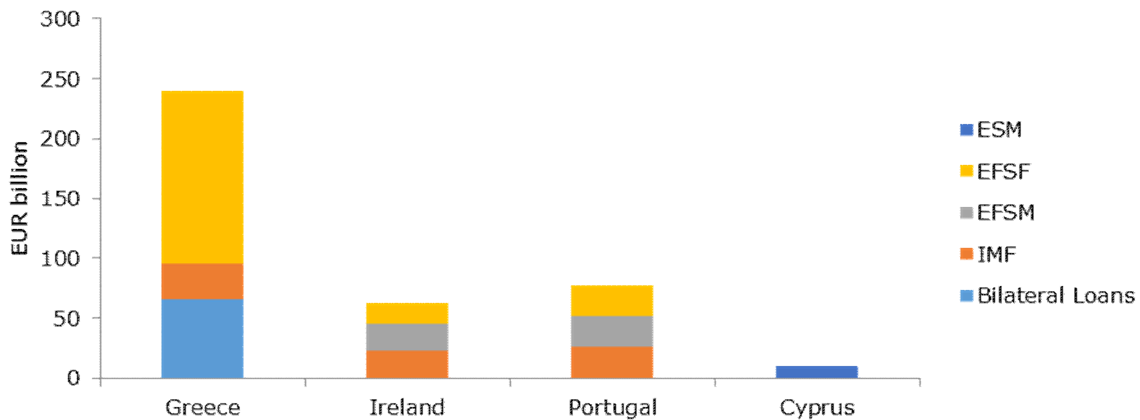
Summary of findings: Decisions are characterised by a lack of transparency, the absence of clear lines of responsibility and no political accountability; yet formally input legitimacy rests on national parliaments that adopted the measures. *De facto* the countries under adjustment programmes lost part of their sovereignty when they lost their solvency and parliaments had no other choice than to accept the measures imposed by the Troika. In terms of output legitimacy, the outcome of the programmes has been more or less successful depending on the country. At aggregate level, the real economy has recovered but remains weak and it is difficult to disentangle how much of the ability to avoid the worst-case scenario should be attributed to the programmes and how much to other tools like the intervention of the ECB.

Among the existing procedures included in the exercise, the one associated with the highest constraints on national sovereignty and hence the lower degree of discretion in setting national policies is the Macroeconomic Adjustment Programme.

The procedure has been activated in four occasions, namely for Greece, Ireland, Portugal and Cyprus. The adjustment programmes have been designed by the Troika of lenders

(European Central Bank, European Commission and International Monetary Fund) and, as illustrated in Figure 4, since May 2010 implied the disbursement of around €400 billion.

Figure 4. Macro-financial assistance to euro-area Member States



Source: Authors' elaboration on official European Commission documents (May 2014).

The democratic legitimacy of this procedure has been the object of a large debate within the institutions, in particular the EP, and the outcome of the Greek programme will make the object of an assessment of the European Court of Auditors.

Input legitimacy

When the Troika was set up for the first time in 2010, the intent was to create an informal body to deal with the design of an adjustment programme[20] for Greece and manage the disbursement of funds having different sources (bilateral loans, EU budget guarantees, and IMF funds). However, as the need for financial assistance moved from Greece to other countries, the visibility and the role of the Troika increased massively in the European panorama to become almost like a new institution. This happened despite the lack of a well-defined mandate and a system of transparent and democratic oversight. The Troika was not obliged to report to the EP about how and why decisions were taken.

In each of the four countries that have been assisted by the Troika, national governments and parliaments have accepted the conditions imposed by the lenders in the Memorandum of Understanding in exchange for financial support. *Stricto sensu*, national authorities carry the responsibility for the policies chosen and voted. Yet, de facto, given the emergency situations there is little doubt that national governments and parliaments had little choice but to accept the conditions imposed. In these cases, Member State had little discretion even on how to comply with certain objectives, as specific implementing measures were often dictated ('Obligation of means'). In practice, the costs associated with rejecting the conditions attached to the financial assistance were estimated as being too high relative to their, de facto, low degree of democratic legitimacy.

[20] Two key reasons for the creation of a body with three heads (EC, IMF and ECB) stem from a) the inexperience of the European Commission to design and deal with adjustment programmes, in contrast with the long standing experience of the IMF, and b) the fact that the ECB was strongly supporting the banking systems in the most stressed countries and de facto being the only institution that could potentially commit unlimited amounts of resources, if necessary.

In 2013, European legislation has evolved to provide better regulation of the conditions applied to countries under macroeconomic adjustment programme. Regulation 472/2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability (two-pack) establishes how the adjustment programmes should be prepared and adopted, the role of the Commission to monitor its implementation and the capacity of the Council to interrupt disbursements of the financial assistance of the EFSF/ESM in case of non-compliance. These legislative developments have certainly represented a step forward in the clearer definition and better recognition of the powers of the European institutions, helping to enhance the democratic legitimacy of the decisions of the Troika. However, as the enquiry report on the role and operations of the Troika (European Parliament, 2014) testifies, several points still remain open.

Output legitimacy

Has the low level of input legitimacy been compensated or supplemented by a high degree of output legitimacy?

Considering the results delivered by the countries under macroeconomic adjustment programmes, two of the four programmes – Portugal and Ireland – can be considered a success in the sense that the initial expectations in terms of adjustment, both fiscal and external, were broadly fulfilled (Gros et al., 2014). The 'clean exit' from the bailout and the return to financial markets without resorting to a credit line represent a confirmation that these programmes have worked well, at least in the assessment of the markets.[21]

By contrast, Greece stands out as a negative exception. The macroeconomic adjustment that the country had to undergo has been accompanied by a deep and long recession and series of downward revisions of growth projections. This has put a strain on the whole economic and social system of the country.

The reasons for the failure should be sought both in the deficiency of the initial plans and in the unsatisfactory implementation of it (see Gros et al., 2014). In the first programme fiscal targets were repeatedly missed, resulting in a serious underestimation of the output losses. Only with the following programmes, the situation has been partially improving over time and the fiscal adjustment is now almost completed. By contrast, the external adjustment has not proceeded well in terms of export recovery and the country has been unable to offset the negative impact of the fiscal adjustment on demand. Exports have been at best stagnating despite the significant fall in wage costs. The resistance to structural reforms has been striking and almost no progress has been made in improving the quality of the administration and governance of the country.[22]

The experience of Cyprus is more difficult to assess because the programme started later and the problems of the country are very specific and strictly linked to the structure of its financial sector.

At aggregate level, it is still too early to find robust evidence that the programmes have increased the long-term growth potential by structurally increasing the competitiveness of these countries and the efficiency of their economies.

[21] See also De Souza et al. (2014).

[22] See Böwer et al. (2014).

Overall whether the programmes have 'protected' the EMU from negative externalities remain unclear. On the one hand, the crisis started in Greece and then spread also to other countries suggesting, from the governance system perspective, a failure of the programme and hence low output legitimacy. On the other hand, it is also true that financial turbulences stopped when the Irish and Portuguese programmes started to deliver good results, even if it is difficult to disentangle how much of the ability to avoid the worst-case scenario should be attributed to the programmes and how much to other tools like the intervention of the ECB.

2.3.2 *Enhanced budgetary surveillance*

Summary of findings: The Commission plays a prominent role by deciding on the activation of the procedure, stipulating the measures that the country must adopt and monitoring and assessing the implementation. Although the Commission is accountable to the EP, in practice specific decisions taken under these circumstances are accompanied by only a little degree of accountability. Since the procedure was never used, it cannot be said whether an increased output legitimacy could compensate for low input legitimacy. It should be recognized, however, that the idea behind its design is to prevent crisis from spilling from one country across the rest of the Union

Under Regulation 472/2013 included in the two-pack, the European Commission might (unilaterally) make a euro area Member State subject to enhanced surveillance when it is facing or experiencing severe difficulties with regard to financial stability but no financial support is being provided. Euro area Member States receiving precautionary financial assistance from the ESM are automatically placed under the enhanced surveillance procedure.

Input legitimacy

In order to activate the regular enhanced surveillance, the Commission needs first to provide an assessment whether the euro area Member State is experiencing or threatened with serious difficulties with regard to its financial stability that are likely to have adverse spill-over effects on other euro area Member States. If this condition is fulfilled, the Commission may unilaterally decide to subject the Member State to regular enhanced surveillance in accordance with Art. 2.1 of the new regulation.

A number of parameters are to be considered when conducting this comprehensive assessment.[23] If a Member State is receiving financial assistance on a precautionary basis, i.e. Precautionary Conditioned Credit Line (PCCL) or Enhanced Conditions Credit Line (ECCL), the enhanced surveillance procedure is launched automatically as soon as the credit line is drawn.[24]

A Member State under enhanced surveillance has to take measures to address the sources of the difficulties and other measures requested by the Commission in order to implement the

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23 In particular, the legislation requires the Commission explicitly to take a number of parameters into account: i) the alert mechanism report, ii) the latest in-depth review, where available, iii) the borrowing conditions of the Member State, iv) the repayment profile of its debt obligations, v) the robustness of its budgetary framework, vi) the long term sustainability of its public finances, vii) the importance of the debt burden and ix) the risk of contagion from severe tensions in the financial sector on its fiscal situation or on the financial sector from other Member States.

24 See European Commission (2013).

enhanced surveillance. Regular review missions are conducted by the Commission in liaison with the ECB and with the relevant European Supervisory Authorities (ESAs) and, where appropriate, the IMF, to verify progress in the implementation by the Member State. The Commission has to report to the Economic and Financial Committee of the Council and the Economic and Monetary Affairs Committee of the EP on the findings of these missions. If further measures are considered as needed, it might recommend the Council to ask the concerned Member State to adopt precautionary corrective measures or prepare a draft macroeconomic adjustment programme.

While the activation of the procedure should be based on indicators allowing the Commission to take a decision as objective (and hence less political) as possible, in practice this will only be possible to a limited extent. And the policy measures requested by the Commission will inevitably affect the setting of national economic policy and hence the legitimacy of the decisions, given that in practice the EP will have only a limited role in the assessment of the implementation.

Output legitimacy

To date, no country has requested the activation of precautionary financial assistance from the ESM and no country has been placed under enhanced surveillance by the Commission. Hence the assessment of output legitimacy can only relay on predictions of theory. This makes it difficult to assess the actual ability of this instrument in preventing crisis situations.

More in general the fact that both Ireland and Portugal have exited their adjustment programmes without a precautionary credit line could even raise questions about the use and the effectiveness of this financial instrument.

2.3.3 Corrective actions for excessive deficits and imbalances

Summary of findings: The decision to activate the excessive deficit procedure (EDP) is almost automatic, the excessive imbalance procedure (EIP) is less so. In the first phase of the procedures, countries are free to choose the policies they deem appropriate to achieve certain objectives. Under the monitoring of the Commission, however, in the enforcement phase, if it occurs, the Commission alone plays a key role, while the Council can only block the Commission's actions. In terms of output legitimacy, doubt exists on the ability of such procedures to prevent negative externalities given potential enforcement problems for the EDP and the weaknesses of some indicators (of the MIP scoreboard) potentially relevant for the activation of the EIP.

A third category includes countries under the excessive deficit procedure (EDP) or the macroeconomic imbalance procedure (MIP), as defined by SGP and the six- and two- packs. Under this situation, countries are free to choose the policies that are deemed to be more appropriate to meet certain objectives (obligation of results) defined by the European Commission, possibly following the recommendations issued by the Council as indicated by the European Commission.

Input legitimacy

In this context, the six-pack established financial penalties for breaching either the deficit or debt limit, and also a reverse qualified majority voting (QMV) in the Council for adopting

some sanctions.[25] Regulation 473/2013 (two-pack) established the obligation of countries under EDP to inform the Commission and the Council about relevant fiscal policy decisions before they are submitted to the national parliaments, in any case every 6 or 3 months, according to the stage of the procedure. Moreover, the two-pack also requires euro-area Member States entering EDP to design an Economic Partnership Programmes (EPPs) and define a precise roadmap for structural reforms, considered instrumental to an effective and lasting correction of the excessive deficit.

If a euro-area Member State is found to experience an excessive imbalance in the sense of the MIP regulation, an excessive imbalance procedure (EIP) may be opened by the Commission and the Council. According to the procedure, the Member State is obliged to define a clear roadmap and set deadlines for implementing corrective actions to absorb the imbalance. During this phase, the concerned Member State should regularly report to the Commission on progress to assure an adequate monitoring of the adopted policies. If the euro-area Member State fails to submit an adequate corrective action plan or fails to enforce the agreed corrective actions, the Council, under the reverse QMV rule, could impose sanctions following a two-step approach. First, an interest-bearing deposit can be imposed in the case of one compliance failure; after a second failure, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP).

Output legitimacy

In order to assess the output legitimacy of the excessive deficit procedure and excessive imbalance procedure, it is first necessary to evaluate whether the parameters that define the absence/presence of imbalances are indeed appropriate as early warning indicators and well designed to identify situations of real risk.

In this respect, two major issues emerge, one for each procedure. The first one relates to the fact that some key targets in the framework of the EDP are set for unobservable variables. The second one relates to the very definition of the indicators used in the MIP scoreboard to identify emerging or persistent macroeconomic imbalances.

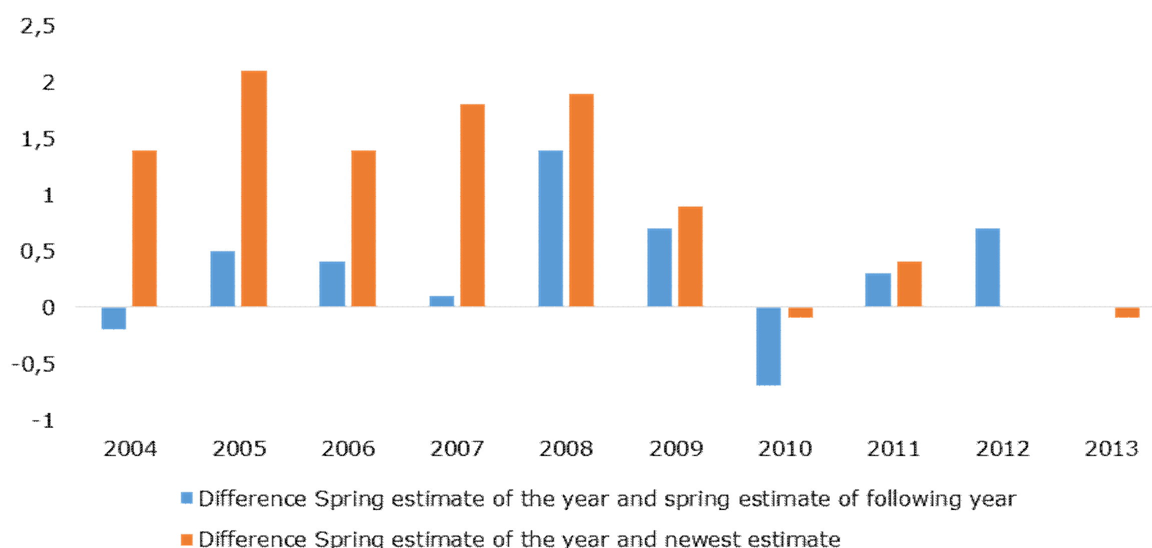
Regarding the first issue, in the new provisions of the SGP as well as in the Fiscal Compact, the output gap and the potential growth rate are crucial parameters in the establishment of countries' fiscal objectives as well as for compliance with rules written in the national constitution. Indeed the definition of the medium-term objectives (MTOs) requires the computation of the government balance in structural terms (i.e. cyclically-adjusted and net of one-off measures), like the rule of the balanced budget imposed by the Fiscal Compact. While this approach makes sense from an economic point of view, given that assessing fiscal sustainability using nominal targets can be misleading, at the same time that it creates important uncertainties in terms of measurement (as the structural government balance is not an observable variable) and, therefore, definition of appropriate fiscal policies at national level.

In practice the calculation of the structural deficit requires the identification and estimation of some key parameter which can lead to very different outcomes. The commonly used methodology assures that calculating the output gaps and potential output does not result in bias in favour of any Member State, but the same methodology does not necessarily assure

[25] The Fiscal Compact establishes a stricter limit for the structural deficit in the euro-area Member States, including the obligation to enshrine the balanced budget and debt-brake rules in their constitutional or similar legal orders and extends the use of the reverse QMV in most sanctions.

that structural deficit indicators are an effective tool in guiding policy decisions. Alcidi and Gros (2014a) point to the high real-time volatility in the estimates of the output gap and structural deficit figures leading to high uncertainty in the ex-ante formulation of policies in order to keep the budget below the 0.5% threshold as foreseen by the Fiscal Compact. In practice, another degree of uncertainty is introduced by the fact that the structural balance has to be estimated ex-ante for the formulation of appropriate policies. This implies that the uncertainty associated with the measurement of the structural component of GDP is combined with the uncertainty of the future, i.e. forecasts about future GDP and budgetary items. Of course, the two errors could either offset or magnify each other. Figure 5 shows, for example, the case of Italy and how estimates of the structural balance are almost always subject to corrections over time, which can be quite large – sometimes equal to as much as a 2 percentage point difference from one year to another. Budgets submitted in the spring are almost systematically over-optimistic (as shown by the orange bars). This would imply that pressure at EU level on national fiscal policies may exist when not necessary and, vice versa, the system may remain silent when risks are emerging.

Figure 5. Italy: Structural balance as % of GDP, real time data with revision for yearly values of the time series



Source: Authors' elaboration on European Commission data.

As regard the second issue, the indicators in the MIP scoreboard (as presented in an annual Alert Mechanism Report (AMR) and the 'in-depth review' (IDR)) should be able to correctly identify the build-up of stock imbalances that might precipitate a crisis.

However, the design of some of the indicators in the MIP-scoreboard[26] could imply that the indicators are unable to differentiate between imbalances that could pose a 'serious risk' from those that do not (Gros and Giovannini, 2014). Thus, policy-makers are not provided with solid bases to take effective corrections.

This is the case, for instance, with scoreboard indicators relating to external imbalances and competitiveness.

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[26] It should be noticed that the scoreboard is only one element of the assessment for the EIP, but it is supposed to be the most objective.

As shown in Figure 6 (in the first row), the indicator on the evolution of export market shares signals that only three of (shown) 17 euro-area Member States did not exceed the limit defined by the scoreboard (decline in export market shares by more than 6%). But if the same 'alarm' rings for all countries, it may be difficult to understand which countries are experiencing a macroeconomic imbalance or are exposed to that risk. Furthermore, in the absence of the (bilateral) exchange rate channel to correct external imbalances, the competitiveness indicators should especially highlight deteriorating external imbalances relative to other countries so as to suggest policy action. However, should most of the Member States experience a similar trend, the effective exchange rate of the euro would react, limiting the need for structural adjustments at the level of individual Member States. In this perspective, looking at the performance of relative rather than absolute indicators thereby considering as excesses only imbalances that deviate from the euro-area average could ensure a better monitoring and assessment of the functioning of EMU (Gros and Giovannini, 2014). The second row in Figure 6 shows how the use of a relative measure for the market share indicator reduces the number of 'alerts' singled out by the scoreboard, thus helping to better identify those countries that have a greater (and riskier) imbalance.

Figure 6. Export market share indicator: absolute vs. relative (to euro area average) scoreboard (2013)

	BE	DE	EE	IE	GR	ES	FR	IT	CY	LX	MT	NH	AT	PT	SL	SK	FI
ABS																	
REL																	

Source: Authors' elaboration on Eurostat data.

2.3.4 Coordination and surveillance of fiscal and macroeconomic policies

Summary of findings: Input legitimacy rests largely with national governments. The Commission and the Council (and only to a limited extent the EP) have an important role in the formulation of the country-specific recommendations, but experience suggests that they are only partially taken into account by national governments. The steps foreseen in the framework of the coordination process remain of key importance to ensure transparency of and commitment to certain policies by national governments. In terms of output legitimacy of EMU, coordination is the fundamental answer in order to avoid the emergence of negative externalities, which we interpret here by the idea that Member States with sound policies contribute to an EMU that is able to deliver good outcomes.

Input legitimacy

EU Member States have to submit their stability or convergence programmes (outlining their medium-term budgetary strategies) as well as their national reform programmes (outlining specific structural reforms to promote growth and competitiveness) to the Commission in mid-April following the European Council's policy orientations based on the AGS and, where appropriate, taking into account the Commission's recommendations following the in-depth reviews of macroeconomic imbalances. The Commission evaluates the national plans and presents draft country-specific recommendations, which are then discussed and adopted by the Council – once they have been endorsed by the European Council. The Council has to justify any changes to the Commission's proposal. Regulation 473/2013 of the two-pack established the obligation of the euro-area Member States to submit their draft annual budgetary plans before mid-October to the Commission in order to check, and the

Eurogroup to discuss, whether they are in line with the recommendations of the European Semester.

If the Commission identifies particularly serious non-compliance with the budgetary policy obligations, the Commission might ask the concerned Member State to present a revised draft. Before the end of November, the Commission has to publish its final opinion on the draft budgetary plans for discussion in the Eurogroup.[27]

All these steps were undertaken as the sovereign debt crisis has clearly shown the ineffectiveness of control mechanisms and sanctions of the SGP. On the one hand, the case of Greece revealed how the quality of the information provided by the states was often inaccurate or reductive. On the other hand, the procedures to sanction ex-post have never produced the enforcement necessary to ensure that the SGP rules were truly respected and could act as a constitutional constraint on the states.

Output legitimacy

The problems related to the lack of effectiveness of an EU rule-based system which have to co-exist with national sovereignty are well known and widely documented. The measures contained in the six-pack and in the two-pack have been designed to effectively solve some of these problems and thus increase the output legitimacy. However, significant issues remain.

In the framework of the European Semester country-specific recommendations endorsed by the European Council at the end of the Semester cycle in early July represent a crucial EU output for policy coordination. They are formulated on the basis of specific challenges previously identified by the Commission and they are intended to provide policy prescriptions to Member States and concrete and measurable policy objectives that should be assessed ex-post by the Commission. Nonetheless countries tend either to circumvent or just disregard them.

Country-specific recommendations could be divided into two broad classes. Policy recommendations regarding fiscal policy are usually precise and refer to specific numerical targets. In this case it is more difficult for the country to avoid compliance, despite economic circumstances are often advocated for benefiting of delays. By contrast, policy recommendations on structural reforms aiming at the promotion of growth and competitiveness, financial stability or the improvement of the judicial system are usually very broad and quite vague. While this is unavoidable, as specific numerical targets cannot be applied in all contexts, the assessment of compliance becomes very difficult. In some cases, the vagueness of the country-specific recommendations, results in a poor delivery of the requested policies (this is especially true for some parts of structural reforms).[28]

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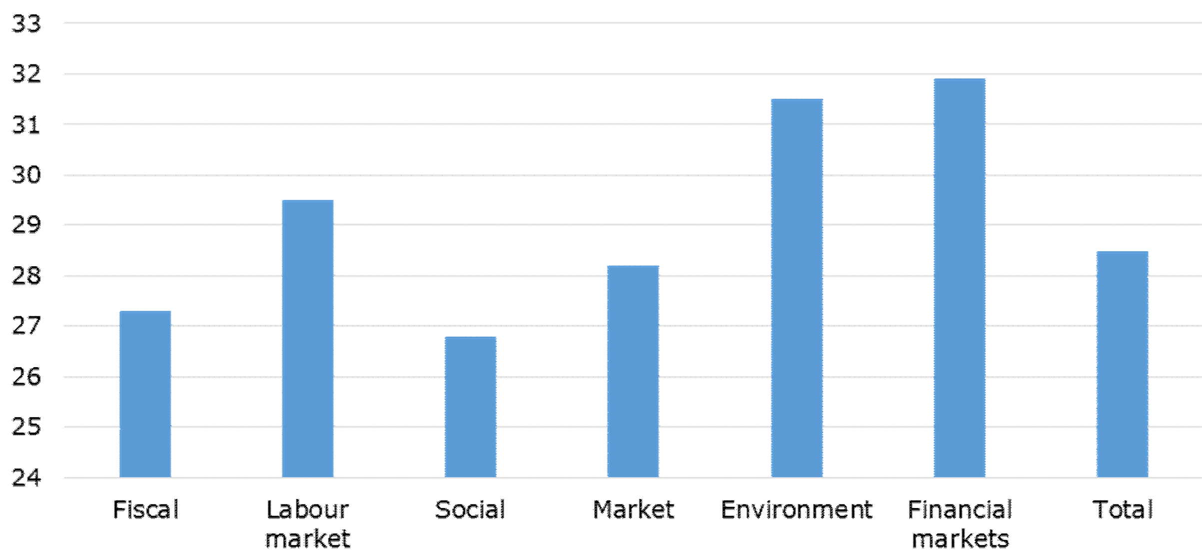
[27] Among others, the draft budgetary plan must contain the following information: i) The targeted budget balance for the general government as a percentage of gross domestic product (GDP), broken down by subsector of general government; ii) The projections, assuming no change in current policies, for expenditure and revenue as a percentage of GDP for the general government and their main components, including gross fixed capital formation; iii) The targeted expenditure and revenue as a percentage of GDP for the general government and their main components; and iv) Relevant information on the general government expenditure by function, including on education, healthcare and employment, and, where possible, indications on the expected distributional impact of the main expenditure and revenue measures.

[28] Alcidi and Gros (2014b) provide two, admittedly extreme, examples of the ambiguity of these recommendations. The first one is the recommendation to "further stimulate competition" in the

In general terms, it is hard to describe the overall progress made with the implementation of the country-specific recommendations as a success, especially for particular policy domains. According to recent analysis (Clayes et al., 2013), only 16% of the recommendations issued in the social domain were actually implemented by the Member States, while 44% were just 'promised' in the National Reforms Plans. Also in the domain of internal market policy, the number of recommendations actually implemented by Member States is only 28% of the total (Figure 7). By contrast, measures on financial markets and the environment have shown a higher degree of implementation.

In this framework, the assessment of output legitimacy is very difficult. The one message that emerges is that countries seem unable to see the benefit of policy coordination and tend to make efforts in bypassing country-specific recommendations rather than to comply with them.

Figure 7. Index of implementation of country-specific recommendations by domain



Source: Authors' elaboration based on Clayes et al. (2013) data.

German services sector contained in the 2012 country-specific recommendations. The German government responded to this request by adopting measures on....chimney sweeping! The second case refers to Italy, where the 2013 country-specific recommendations invited the country to "shift the tax burden away from capital and labour towards property". In 2013 the government proceeded to abolish the real estate tax (IMU) introduced by the Monti government in 2012. A somewhat similar real estate tax was then introduced again for 2014.

3. Enhancing input legitimacy: the role of the European Parliament

KEY FINDINGS

- Strong executive powers have been conferred to the EU institutions, thereby creating gaps in terms of political accountability that can only be solved at EU level. It is, therefore, essential to strengthen the involvement of the EP in EMU governance.
- In the European Semester, there is room to improve the contribution of the EP in establishing the EU's economic priorities and the parliamentary oversight of the country-specific recommendations and their implementation by Member States.
- The 'troika' model should be adapted to the new provisions in the six- and the two-packs. The Commission can provide an evaluation of its participation and recommendations. The involvement and responsibilities of the Eurogroup and the ECB should be spelled out more clearly.
- The EP could be authorised to set the budget appropriations of the Convergence and Competitiveness Instrument, and the financial facility could be adopted through EU legislation.
- Parliamentary oversight of the European Council and the Eurogroup could be improved through better use of the economic dialogues with their Presidents on EMU decisions and policy actions.
- An exchange of views with the President of the Eurogroup and the Managing Director of the ESM could contribute to improving the political accountability of this body.
- The agreed mechanisms for the oversight of the ECB's supervisory powers and the Resolution Board should be used to their full potential.
- The creation of a subcommittee of the Economic and Monetary Affairs Committee for the scrutiny of EMU would facilitate the exercise of all these tasks by the EP. It would also allow for a more effective format of inter-parliamentary cooperation with (and among) the national parliaments of the euro area.
- The selection of the President of the Commission through the EP elections could contribute to increasing the political capital of the EP, citizens' interest in the elections and their support for the EU, but there are still many hurdles that need to be overcome before these objectives can be achieved.

The previous chapter identified the main shortcomings in terms of input legitimacy of the current governance framework. Stronger implementing and supervisory powers have been transferred to the EU level but political accountability and parliamentary oversight is not fully ensured. Although the two-pack was meant to improve the regulation and accountability of the Troika, the role of its different members and the lines of responsibility are not yet clearly defined. Nevertheless, the government of the country concerned has little choice but to accept the Memorandum of Understanding with important '*obligations of means*' for state spending and tax policies. The enhanced budgetary surveillance by the Commission, the Economic Partnership Programmes (EPPs) and the supervision of national macroeconomic imbalances also pose some concerns in terms of input legitimacy. Unlike national governments, the Commission does not respond to citizens for its actions in general elections and therefore parliamentary oversight becomes crucial. Although the obligations of

the euro-area countries in the case of coordination and surveillance of fiscal and macroeconomic policies are less significant and more difficult to enforce, the adoption of country-specific recommendations in the framework of the European Semester and the ex-ante control of the draft budgets in October by the Commission and the Eurogroup also require proper parliamentary scrutiny both at EU and national level.

After looking into the reasons that justify the involvement of the EP in the governance of EMU, this section reviews the role of the EP in the development and implementation of the new regulatory framework and outlines how it could be strengthened in order to increase the input legitimacy. It then examines specific proposals to modify the organisational structures of the EP so as to improve the parliamentary oversight of the euro-area governance and ways to enhance the cooperation between the EP and the national parliaments. The last section looks into the benefits that increased political conflict in the EP could bring in terms of input legitimacy.

3.1 The input legitimacy of EMU and the EP

The involvement of the EP is essential to the input legitimacy of EMU governance and can be justified on several grounds. Even if many matters of economic governance fall within the category of 'coordination competences' (Art. 5 and from 120 to 126 TFEU), key measures in the realm of monetary and financial policy aim to preserve the stability of the euro, which is an exclusive competence of the EU (Art. 3 TFEU). The EP is also – together with the Council – the budgetary authority of the EU and the EU budget is highly dependent on national budgets and contributions.[29] Compared to national governments and parliaments, which are more prone to represent the national interests, the EP is in a better position to promote the EU's common good and ensure that the strong interdependence between EU economies is fully taken into account. Its participation has also proved essential to ensure the protection of the rights of non-participating Member States in the light of increasing differentiated integration. Moreover, the management of the euro crisis increased confrontation between debtor and creditor countries, adding up to the traditional divisions between small and large Member States and different geographical regions. The EP could contribute to building up solidarity and trust among Member States and their citizens, which is essential for the effectiveness and sustainability of the governance of the euro area in the future. Otherwise, citizens might fail to understand certain decisions and regard them as imposed by 'the others', which would undermine their credibility and efficacy.

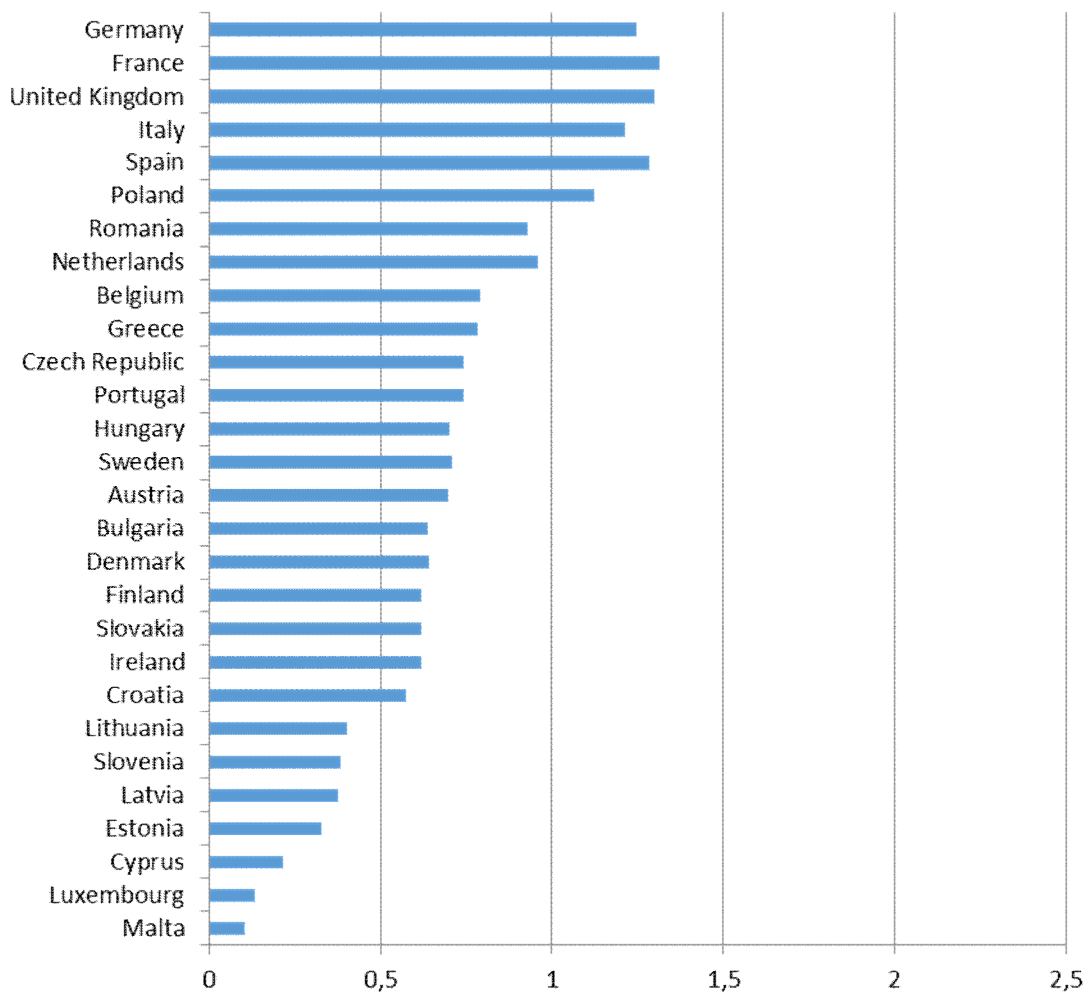
EU decisions and policies have a strong impact on national spending and tax policies, which lie at the heart of national sovereignty and national parliaments' powers. It is therefore crucial to engage national parliaments in the process through strengthened inter-parliamentary cooperation and to adopt measures to ensure the accountability of their respective governments. The EP, however, should be responsible for ensuring that EU institutions and policy-makers are held accountable for their actions. New implementing and supervisory powers have been conferred to the European Commission and the European Central Bank (ECB). The European Council, the Council and the Eurogroup have played a crucial role in the development of the new regulatory framework and are key players when it comes to its implementation.

The Commission, the President of the European Council and the President of the Eurogroup (especially if it becomes a full-time position) are not – and cannot be – accountable to specific national parliaments or citizens, but rather to the EP, representing all the European citizens,

[29] See Fasone (2012).

and being directly elected by them. Decisions taken by the European Council and the Council do not necessarily require unanimity and might affect Member States unevenly. The same applies for the Eurogroup. A decision might severely affect a Member State with a very limited power on its adoption. The electorate of that country has therefore no capacity to hold those responsible for the decision accountable. In these circumstances it is essential to ensure the effective parliamentary oversight of these decisions at the EU level. Equally, the new powers of the ECB that go beyond its exclusive autonomous competences in monetary policy must be held accountable at the EU level. Only in this way can the democratic principles of representation and checks-and-balances, which are key to the concept of input legitimacy in the EU, be ensured.

Figure 8. Inequality in terms of population in the EP*



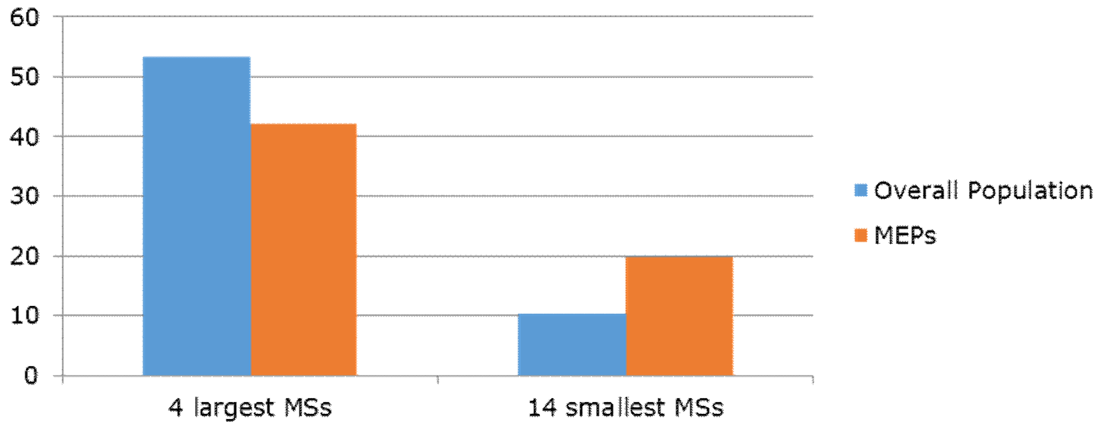
* Inequality is measured as the ratio between the population of each country divided by its number of seats and the total population divided by the total number of MEPs (751).

Source: Authors' own elaboration.

The representativeness of the EP has elsewhere been contested on grounds that the larger Member States are underrepresented and the smaller Member States are largely overrepresented. Compared to lower chambers representing citizens (not states) in national states, indeed, the EP shows a substantive departure from the principle 'one person, one vote', which would be achieved by allocating the seats in strict accordance with the total population of each Member State, as shown in Figure 8.

Figure 9 shows how the four larger Member States, which represent over 53% of the EU population, elect only 42% of the 751 MEPs, whereas the MEPs elected in the 14 smallest countries represent almost 20% of all MEPs, which is double their population share.

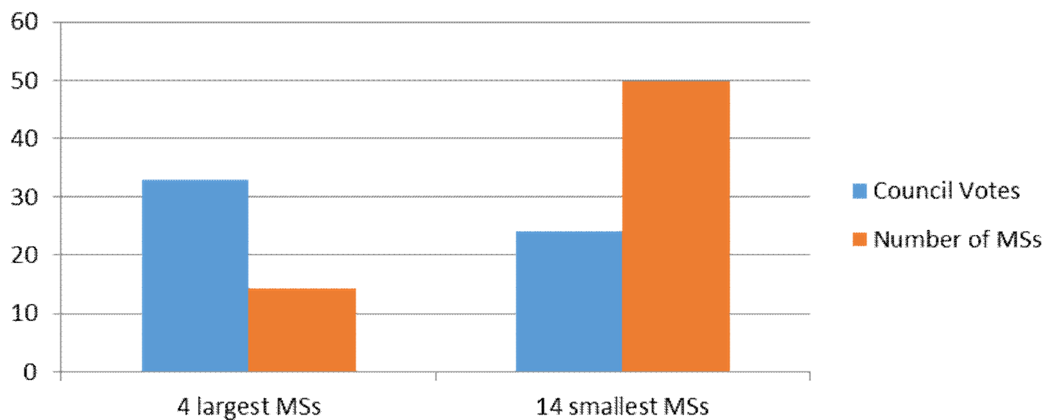
Figure 9. Share in the overall population and total MEPs: Large vs. small Member States



Source: Authors' own elaboration.

In federal states with two chambers, however, representation in the upper chamber responds to the principle 'one state, one vote', whereas in the Council of the EU the larger Member States are overrepresented in the current allocation of votes for qualified majority voting.

Figure 10. Share in the Council votes and total number of Member States: Large vs. small Member States (%)



Source: Authors' own elaboration.

In a hypothetical 'Senate' made up of the same number of representatives for each Member State, the 14 smallest countries – representing one-half of the total Member States – would have 50% of the votes. But in the Council these countries account for 24% of all votes (under the voting weights currently in force), that is about one-half of the weight they would have under the principle of equality among states. Conversely, the four largest Member States

would have 14% of the Council votes under the principle 'one state, one vote' (Figure 10), but in reality they have one-third (more than double).[30]

3.2 The EP in the development of the new EMU

As described in the previous chapter the development of the new governance of EMU has on occasion taken the form of inter-governmental agreements outside the EU's legal framework, whereas in other instances it has proceeded by means of EU secondary legislation under ordinary or special legislative procedures.[31] In the first case, the involvement of the EP in the negotiations was much more limited. In the second case, the EP either had co-decision powers or was consulted on decisions ultimately to be taken by the Council. On certain occasions, the EP used its co-decision powers in a file to influence an intergovernmental agreement or a consultation procedure. This section will examine the role played by the EP in shaping the new economic governance and the position envisaged for this institution in the application of the new regulatory framework.

During the negotiations of the so-called 'six-pack', the EP could exert its leverage because four of the regulations were under the OLP (Ordinary Legislative Procedure), in which the EP and the Council have co-legislative powers. The EP secured the introduction of the so-called 'economic dialogues'; the automatic application of a Commission's warning to a specific country unless a qualified majority of the euro-area governments rejects the warning (in which case they have to explain their decision to the EP); the establishment of a legal basis for the European Semester (See Article 2a Regulation 1175/2011); the right to invite finance ministers from countries that have received a warning to a hearing; the obligation of the Commission to scrutinise – when investigating the sources of macroeconomic instability – not only countries with a trade deficit but also those running current account surpluses; the introduction of principles on statistical independence (Article 10a Regulation 1175/2011) and sanctions (Article 8 Regulation 1173/2011) for providing misleading statistics; and the agreement by the Commission to prepare a report on "euro/stability bonds".

The ability of the EP to influence the negotiations of the 'two-pack' was even higher because both regulations were under the OLP and there was closer cooperation between the two largest groups in EP. On this occasion, the EP ensured a stronger focus on growth, a higher concern for education and healthcare in the Commission's assessments and a better oversight of the Commission's increased powers. For instance, the Commission's powers to impose extra reporting requirements on Member States' governments must be renewed every three years and can be revoked by the EP and the Council. In relation to the countries under enhanced and post-programme surveillance, the Commission must communicate its assessment to the EP Economic and Monetary Affairs Committee, and orally inform its Chair and Vice-Chairs of the progress made in preparation and monitoring of countries under adjustment programmes. The EP may invite the Commission and the Member State concerned to participate in an exchange of views on the recommendation to adopt a precautionary or macroeconomic programme and on the progress made in the

[30] As from 1 November 2014, Art. 16 TEU provides that a qualified majority will be defined as at least 55 % of the members of the Council (16 countries in EU-28) comprising at least 65 % of the population of the EU. Population will therefore continue being an important factor in the Council and larger Member States will still be essential to winning coalitions.

[31] In the ordinary legislative procedures (OLPs), the EP and the Council are on an equal footing. In most (but not all) special legislative procedures, the EP is consulted or has to give its consent to the legislative act adopted by the Council.

implementation of the adjustment programme. Finally, during the negotiations the EP also secured an agreement on the provision of an instrument to mobilise 1% of the GDP to promote growth and the preparation of a roadmap for the implementation of a debt redemption pact.

In the case of the Capital Requirements Directive IV, the EP used its co-decision powers to tighten the liquidity requirements, to increase the cap on management remuneration and to establish a more transparent method of reporting tax payments. The approval of Regulation 1024/2013, conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions, only required the EP to be consulted, but the EP used its co-decision powers in the negotiations of the related Regulation 1022/2013 amending the European Supervisory Authority to force an inter-institutional agreement with the ECB on the oversight of these supervisory tasks.

The involvement of the EP in the negotiations of the three intergovernmental treaties agreed so far by Member States outside the EU legal framework has varied widely from one to another. It was not involved at all in negotiating the Treaty establishing the European Stability Mechanism (ESM), whereas it participated in the negotiations of the Treaty on the Stability, Coordination and Governance of EMU (TSCG) and played a key role in the case of the Single Resolution Mechanism (SRM). The EP's leverage and participation were in part determined by the legal basis inspiring each of the treaties.

On 16 December 2010, the European Council agreed to add the following text in Art. 136 TFEU:

> The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.

In March 2011, the EP approved the treaty amendment after receiving assurances that the European Commission would play a central role in running the ESM and that the intergovernmental mechanism would be eventually brought within the EU framework. On the basis of the new treaty amendment, the (then) 17 Member States of the euro area signed the Treaty establishing the ESM on 2 February 2012. As from October 2013, the ESM issues debt instruments in order to finance loans and other forms of financial assistance to euro-area Member States. The direct recapitalisation of banks is possible under certain circumstances. The ESM Board of Governors consists of the Ministers for Finance of the euro-area Member States and is chaired by the President of the Eurogroup. The Commissioner for Economic and Monetary Affairs and the President of the ECB participate in the meetings as observers. The Commission in liaison with the ECB, and wherever possible, together with the IMF, are responsible for negotiating a Memorandum of Understanding with the Member State concerned, detailing the conditionality attached to the financial assistance facility and for monitoring its compliance. The EP was not involved in the negotiations and the treaty establishing the ESM does not make any reference to this institution.

Despite the fact that many provisions in the TSCG could have been regulated by EU legislative acts on the basis of Arts 121, 126 and 136 TFEU, the EP eventually accepted the inter-governmental negotiations and sent three representatives to the talks. The involvement of the EP was essential to bring the agreement in line with the six-pack, ensure its implementation through secondary legislation and secure the commitment to incorporate it into the EU legal framework within five years. In the negotiations, the EP also advocated the

rights of the non-euro-area Member States and promoted their participation in some discussions of the Euro Summit meetings.[32] Finally, Art. 13 of the TSCG provided for the creation of an inter-parliamentary conference with representatives from the EP and the parliaments of the Member States signing the agreement to discuss the budgetary policies and other issues covered by this treaty.

The decision of the Ecofin Council on 18 December 2013 to resort to an inter-governmental treaty for some aspects of the resolution fund – taking them out of the Commission's original proposal under the ordinary legislative procedure – was strongly criticised by the EP. Nevertheless, the EP used its leverage in the negotiations with the Council on the SRM regulation to influence the inter-governmental agreement. As promoted by the EP, the decision-making of the Resolution Board was simplified, the mutualisation of the resources was speeded up and a credit line for the fund, which so-called 'pre-in' EMU members could use as well, was included. Also, the involvement of the EP was essential to make the Resolution Board accountable not only to the Council and the Commission, but also to the EP, having the obligation to keep all three institutions informed of its activities on a regular basis and to participate in hearings with the EP.

3.3 The EP in the implementation of the new regulatory framework

As explained in the first section of this chapter, the contribution of the EP is essential to improve the input legitimacy of the governance of EMU. This section looks into how the role of the EP could be strengthened in three particular areas: 1) its participation in the European Semester; 2) the parliamentary oversight of the macroeconomic adjustment programmes, and, eventually, the enhanced budgetary surveillance and the competitiveness and convergence instrument; and 3) the assurance of the political accountability of the European Council, the Eurogroup and the ECB.

3.3.1 EP's participation in the European Semester

The competent EP committee may invite the President of the Council, the Commission, as well as the President of the European Council and the President of the Eurogroup where appropriate, for an economic dialogue to discuss a number of issues related to the six pack, namely:

1. Information provided by the Council on the broad guidelines of economic policy (Art. 121.2 TFEU) and general guidance to Member States issued by the Commission at the beginning of the annual cycle of surveillance. Conclusions drawn by the European Council on orientations for economic policies in the context of the European Semester.[33]
2. The results of the multilateral surveillance and the conclusions drawn by the European Council on the orientation and results of multilateral surveillance. The review of the conduct of multilateral surveillance at the end of the European Semester.[34]
3. Council recommendations addressed to Member States in accordance with Art. 121(4) TFEU when there is a significant deviation. As a rule, the Council is expected to follow the recommendations and proposals of the Commission or explain its position publicly.

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[32] Namely, in those meetings concerning competitiveness, the modification of the global architecture of the euro area and the fundamental rules that will apply to it in the future, as well as, when appropriate and at least once a year, in discussions on the implementation of the TSCG.

[33] Regulation 1466/97 as amended by Regulation 1175/2011, and Regulation 1176/2011.

[34] Regulation 1466/97 as amended by Regulation 1175/2011, and Regulation 1176/2011.

The report made by the Council to the European Council as defined in Art. 6(2) and Art. 10(2) of Regulation 1175/2011. The Council and the Commission shall regularly inform the EP of the application of this regulation.

4. Council recommendations establishing the existence of macroeconomic imbalances and corrective actions (Art. 7.2 Regulation 1176/2011), Council's adoption of the corrective action plan of the concerned Member State (Art. 8.2) and Council's decision establishing non-compliance (Art. 10.4).
5. The adoption of a Council decision (Art. 126.6 TFEU), recommendation (Art. 126.7 TFEU), notice (Art. 126.9 TFEU) or sanction (Art. 126.11 TFEU) regarding the EDP. As a rule, the Council is expected to follow the recommendations and proposals of the Commission or explain its position publicly.[35]
6. The adoption of a Council decision imposing sanctions to Member States failing to comply with the medium-term budgetary objective or infringing the SGP, as well as fines on those failing to take effective action to correct the excessive deficits.[36]
7. The adoption of a Council decision imposing sanctions on Member States failing to comply with the corrective action for the macroeconomic imbalances, including fines when the infringement persists.[37]

The EP is already making use of all these economic dialogues in the European Semester cycle. To start with, the Commissioners for Economic and Monetary Affairs and Employment usually appear in November before the relevant committees of the EP (ECON/EMPL) to present the Annual Growth Survey (AGS) and the Alert Mechanism Report (AMR) before the start of a new European Semester. These exchanges of views have proved very valuable, but the EP does not yet have the capacity to influence the Commission's guidelines. The EP may publish an own initiative report on the AGS and issue an opinion on the employment guidelines. Last year, the resolution was adopted in February, when the ministers of finance in the Council had already discussed their conclusions on the AGS and the AMR, as well as the main priority areas. To have any impact, the EP's resolutions should be released earlier in the process. By means of an inter-institutional agreement (or as part of the framework agreement on relations between the EP and the Commission), the Commission could commit to explain how it is taking the EP's views into account.[38] Although some argue that the nature of the process is rather 'technocratic' and thus there is no need to involve the EP further, it is beyond question that, in today's context, adoption of the EU's main economic priorities entails a fair dose of politics and, therefore, justifies to some extent a stronger parliamentary dimension.

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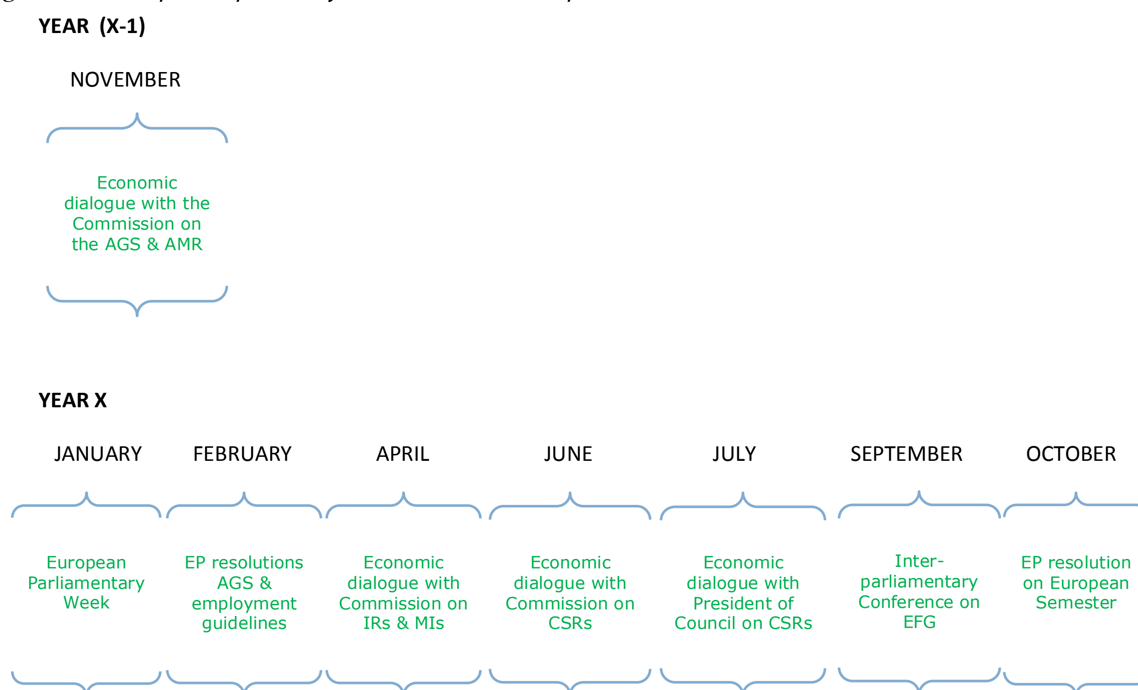
[35] Regulation No 1467/97 as amended by Regulation 1177/2011.

[36] Regulation 1173/2011.

[37] Regulation 1174/2011.

[38] In fact in the draft of country-specific recommendations, the Commission mentions that the resolution of the EP has been taken into account.

Figure 11. The participation of the EP in the European Semester



Source: Authors' own elaboration.

The ECFIN Commissioner presents the in-depth reviews and macroeconomic imbalances before the ECON Committee around April. In the subsequent process of discussing and adopting the country-specific recommendations, the EP has no decision-making powers but can hold economic dialogues with both the Commission and the Council. During the 2013 Semester Cycle, the ECFIN and EMPL Commissioners presented on 17 June 2013 the draft country-specific recommendations before the ECON and EMPL Committees. The Irish Minister of Finance explained the Council's position to the members of the ECON Committee in the following week (24 June), and the European Council endorsed them just five days later (29 June). The Lithuanian President explained the country-specific recommendations as adopted by the Council on 9 July. An Economic Dialogue on the euro area country-specific recommendations with the President of the Eurogroup took place on 5 September 2013. For the effective exercise of the parliamentary oversight, the hearing with the Commission should take place earlier and the Council and the European Council should inform the EP about their positions and deliberations in real time.

In its report on the "European Semester for economic policy coordination: Implementation of 2013 priorities", the EP (2013a) welcomed the fact that the 2013 country-specific recommendations were much more detailed than the year before, gave more insight on compliance by Member States, were more in tune with national specificities, had a stronger focus on growth, employment and competitiveness and included recommendations for the euro area as a whole (and not only for individual countries). Notwithstanding these positive observations, the EP called for the introduction of the Europe 2020 national objectives into the recommendations issued to Member States under economic adjustment programmes and called on Member States to include the Europe 2020 progress report in their contributions to the European Semester. It also asked the Commission to carry out a thorough ex-ante assessment of the short- and long-term social impact of newly proposed reforms. It is still to be seen the extent to which these considerations will be taken into account in the future.

The EP can also play an important role in monitoring the implementation of the country-specific recommendations. In December 2013, it invited the President of the ECOFIN – the Lithuanian Minister of Finance – for an economic dialogue. In January 2014, there was also a dialogue with the Greek Minister of Finance about the 2014 Semester cycle. The President of the Eurogroup was invited on 20 February. The role of the EP in ensuring the enforcement of the country-specific recommendations and other recommendations related to the development of the European Semester could be strengthened if the necessary resources were provided. As provided in Regulation 473/2013, in autumn, the competent committee of the EP could hold economic Dialogues with the Commission and the Presidents of the Council and the Eurogroup to discuss the content of the draft budgetary plans, the Commission's opinions and the discussions in the Eurogroup and the related Council's acts. This monitoring task by the EP may be facilitated by the recent inclusion of reporting guidelines indicating how measures in the draft budgetary plans address country-specific recommendations and the targets set in the Europe 2020 strategy and on the expected distributional impact of the main expenditure and revenue measures.

Finally, the EP may also offer the opportunity to the Member State that is the object of a Council recommendation or decision to participate in an exchange of views. In 2013, there were economic dialogues with the Ministers of Economy and Finance of Italy, Malta and Slovenia and in 2014 for Spain, and a planned dialogue with France was postponed.[39]

3.3.2 *The parliamentary oversight of the CCI, the enhanced budgetary surveillance and the macroeconomic adjustment programmes*

In addition to its contribution to the European Semester, the EP can also play an important role in the oversight of the macroeconomic adjustment programmes and the enhanced budgetary surveillance of euro-area members under financial difficulties – in case a country is placed under this condition in the future. It is also important, in terms of input legitimacy, that the EP is not marginalised from the adoption of arrangements of a contractual nature with Member States if negotiations eventually materialise in agreement.

At the moment, negotiations are being carried out on the terms of the "individual arrangements of a contractual nature with the EU institutions on the reforms promoting growth and jobs".[40] The Convergence and Competitiveness Instrument (CCI), as proposed by the Commission, refers on the one hand to the contractual arrangement with Member States to adopt a number of measures to implement the country-specific recommendations – especially those emanating from the Macroeconomic Imbalance Procedure (MIP) – and, on the other, it includes a mechanism for financial support for the implementation of costly reforms.[41]

It is still to be seen whether such as an instrument would be voluntary or obligatory for euro-area members and how it will be made available to non-members. Everything seems to indicate, however, that if the Commission and the government of the concerned Member State fail to reach an agreement, of if the agreement is not approved by the Council, there will not be a contractual arrangement. At national level, each government would therefore be accountable to its parliament.

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[39] See http://www.europarl.europa.eu/committees/en/econ/publications.html?id=ECON00012#menuzone.

[40] See Van Rompuy (2012).

[41] European Commission (2013).

Financial support, conditional on the full and timely implementation of the reforms set out in the contractual arrangements, could be obtained via specific contributions (based e.g. on the GNI[42] key) or new own financial resources, and be included in the EU budget as external assigned revenues (therefore, over and beyond the MFF ceilings), as proposed by the Commission and supported by the EP.[43] In this case, the EP would be entitled to authorise the budget appropriations. The European Council, however, is also discussing the use of loans and it is not yet certain whether the financial facility will be adopted by means of secondary legislation under the community method, which would guarantee the role of the EP in the process.[44]

In the case of enhanced surveillance of Member States in the euro area experiencing or threatened with serious financial difficulties, according to Regulation 472/2013 of the two pack, the competent committee of the EP could invite representatives of the Commission, the ECB and the IMF to participate in an economic dialogue. The EP could also invite representatives from the Member State concerned and the Commission to participate in an exchange of views about the recommendations and the adjustment programmes.[45]

In relation to countries under adjustment programmes, the EP asked the Commission in the 2013 report on the European Semester to adapt the 'troika' model to the new provisions in the six- and the two-packs in order to improve its democratic accountability, and also to conduct and publish internal ex-post evaluations of its recommendations and its participation in the Troika. However, progress so far has been quite modest. Since the entry into force of Regulation 472/2013 in March 2013, there have just been updates of the Irish, Portuguese and Cypriot macroeconomic adjustment programmes to Art. 7(5) – and also 7(2) in the case of Cyprus.[46] The Commission's evaluation of the adjustment programmes (following the new obligations provided in the regulation) has been very limited.[47] In February 2014, the President of the Eurogroup appeared before the ECON Committee to explain the implementation of the macroeconomic adjustment programmes, but no economic dialogue has taken place so far with the Commission.[48]

The EP Resolution of 13 March 2014 on the enquiry on the role and operations of the Troika with regard to the euro-area programme countries assessed the main shortcomings in legitimacy of the functioning of the Troika in recent years, highlighting the poor democratic accountability of its decision-making process at national level and the lack of it at EU level. It

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[42] Gross National Income (GNI) is broadly the same as GDP except that it adds what a country earns from overseas investments and subtracts what foreigners earn in a country and send back home.

[43] See European Parliament (2013a, p. 8).

[44] Annotated Agenda of the Sherpa meeting (http://blogs.ft.com/brusselsblog/files/2013/11/Sherpa.pdf).

[45] Regulation 472/2013.

[46] The Regulation's macroeconomic adjustment programme provisions do not apply to Spain, but the country will be subject to post-programme surveillance in accordance with Art. 14 of the Regulation as soon as the current financial assistance programme ends (also Ireland).

[47] According to the Commission, because "the short timeframe during which this Regulation has been in force provides limited evidence on which to base this evaluation". See European Commission (2014).

[48] In the case of ministers of the states concerned, only the Greek Minister of Finance has appeared before the committee for an exchange of views (11 November 2012), although there is one planned with Portugal later this year. See http://www.europarl.europa.eu/committees/en/econ/publications.html?id=ECON00012#menuzone.

insisted on the need to establish ”clear, transparent and binding rules of procedure for the interaction between the institutions within the Troika and the allocation of tasks and responsibility therein”, noting a number of institutional weaknesses and conflicts regarding the role of the Commission, the ECB, the Council and the Eurogroup that should be addressed.[49]

3.3.3 *Boost the political accountability of the European Council, the Eurogroup and the ECB*

In order to give a quick and strong response to the economic and financial crisis, the European Council acquired a salient role in the initiation, adoption and implementation of measures regarding the governance of EMU. But this has sometimes transpired to the detriment of the EP. Additionally, the growing powers of the European Council have not encompassed the provision of mechanisms to ensure its democratic legitimacy at EU level. The argument that the Heads of Government and State are already accountable at national level should not be used to obstruct this development for several reasons. The full-time President of the European Council, who is not accountable at national level, has important agenda-setting and policy-shaping powers. And the meetings of the President's Cabinet with the 'sherpas' – representatives of the heads of government – have become very important in the functioning of this institution. In addition, some Member States are more influential and some major decisions do not require unanimity. Moreover, the parliamentary scrutiny of the actions of the heads of government or state in the European Council is rather weak in many Member States.[50]

The President of the European Council is only obliged by the treaties to present a report to the EP after each of the summits (Art. 15.6 TEU). This reporting usually takes place before the so-called "enlarged Conference of Presidents".[51] There was only one occasion in 2013 when the President of the European Council (Herman Van Rompuy) reported to the plenary session. These hearings constitute an ex-post marginal source of information. According to the rules of procedure of the Euro Summits, adopted on 14 March 2013 upon the entry into force of the TSCG, the President of the European Council has to report to the EP after each of the meetings.[52] There has not been a Euro Summit since then, but if – as envisaged in the rules of procedure – this finally takes place in the aftermath of the European Council meetings, one can expect that the President will report to the EP about both meetings at the same time.[53]

The Eurogroup meets once a month, on the eve of the meeting of the Economic and Financial Affairs Council of the EU (ECOFIN) and is responsible for the preparation and follow-up of Euro Summit meetings.[54] The President of the Eurogroup is not accountable to the EP, although s/he might be invited to take part in an economic dialogue in the framework of the

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[49] See http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2014-0239&language=EN.

[50] See Hefftler et al. (2013).

[51] A Conference of Presidents of the EP that can be attended by other MEPs.

[52] See Council of the European Union (2013).

[53] Unless an EMU subcommittee is finally set up and the President of the Council is invited to report on the Euro Summits in that setting.

[54] The Eurogroup is the informal body that brings together the finance ministers of countries whose currency is the euro. The Commission's Vice-President for Economic and Monetary Affairs, as well as the President of the European Central Bank, also participate in Eurogroup meetings.

six- and the two-packs. According to the latter, s/he can be invited to discuss the Eurogroup's opinion on the national draft budgetary plans submitted by euro-area members in October. Where necessary, s/he can also be invited to discuss some aspects of the operation of the ESM, which s/he chairs.[55] Although inter-governmental in nature, the ESM is an essential element to the functioning of the euro area and powers to disburse financial assistance, establish conditionality and monitor its compliance require some degree of parliamentary accountability at EU level. The Eurogroup has also shown that it exercises significant leverage on the Commission when deciding the scope of this assistance and the conditionality attached.[56] Jeroen Dijsselbloem, the current President of the Eurogroup, has participated so far in three economic dialogues: one on the Cyprus adjustment programme (7 May 2013), a second on the implementation of the euro area-relevant country-specific recommendations (5 September 2013) and a third on the implementation of the adjustment programmes and the six-month priorities of the Eurogroup (20 February 2014). The provision of a full-time president of the Eurogroup would make a stronger case for improving the parliamentary oversight of its activities.

In relation to the ESM, its Managing Director, Klaus Regling, also participated in an exchange of views with members of the ECON committee on 24 September 2013, admitting the importance of this dialogue between the EP and the ESM and his readiness to answer written questions when possible.[57] The ESM sends its annual report and audit report to the EP.

Monetary Dialogues with the ECB and supervisory hearings with the Chair of the SSM are also of high importance, in particular in view of its new powers on banking supervision. Art. 20 of Regulation 1024/2013 conferring specific tasks on the ECB concerning the supervision of credit institutions provides that the ECB has to cooperate with any investigations by the EP and that, upon request, the chair of the supervisory board will hold confidential oral discussions with the chair and vice-chair of the competent committee of the EP. According to the inter-institutional agreement struck by the EP in the negotiations on the single supervisory mechanism:

i) The chair of the supervisory board has to appear once a year before the EP to present the annual report on the execution of its tasks and has to participate in two public hearings. Additional ad hoc exchanges of views and special confidential meetings can also be held.

ii) The appointment of the chair of the supervisory board requires the approval of the EP.

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55 In a letter of 22 March 2011, the President of the Eurogroup and the Ecfin Commissioner committed on behalf of the Council and the COM to inform the EP on a regular basis about the establishment and the operations of the ESM. See Annex 3 of the European Parliament resolution of 23 March 2011 on the draft European Council decision amending Art. 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro (www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2011-0103+0+DOC+XML+V0//EN#BKMD-4).

56 See the EP resolution of 13 March 2014 on the enquiry on the role and operations of the Troika (ECB, Commission and IMF) with regard to the euro-area programme countries, point 50. (www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2014-0239&language=EN).

57 See note on the EP website examining the relationship between the ESM and the EP.

iii) The ECB has to reply in writing to written questions put to it by the EP and provide the competent committee with a record of the proceedings of the supervisory board, including a list of the decisions adopted and those objected to by the Governing Council.

iv) In the event that a credit institution is declared bankrupt, non-confidential information will also be disclosed ex-post.

The Resolution Board is accountable not only to the Council and the Commission, but also to the EP, and must keep all three institutions informed of its activities on a regular basis and to participate in hearings with the EP.

3.3.4 The EP's organisational structure

Either through legislation or informal agreements, the European Council and the Council have adapted their organisational structures to better deal with the governance of the euro area (e.g. voting rules, Eurogroup and Euro Summits). In the case of the EP, the issue remains an open question. On the one hand, euro-countries MEPs defend the need to improve the parliamentary oversight of the euro-area governance and their involvement in the process. On the other, the EP represents the European (not national) citizens (Arts 10 and 14 TEU), the euro is meant to be the currency of the whole EU (Art. 3 TEU) and the Union must respect the equality of citizens and Member States across the Union (Arts 4 and 9 TEU).

As pointed out elsewhere, the proposal to create a Euro-Parliament formed by MEPs and MPs from the euro-area countries would not only create an unnecessary additional layer to the already complex EU political system, but it will also be in flagrant conflict with core treaty principles and contribute to the 'institutional secession' of the euro area.[58] The alternative proposal to limit the EP's voting rights to euro-area MEPs when dealing with euro affairs and legislation would breach the treaty conception of the EP as the representative chamber of all the European citizens. It would also be questionable on the grounds that MEPs from 'pre-in' countries would be deprived of their voting rights in the development of EMU, which they will eventually join.

If a stronger role on the part of the EP in EU economic governance is in part justified by the fact that it represents all European citizens and promotes EU common good and the rights of all Member States, any institutional reform to improve the parliamentary dimension of the euro area should not contravene these core principles. As an alternative to the proposals above mentioned, the party coordinators of the ECON Committee made recently a suggestion for a possible creation of a subcommittee to deal with the scrutiny of the EMU, which in principle is compatible with these goals and the treaties' principles.[59] The legislative role – and the parliamentary oversight of non EMU-specific policies – would be confined to the ECON Committee, whereas the sub-committee would manage non-legislative scrutiny tasks related to the euro area, the banking union and the fiscal compact – mainly economic and monetary dialogues and the preparatory work for non-legislative acts of the main committee. The EMU sub-committee would ultimately report to the ECON Committee.

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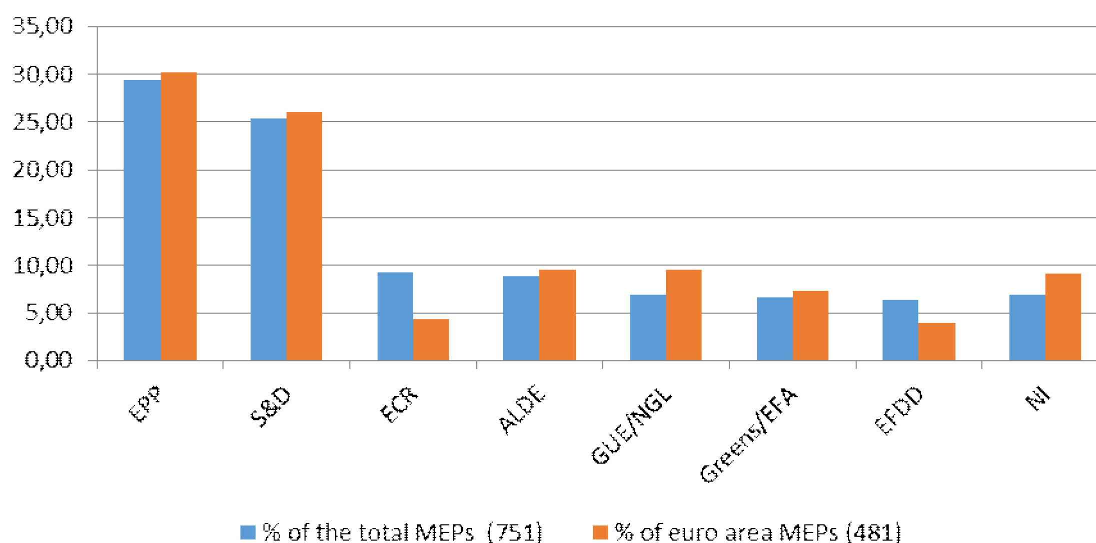
[58] See for instance A. Maurer, 'From EMU to DEMU: The Democratic Legitimacy of the EU and the European Parliament', IAI Working Papers 13/11, April 2013; European Parliament, *Report on constitutional problems of a multitier governance in the European Union*, A7-0372/2013a.

[59] See letter of the former Chair of the Economic and Monetary Affairs Committee to the President of the European Parliament on the Structure and Modalities with the Parliament for euro-area governance in the next legislature (http://sylvie-goulard.eu/articles2014/Annex-3a-Chair-s-Announcements-ECON-structure.pdf).

Figure 12. Balance of power of the political groups in the 8th EP: EU28 vs. euro area



Source: Authors' own elaboration.

The most problematic issue with this proposal is that participation in a sub-committee cannot be restricted to MEPs of specific Member States. Therefore, it would require the agreement of all the political groups to send MEPs that have been elected in euro-area countries. However, should the composition of the sub-committee reflect the composition of the euro area or the composition of the EP, as all committees do? Figure 12 shows the winners or the losers in both cases.[60] Composition reflecting the distribution of seats in the EP would enhance the power of those groups that, as ECR and EFDD, have a higher proportion of MEPs coming from non-euro-area members. Whether allocating the sub-committee seats according to the composition of the euro area would benefit the other political groups with a higher percentage of MEPs coming from euro-area members, especially the GUE/NGL group. The existing sub-committees (Human Rights and Security and Defence) reflect – as the main committees – the composition of the EP. An allocation based on the actual composition of the euro area would be more representative but would create an unprecedented case that could accentuate the existing divisions between euro and non-euro-area countries.

3.4 Inter-parliamentary cooperation with national parliaments

Given the dual legitimisation of the EU political system both at national and EU level, the engagement of the national parliaments is paramount to the process. Enhanced inter-parliamentary cooperation between the EP and the national parliaments can contribute to this goal.[61]

The participation of MPs in the inter-parliamentary European week in late January or early February every year should enable them to debate the key findings and conclusions from the

[60] The estimates have been made according to the affiliation of the parties in the outgoing Parliament given that the composition of the political groups in the incoming Parliament is still unknown.

[61] Dual legitimation refers to the two channels to legitimize EU decision-making. Through EP elections voters elect and hold accountable their European representatives and through national elections they elect and hold accountable their representatives in the European Council (and the Council).

Annual Growth Survey, the Alert Mechanism and other related issues. In this way, they could hold appropriate hearings with the members of their government in relation to the adoption of the conclusions on the AGS by the Council and the provision of the policy orientations by the European Council. They would also be in a better position to scrutinise the draft national reform programmes that their governments must submit to the Commission in April. The inter-parliamentary European week may also allow the EP to collect the views of the national parliaments for its resolutions on the AGS and the employment guidelines. However, the size of the parliaments' delegations –and ultimately of the conference itself – complicates the exchange of views between the national parliaments and with the EP and the management of the event, with negative consequences in terms of impact and visibility.

This problem has become more prominent with the co-celebration of the Inter- parliamentary Conference on Economic and Financial Governance (EFG) of the European Union (envisaged in Art. 13 TSCG), following the conclusions of the Conference of Speakers of EU Parliaments in Nicosia in spring 2013.[62] The second meeting of the inter-parliamentary conference EFG, which was first convened by the Lithuanian Presidency in Vilnius in October 2013, took place in the framework of the 2014 European Parliamentary Week in Brussels and was co-organised by the EP and the Hellenic Parliament. The size and composition of each delegation is decided by the respective national parliaments and the EP itself and, therefore, the conference itself tends to be too large and difficult to manage in an effective way. In the 2013 Parliamentary week, there were over 100 members of national parliaments and around 80 officials. Moreover, the conference may only adopt non-binding conclusions by consensus on matters of economic and financial governance of the EU related to the agenda of the meeting. Against this backdrop, the conference might eventually not be attractive enough for relevant MPs to attend, which would further damage its impact and visibility.

The second meeting of the inter-parliamentary conference on EFG takes place in autumn as a replacement of the meetings of the chairpersons of the relevant committees organised after the summer break by the parliament of the country holding the rotating presidency of the Council, which allowed for a less representative but more constructive interaction between parliaments. If it were held early enough and run effectively, the new inter-parliamentary conference on EFG could promote discussions with the national parliaments on the country-specific recommendations in view of their eventual incorporation in the draft national budgets and could feed into the EP's resolution on the implementation of the European Semester. However, the large size of the conference, the modest scope of its mandate and the difficulties to reconcile divergent positions on the rules of procedures all seem to be setting the scene for a low profile event.

The inter-parliamentary conference on EFG has fallen short of expectations to actively engage the parliaments of the euro countries in the oversight of the new economic governance. The proposal to create a sub-conference only formed by MPs and MEPs coming from euro-area members to meet on the margins of the main conference would complicate the agenda of the MPs and add an additional layer to the system. In view of the protracted negotiations on the creation of the conference itself, it is also likely that it would be strongly contested by non-euro-area members.[63] As an alternative, the creation of an EMU sub-committee of the ECON Committee would allow for the organisation of inter-parliamentary

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[62] See http://www.senate.be/event/20130422-Nicosia/Conclusions_Speakers_ConferenceEN_24-4-2013.pdf.

[63] An overview of the process can be found at Kreilinger (2013).

meetings with the relevant members of the related committees in the national parliaments of the euro-area countries (e.g. budget, finance and employment). The meetings could then take place at the most appropriate time during the European Semester and draw in the most appropriate representatives in order to streamline the delivery of results.

In order to improve EU democratic accountability at national level, enhanced inter-parliamentary cooperation should be accompanied by the reinforcement of the Commission's political dialogue with the national parliaments and a stronger commitment on the part of national governments. In particular, the Commission could communicate the country-specific recommendations to the national parliament concerned in the framework of the political dialogue, and the parliament could then hold a question-and-answer session with its respective government. It would also be necessary for governments to provide their parliaments with accurate and timely information about the negotiations in the Council and the European Council. The Commission (as provided for in Regulation 473/2013) could also appear before the concerned national parliament to present its opinion on the national draft budgetary plan, with the national minister giving further account of the discussions in the Eurogroup. In the case of Member States under enhanced surveillance, economic dialogues between the national parliament and the Commission, and the ECB where appropriate, could be promoted as well.

3.5 Increasing politicisation in the EP and the Commission

Beyond reinforcing the role of the EP and its scrutiny powers, the input legitimacy of EMU governance could also be improved by promoting citizens' participation in the election of their representatives at EU level. Unlike national governments, the European Commission is not elected by citizens or the members of the party able to secure a sufficient majority in the EP. Moreover, voter turnout in the elections to the EP is very low as compared to national elections. Proposals to upgrade these circumstances are often suggested so as to improve EU democratic legitimacy. However, the initial steps taken in this direction have had a limited impact due to the peculiarities of EU political system. The euro-area crisis and the reform of EMU economic governance have propelled the EU to the front of the public debate, contributing to its politicisation and the change in perceptions that the EU was mostly about 'policies' and not that much about 'politics'. The polarisation of the debates had the potential to increase political conflict in the EP and make the left/right cleavage clearer, bringing Europe closer to the citizens and boosting participation in the European elections. A stronger involvement of the EP in the selection of the President of the Commission according with a specific political programme could also contribute to this goal. Progress in both directions, however, must be taken with caution.

3.5.1 Politics in the European Parliament

That the economic and financial crisis has brought the EU to the forefront of the public debate in many EU countries has been particularly evident in the recent election campaigns to the EP. Traditionally focused on national issues and domestic politics, this year's elections revolved around the EU more than in the past. However, political conflict has increased the pro- vs. anti- EU divide rather than the traditional right-left cleavage.[64] Whereas in some countries such as in the UK the focus was on EU membership itself, in others the 'anti' voices were directed at particular policies (e.g. the euro, fiscal discipline, austerity, immigration, enlargement), the EU's growing intrusiveness or 'politics as usual'.

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[64] See Piedrafita & Lauenroth (2014).

This was eventually reflected in the outcome of the elections. Although the elections to the EP tend to penalise ruling and large parties, the protest vote in its different versions this year was much more relevant and radical than before. As Table 3 shows, the mainstream political parties have generally lost votes and their groups in the EP (EPP, S&D, ALDE and Greens) have all lost seats. The 'anti-austerity' message brought substantial gains to the European left, and especially to the party of its leading European candidate, Alexis Tsipras, who won the elections in Greece. Eurosceptic or 'eurocritic' parties of different kinds improved their share of the vote and representation in 13 Member States, reaching in most of these countries over 15% of the total. In the UK, France and Denmark, they won the elections ahead of conservatives and socialists. As a result, the European Conservative and Reformists (ECR) and European Freedom and Direct Democracy (EFDD) groups have increased their representation in the new EP. The ECR has indeed become the third-largest group and the main opposition to the two largest groups, the European People's Party (EPP) and the Socialists and Democrats (S&D), which – as the result of the new allocation of seats – will have to work together in the coming years in order to build majorities to adopt decisions and passing legislation.

Table 3. Composition of the outgoing and incoming EPs

	7th EP : June 2009	7th EP : May 2014	8th EP June 2014
EPP	265	273	221
S&D	184	196	191
ALDE/ADLE	84	83	67
Greens/EFA	55	57	50
ECR	54	57	70
GUE-NGL	35	35	52
EFD	32	31	48
NI	27	33	52
TOTAL	**736**	**765**	**751**

Source: Authors' own elaboration.

This is not something new. Despite increasing politicisation of EU policies, the EP tends to form large majorities that usually include the two main political groups (EPP and S&D) so as to reinforce its position in the negotiations with the Council. As shown in Table 4, this trend increased in the 7th EP, with the EPP and S&D voting together in 73.64% of the total roll call votes. Still, the EPP and the S&D were not part of the winning coalition in around 10% and 16% of the votes, respectively. In the incoming EP, this tendency is likely to increase since conservatives and socialists will in most cases need each other to form a winning coalition. This might come at the cost of politics in the EP and the fading out of the right-left divide, whereas the strong presence of right Eurosceptics – although split into different groups and non-attached members – will accentuate the pro- vs. anti-EU divide.

Table 4. Voting coalitions in the 6th and 7th terms of the EP

	2004-2009 : PPE-DE + PSE	2009-2014 : EPP + S&D
Culture & Education	77.61%	98.75%
Regional Development	82.91%	97.03%
Budget	74.94%	89.33%
Internal Regulations of the EP	70.59%	87.50%
Constitutional & Interinst. Affairs	78.40%	85.88%
Judicial Affairs	98.15%	83.80%
Transport & Tourism	74.01%	81.53%
Agriculture	80.06%	80.75%
Fisheries	87.07%	79.75%
Foreign & Security Policy	70.18%	77.72%
Int. Market & Consumer Protection	67.31%	77.30%
Gender Equality	58.27%	71.04%
Development	64.04%	71.03%
International Trade	67.06%	71.03%
Industry. Research & Energy	68.52%	68.52%
Employment & Social Affairs	56.50%	67.89%
Budgetary Control	86.49%	67.35%
Economic & Monetary Affairs	52.43%	66.73%
Civil Liberties. JHA	63.65%	66.28%
Environment & Public Health	59.70%	56.56%
Petitions	72%	35.29%
ALL POLICY AREAS	**69.65%**	**73.64%**

Data source: http://www.votewatch.eu/

3.5.2 The indirect election of the President of the Commission

A progressively stronger involvement of the EP in the selection of the President of the Commission, in accordance with a specific political programme, could also contribute to the goal of increasing the political capital of the EP and citizens' interest in the elections. The Commission has now a stronger leverage over decisions that involve economic policy choices and that have a strong impact on national tax and spending policies, and such an initiative would contribute to enhancing its democratic legitimacy.

As a first step in this direction, the EP last year adopted a resolution encouraging European political parties to nominate candidates for the position of Commission President, who would also lead pan-European campaigns. The resolution also called on the European Council to give first consideration to the candidate of the party winning most seats in the elections.[65] However, the initiative had a very limited impact on the electoral campaign and

[65] http://www.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2013/2102(INL)&l=en

voter turnout in most Member States, where national parties and domestic politics continued to be more prominent.[66] It is also difficult for such an initiative to take off if the candidates for the position of Commission President cannot base their campaigns on a clear political programme for the coming years and if there are uncertainties about whether the European Council would consider them at all. Therefore, there are a number of obstacles that would need to be overcome for such an initiative to work.

It is argued that the proposal of candidates to the position of Commission President by the European political parties and his or her selection through the elections to the EP could increase the 'politicisation' of the Commission, when the treaty establishes that it has to carry out its functions independently. Moreover, its increased powers in monitoring national economic and budgetary policies make a stronger case for improving its neutrality. However, a key role of the EP in the selection of the President of the Commission does not guarantee his/her independence or neutrality. Furthermore, although the President plays a key role in the Commission, the political composition of the College will continue to be determined by the ideological affiliation of the members of the European Council, who ultimately proposes the other 27 Commissioners. The role of the President in the selection process is very limited, and so is the role of the EP, which only has the capacity to accept or veto the whole Commission. In a similar vein, the EP can only oblige the whole Commission to resign by approving a motion of censure by a two-thirds majority. Therefore, the relationship between the Commission and the EP cannot be compared to that of the national parliaments with their respective governments.

In conclusion, there are several ways in which the input legitimacy of the euro area can be increased: the role of the EP in its governance can be reinforced; the parliamentary accountability of the European Council, the Eurogroup and the European Central Bank can be improved; the EP can be endowed with the necessary tools to effectively conduct the economic and monetary dialogues; and the inter-parliamentary cooperation between the EP and the national parliaments can be upgraded. The increase of the political conflict in the EP and the indirect election of the President of the Commission through the European elections could contribute to reducing the gap with the citizens and boosting participation in the elections, promoting acceptance and support for the EU. However, political conflict seems to be increasing around the pro/anti-EU cleavage, whereas the right/left divide risks being diluted even more in the next legislature. Moreover, the initiative to nominate leading candidates by the European political parties for the position of Commission President will fail in its goals to promote genuine European elections and to enhance the citizens' say if the existing flaws are not resolved.

[66] Piedrafita & Lauenroth (2014).

4. Output legitimacy and EMu externalities

KEY FINDINGS

- Reducing the EMU functioning externalities would provide higher benefits to euro-area members, thereby increasing the output legitimacy of EMU.
- One way is to undertake institutional reforms that aim to reduce the risk of an idiosyncratic shock turning into a systemic shock. This could be achieved through the creation of a fully-fledged banking union and the development of more effective market-based systems of risk-sharing.
- A second avenue, which foresees even deeper changes, considers the option of equipping EMU with additional institutions that could directly tackle the emergence of negative externalities associated with idiosyncratic shocks. This could be achieved by setting up a common fiscal capacity, namely through the establishment of a European unemployment insurance scheme.

In addition to the inadequacies of the SGP to ensure the stability of EMU, the crisis has highlighted deficiencies associated with the absence of appropriate instruments to withstand asymmetric shocks.[67] Federal states, such as the United States, are usually equipped with common safety nets (like a federal budget) and a full banking union. Their role is to work as fiscal and market risk-sharing mechanisms, respectively, with the objective of minimising the probability and/or the size of welfare losses. This is usually achieved by smoothing out either consumption or income over time.

When the global financial crisis hit EMU in 2008, with monetary policy constrained by the ECB price stability mandate, no banking union and no common fiscal instrument, the only possible response for the EU (there was no specific EMU reaction at that time) was to coordinate national fiscal policies. This resulted in the European Economic Recovery Plan, which provided assistance amounting to 1.5% of EU GDP over two years, with a contribution from the EU budget amounting to 0.3% of GDP. This tiny figure, with an uncertain outcome, was hardly comparable to the size of the fiscal stimulus programme launched immediately in the United States after the outbreak of the crisis worth more than €600 billon (i.e. around 5% of GDP). By contrast, policy responses in Europe were mainly national.

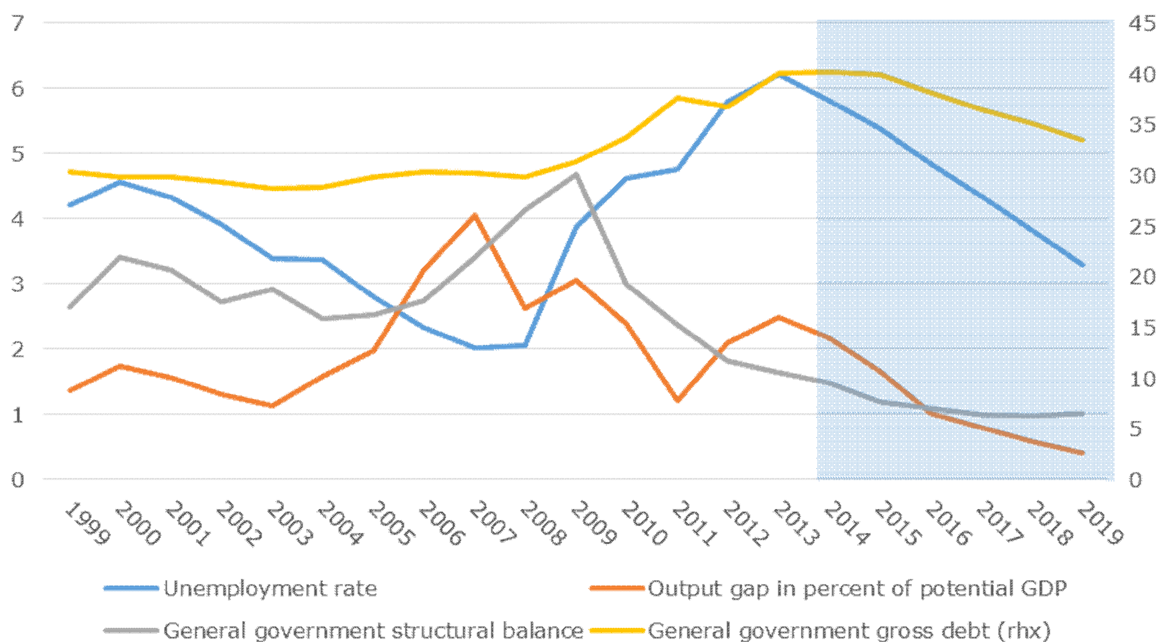
The subsequent waves of the crisis that have more specifically hit EMU did not lead to any common response either. In the absence of a common EMU response and of any risk-sharing mechanism, the burden of the adjustment has fallen disproportionally on some countries, resulting in divergent growth paths, with gaps widening over time and narrowing only more recently. Such divergences, which have infected the economic, social and political spheres, have put at risk the entire EMU architecture. In the end, Europe responded by increasing the institutional coordination of national fiscal and macroeconomic policies, rather than by introducing countercyclical monetary and/or fiscal policies.

[67] This chapter is primarily concerned with the 18 EU Member States that have already adopted the euro as their currency and that currently comprise the euro area, as opposed to the larger Economic and Monetary Union (EMU), which includes both the 18 euro-area Member States and the 10 non-euro Member States.

The entire EMU governance system is based on the idea of crisis prevention. Rules about fiscal and macroeconomic stability and early warnings aim at averting the emergence of shocks rather than dealing with the absorption of their adverse effects. A deepened policy coordination ex-ante (also in areas of national competence) was intended to facilitate the convergence of the economies of EMU, preventing the creation of harmful imbalances and forcing all members to strengthen their economies by enhancing competitiveness. When the crisis stroke, the system proved to fail and also proved unprepared to deal ex-post with asymmetric shocks.

Since 2010, EMU has been strongly affected by large country-specific shocks, originating from fiscal and current account imbalances in Greece, credit and housing booms / burst and a banking crisis in Ireland and Spain, structural problems related to low productivity growth in Portugal and Italy. The adverse effects of these shocks split EMU in two parts in terms of growth developments: the countries of the euro-area periphery experienced negative growth rates and fast rising unemployment rates. The core economies enjoyed reasonable growth and historically low unemployment rates. Figure 13 illustrates the sharp increase in the degree of heterogeneity (measured by standard deviation) of some key economic variables after 2010. The projections for after 2014 shown in the graph suggest an easing in the degree of divergence of the flow variables (budget deficits and real GDP growth) in the medium term. By contrast only limited convergence is foreseen for stock variables, such as the level of unemployment and, in particular, the level of public debt. Even assuming that EMU economies converge towards a common path in the long run, the economic and social impact of asymmetric shocks may be large in the short run if no stabilisation mechanism is available.

Figure 13. The degree of heterogeneity inside the euro area*



* Heterogeneity is defined as the standard deviation of economic indicators inside the euro area.

Source: Authors' elaboration on IMF data, 2014.

The high degree of heterogeneity illustrated in the figure is largely the result of the absence of adequate tools to absorb asymmetric shocks. Particularly in the euro area, the introduction of the single currency and the consequent definition of a single monetary policy have greatly reduced the space for countercyclical monetary policy traditionally employed to mitigate

economic shocks. At the same time, weak public finance positions of some Member States meant that most hit crisis countries did not have either the fiscal policy tool available to stabilize the economy.

The IMF has recently quantified the economic costs imposed by the absence of common EMU instruments to counteract the adverse effects of asymmetric shocks (Fuceri and Zdzienicka, 2013). While the share of unsmoothed asymmetric fluctuations is only about 25% for the US economy and about 20% for the German economy (the two monetary unions taken as a reference for the exercise), the share of unsmoothed asymmetric fluctuations for the euro-area economy is almost 70%. This translates into large economic and social losses in the concerned Member States and the monetary union as a whole.

The recent crisis has also shown that when the functioning of EMU imposes excessive costs on individual Member States, political support is eroded. This results in tensions in the political, institutional and social spheres. If EMU membership is perceived as failing in delivering the expected results and its governing bodies are unable to solve the problems they are confronted with, the legitimacy of the entire EMU structure is undermined.

In this perspective, the natural question is whether it is possible to change the functioning of EMU so as to improve the efficiency of the response to asymmetric shocks and, as a consequence, its legitimacy. This question is pertinent also in the light of the poor performance of ex-ante coordination discussed in section 2.

Seen through that prism, this section intends to analyse changes that could improve the capacity to absorb or mitigate negative externalities given the current economic and institutional set-up of EMU.

The cornerstone of a monetary union is its single monetary policy: A single interest rate is set by the ECB taking the EMU business cycle as a reference target. Since business cycles are not fully synchronised across Member States, monetary policy setting is not adequate for all. This implies that the response to asymmetric shocks cannot come from the common monetary policy (see Box 2 for an analysis of the difficulties encountered by the ECB in setting a single monetary policy that fits all countries, or at least most of them, in recent years).

Acknowledging that a better definition of monetary policy within a monetary union would not provide an adequate response to asymmetric shocks, this section intends to analyse two, possibly complementary, avenues for increasing the output legitimacy of EMU.

The more conservative approach calls for institutional developments that aim to reduce the risk that idiosyncratic shocks turn into systemic shocks. This can be achieved through the creation of a fully-fledged banking union and more effective market-based systems of risk-sharing. A second avenue, which foresees deeper changes, considers the option of equipping EMU with additional institutions that could directly tackle the emergence of negative externalities associated with idiosyncratic shocks that could hamper the smooth functioning of the monetary union. This could be achieved by building a common fiscal capacity for EMU, namely through the establishment of a European[68] unemployment insurance scheme.

[68] Although economic reasoning would suggest that the rationale for having such an insurance scheme at the euro-area level is stronger than at the EU level, the current debate about a common unemployment benefit scheme is extended to all EU countries.

Box 2. Output legitimacy: The case of the ECB

When discussing the legitimacy of the EU, a relevant distinction can be drawn between input and output legitimacy. In the construction of the European project, output legitimacy is often advocated to offset the lack of input legitimacy and accountability of EU institutions. This issue has emerged clearly during the crisis with reference to decisions taken under crisis circumstances and more specifically in reference to the ECB.

As pointed out in Jones (2009), at least until the euro-area crisis of 2012, the ECB benefited from an economic consensus on the need for complete political/policy independence of central banks. At the same time, it suffered from the ambiguity regarding its democratic credentials: there was a clear division between those asserting that the ECB is democratically illegitimate and those claiming that its legitimacy is derived from the Member States. Before the crisis struck, however, this major issue was allowed to be put aside by the success of the euro and of the ECB in delivering price stability and thus offering advantages to citizens of the euro area.

The economic and financial crisis has represented a turning point. It has, in fact, called into question the ECB's output legitimacy due to its inability to assure price stability, and its monetary policy with possible fiscal consequences (mostly due to the use of unconventional monetary policies) has been increasingly seen as very problematic.

Setting up a single monetary policy for EMU, a currency area consisting of a rather heterogeneous group of countries,[69] was always going to be difficult. It was clear from the start of EMU that the 'one size fits all' policy of the ECB could prove to be potentially inappropriate for a number of euro-area countries. However, under the assumption that the Member States' business cycles were normally distributed along the EMU business cycle, the ECB policy would at least be approximately appropriate for most EMU Member States. The difference between the ECB's chosen stance and that which would be ideal from a national point of view would be very large only for a few outliers, hit by idiosyncratic shocks, either positive or negative.

However, the observed increased divergence among countries' business cycles during the euro crisis is likely to have resulted in 'hollowing out' the centre. As capital fled back from the periphery towards the core, it exerted a deflationary impact on the periphery and a reflationary impact on the core, with some negative output gaps widening and some closing.

One way to measure the difference of the policy stance is to compare the prediction of a standard Taylor rule applied to each Member State and to EMU as a whole. The Taylor rule is a policy guideline that generates recommendations for a central bank's interest rate response to inflation and economic activity. In its original formulation (Taylor 1993), the rule implies that the central bank policy rate should be set as a function that responds to the equilibrium real interest rate, deviations of inflation from the target rate and the output gap:

$$i_t^i = rr + \pi_t^* + 1.5(\pi_t^i - \pi_t^*) + 0.5\bar{y}_t^i$$

Where rr denotes the long-term real equilibrium rate, π is the contemporaneous inflation rate and π* is the target and $\bar{y}_t^i$ is the output gap. As the real interest rate is a long-term concept and, therefore, independent of the business cycle, it can be safely ignored for the purpose of this exercise. Moreover, if one assumes that this real long-term rate is the same across countries, its precise value does not affect the difference of business cycles across member countries or the difference in the appropriate policy rate between any one member country and the one that would be appropriate for the euro-area average, which is expected to guide ECB interest rate policy.

Against this background, in order to assess how well the rate set by the ECB fits EMU member countries, we focus on an indicator of the divergence between the policy rates appropriate for any given country and that which the ECB should set.

[69] For the purpose of this exercise, the euro area is the reference aggregate.

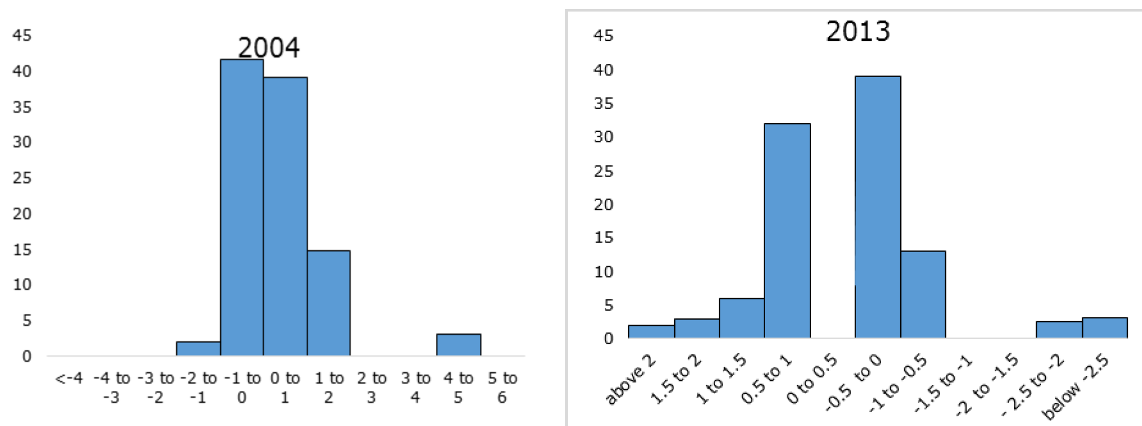
There have been many estimates of the policy rules actually followed by central banks, including the ECB, with many different variants of the economic variables (unemployment instead of the output gap, different measures of inflation, etc.). While the empirical literature has found that the round weights proposed originally (1.5 and 0.5) are almost nowhere exactly correct, the range of values is actually rather limited. Slightly different weights would not lead to materially different results.

The indicator is then defined as:

$$divergence\ indicator = 1.5(\pi_t^i - \pi_t^{EA}) + 0.5(\bar{y}_t^i - \bar{y}_t^{EA})$$

Figure 14 below shows the distribution of the differences in interest rates as prescribed by the Taylor rule for each country and the EMU on average, weighted by the share of each country in the capital of the ECB.

Figure 14. Distribution of the difference between optimal monetary policy at EMU level and national level



Source: Own elaboration, based on real-time data provided by the European Commission Services, economic forecasts.

The picture illustrates two years: 2004, which in principle should be representative of a calm year, and 2013, a more difficult year for monetary policy-setting. The main difference in the two distributions, despite the fact that neither is normal, is that while for 2004 most countries had a predicted interest rate either slightly above or slightly below that predicted for the ECB, indeed most frequencies were concentrated around 0 if one excludes Ireland (which is a clear outlier). In 2013, the distribution lost its single mode, with a hole around the zero difference.

What inferences can be drawn from this exercise? During the first years of the euro, the ECB was able to deliver in terms of price stability. Indeed, the figure for 2004 seems to suggest that the ECB's common monetary policy over that period was also appropriate for most individual countries in EMU. Since the crisis, if one excludes the most recent debate about deflation risks, it shows that the ECB has continued to deliver in terms of its price stability target, but the distribution of 'optimal policy rates' for 2013 would suggest that this has come at the cost of implementing policies that are not appropriate for any country in the Union. This implies a cost in terms of welfare, which undermines the value of the output delivered and hence the very foundation of legitimacy.

4.1 The key role of financial markets for a well-functioning EMU

When talking about shocks and how to withstand them in an efficient manner, it is important to consider the nature of the shocks, the mechanisms for risk-sharing and the implications for welfare (for a clarification of the concept of risk-sharing, see Box 3).

Financial markets play a crucial role in establishing risk-sharing mechanisms among the residents of different regions/countries exposed to idiosyncratic shocks. This role has been

clear since the start-up phase of EMU, as recognised in both the MacDougal Report (European Commission, 1977) and Delors Report (European Commission, 1989).

A well-developed financial system can indeed provide an effective mechanism of loss absorption of negative spillover effects among members of a monetary union. Asdrubali et al. (1996) find that in the United States, around 40% of shocks to per-capita gross state product is smoothed by capital markets (i.e. the cross-ownership of productive assets) and around 25% by credit markets (i.e. through lending and borrowing). Similarly, Athanasoulis and van Wincoop (2001) find that around 70% of the shocks in the United States are smoothed through private and public risk-sharing mechanisms: financial markets play the biggest role, allowing around 60% of the total smoothing, while the federal fiscal policy covers the remaining 10%. More recently, Hepp and von Hagen (2013) find that for Germany, in the pre-unification period, most of the risk-sharing was provided by the federal tax-transfer and grant system (around 50%), while for the post-unification period this effect has significantly decreased.

Box 3. Shocks, risk-sharing and consumption smoothing

The economic literature on risk-sharing (on shock/market adjustment) distinguishes between market mechanisms and fiscal mechanisms: the former are self-financing, the latter require the use of public money. Moreover, correctly identifying the nature (permanent or transitory) of the shocks to be addressed is crucial for the effectiveness of the tool to be used.

Risk-sharing relates to the idea of risk diversification in a context of different states of nature (good/bad) potentially affecting people's welfare. Accordingly, people will act to protect their welfare against the risk of a bad state emerging. Individuals can guard against such risks by buying assets with payoffs that may be uncertain but in principle are unexpectedly high when bad lack does materialise elsewhere; hence a negative correlation between the payoffs is a key feature for diversification. Car and house insurance are common examples of this type of hedging. Financial assets, like stocks, bonds and derivatives, can play a similar role. In broad terms, (market) risk-sharing requires access to international capital markets and occurs either through holding of a diversified portfolio of international assets or an explicit insurance.

Consumption-smoothing posits a consumption choice on different dates; indeed it is an inter-temporal concept according to which individuals (or countries) can maintain a steady level of consumption over time in the face of temporary shocks, which may result in fluctuations in income, which in turn, translate into fluctuations in consumption. The buffering of consumption against income shocks usually occurs through saving and borrowing in international credit markets.

If one imagines a business cycle characterised by an average output gap of ±2%, complete smoothing would allow consumption expenditure to be completely independent from the business cycle, say at 100% of average income (and output). By contrast, in the absence of a smoothing tool, consumption would vary between 98% and 102% of the average income level.

It should be specified that consumption can be smoothed (e.g. using savings or borrowing) if the shock is transitory. If a negative shock hits permanent income, consumption has to fall accordingly in a permanent fashion. Hence consumption smoothing renders consumption independent of current income, but not of permanent income. By contrast, risk-sharing makes it possible to keep consumption independent of permanent income, as it works as a hedge against possible adverse states of nature. The classical example is the one of home insurance against damages from fire. In the case of a fire destroying the house, the insurance repays its full value. Finally, while borrowing can be used as a tool to smooth consumption, it does not work as a loss absorption (if the risk materialises) mechanism, because loans have to be repaid with interest. A less classic but telling example is the European Financial Stability Facility (EFSF). The Facility was designed to provide countries under emergency with funds to avoid abrupt adjustment in consumption (or even default) but resources had (have) to be repaid, augmented by interest. So there is no hedging against losses, which remain with the borrower.

4.1.1 *The integration, disintegration and fragmentation of EMU banking systems*

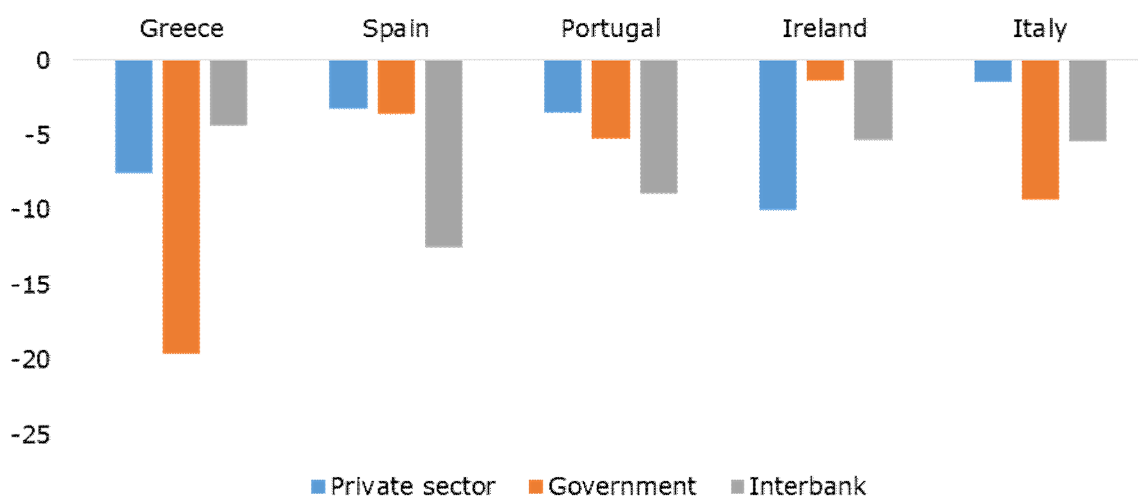
The introduction of the Euro has certainly reduced barriers to financial integration and favoured greater capital flows between countries in the monetary union (Lane and Milesi-Ferretti, 2006). The common payments infrastructure has reduced barriers to financial integration and credit flows via the wholesale interbank market have boosted financial integration. This was expected to facilitate risk-sharing among investors. Banks have been the primary financial intermediaries in the European Union and in the euro area. Most euro-area member countries' financial systems are heavily 'bank-centred' and stock and bond markets provide a relatively modest share of the financing to their private sector. Total bank assets stood at €29.5 trillion at the end of 2012, almost 300% of EMU GDP, compared to about 65% of GDP in the U.S (Fuceri and Zdzienicka, 2013).

There is no robust evidence in the literature that such financial system, dominated by banks (rather than market) and debt (instead of equity) has increased the capacity of the economy for risk-sharing.

Kalemli-Ozcan et al. (2010) and Demyank et al. (2007) find evidence that the increased cross-banking integration triggered by the euro has fostered ex-post the optimality of the currency union by improving cross-country risk sharing. By contrast, Fuceri and Zdzienicka (2013) find that "the decrease in private credit smoothing after the creation of the EMU reflects the fact that credit flows have become less counter-cyclical".

In general, contrary to initial expectations, asymmetric shocks have not been rarer since the creation of the monetary unions (see Allard et al. 2001) nor has such a high degree of banking integration and its presumed ability to improve risk-sharing worked as an effective loss-absorption mechanism.

Figure 15. Percentage change in intra-euro-area cross-border bank exposures (2010-12)



Source: Authors' elaboration on IMF data, 2014.

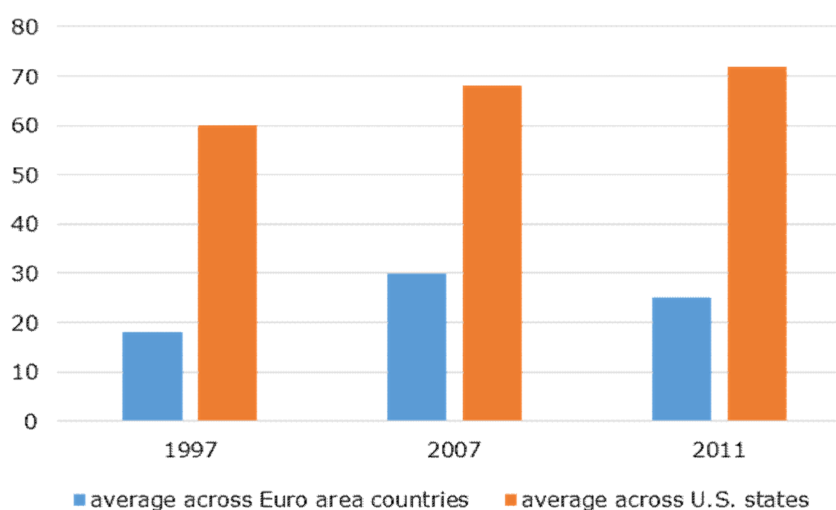
Figure 15 shows how the outbreak of the sovereign debt crisis has revealed the fragilities of market integration: cross-border exposures towards peripheral countries dramatically collapsed, as banks based in the core economies started to withdraw their funds, leading to a sudden stop of those capital flows that had fuelled the operation of EMU in previous years. This led to a subsequent disintegration of EMU financial markets: holdings of cross-border securities diminished by more than 30% after reaching an historical peak in 2008, and claims

of EMU banks versus those of other EMU countries dropped by almost €1 trillion (Valiante, 2014).

This suggests that the supposed risk-sharing benefits from financial integration were in reality very low (or even negative) during the recent crisis period. This was especially the case for peripheral economies. A lesson learnt from this is that what matters for the resilience of the system to spillover effects originated by idiosyncratic shocks is not the level of gross financial integration *per se*, but the channels through which the financial flows are allocated and the composition of these flows.

While cross-border banks' exposure has grown rapidly since 1999, the equity integration in the banking markets remains low on average at the same level as 10 years ago. Figure 16 compares the share of the domestic banking industry held by non-residents in the US and the euro area before the introduction of the euro and then before and after the peak of the crisis. The difference with the US is larger in 2011 than it was 15 years earlier.

Figure 16. Shares of domestic MFIs held by non-residents, in the US and in the euro area



Source: Authors' elaboration on IMF data, 2013.

In spite of attempts by the ECB to revitalise euro-area financial markets and restore their well-functioning by liquidity injection, the cross-border interbank flows and trust among EMU financial institutions dropped significantly relative to the period before the crisis.

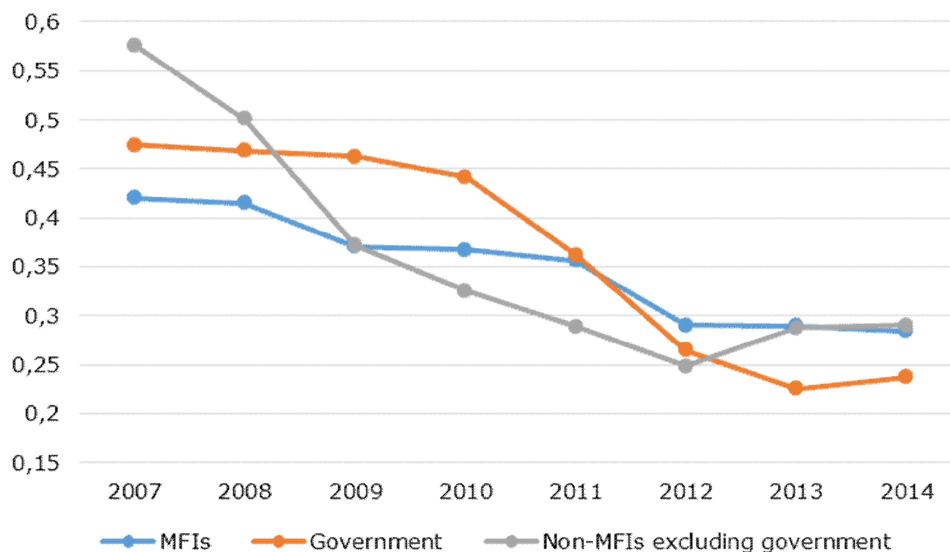
Moreover, as shown in Valiante (2014), the liquidity ring-fencing that EMU monetary and financial institutions undertook after the outbreak of the crisis further fragmented the financial system. National regulatory capital requirements, the functioning of the national resolution mechanisms as well as governance and political interference had negative effects on integration.

National supervisory authorities, for instance, may have contributed to the fragmentation of markets, by requiring banks under their jurisdiction to reduce their cross-border exposure and establish a 'buffer' of capital and liquidity at national level. Although guided by the objective of increasing stability, these prescriptions contributed to financial dis-integration within EMU.

Figure 17 provides some evidence of the increased home bias in the composition of monetary financial institutions' balance sheets, resulting from the liquidity ring-fencing. This is particularly marked in the case of banks' holdings of government debt securities: during the

period 2007-14, a drop of more than €200 billion in the holdings of foreign public debt was more than offset by an increase of roughly €500 billion in holdings of domestic government securities (Valiante, 2014).

Figure 17. MFIs holdings of non-domestic securities (other than shares) as % of total holdings by issuer (2007-14)



Source: Authors' elaboration on Valiante (2014).

The reduction in cross-border holdings of sovereign bonds and the contraction in cross-border bank loans, followed by the surge in banks' exposure to their domestic market, are the main manifestation of financial fragmentation. One consequence is that the differences in interest rates on loans applied by banks started to significantly diverge across Member States: credit became more expensive in the hardest-hit economies, especially for medium and small enterprises, which represent the main production fabric of the euro area's peripheral economies. This has certainly contributed to delaying the economic recovery, giving rise to a vicious cycle in which balance sheets of otherwise-solvent borrowers deteriorate in the absence of credit, thus reinforcing pressures on banks' balance sheets and the forces of fragmentation (Fuceri and Zdzienicka, 2013).

There is some emerging evidence since 2014 that financial fragmentation is on a declining trend. In particular, differences in the funding costs of banks are reducing, but not translating into lower cost of credit for companies. This seems to suggest that financial fragmentation is no longer the main problem; instead, differences in macroeconomic and credit risks across Member States are responsible for persistent divergences.

4.1.2 *What to expect from the European banking union?*

Behind the fragmentation of financial markets lies the sovereign debt crisis and the strong interdependence between public debt and banks. On the one hand, European banks have always been heavily exposed to sovereign debt emissions. On the other hand, guarantees – even of an implicit nature – of the national governments in favour of domestic banks have created a strong link between the dynamics of sovereign states' bonds and the cost of funding for banks in capital markets (IMF, 2012). Consequently, the heterogeneity in the conditions for credit in EMU increased as long as the conditions of the peripheral states

deteriorated, with obvious effects on the macroeconomic conditions of the peripheral countries.

Two main policy responses to increasing fragmentation have been taken in the last four years. On the one hand, the ECB undertook a large set of non-standard monetary policies to increase the liquidity in financial markets and to restore monetary policy transmission mechanisms (Alcidi et al., 2012). Among others, the Long-Term Refinancing Operations (LTROs) and the launch of the Outright Monetary Transaction (OMT) programme in 2012 have certainly helped to avoid further financial market fragmentation. Since 2013, financial stability has gradually improved, especially in the sovereign debt markets.

On the other hand, the decision to build a banking union has been specifically taken to break the banks-sovereign nexus. Two bricks have been laid so far (see Emerson and Giovannini, 2013). The first is the creation of the Single Supervisory Mechanism (SSM) under which the ECB becomes responsible for ensuring the supervision of the banking system.[70] The second brick is represented by the Single Resolution Mechanism (SRM), a single mechanism for banks' resolution with pooled resources at EU level.[71]

It would be mistaken to believe that the banking union represents the solution to the real economy problems in the euro area. But with a banking union in place, EMU financial system should become less exposed to regional instability.

To illustrate the importance of the banking union, it is useful to consider the thought experiment of how the housing bust in Ireland would have played out, had the SRM been fully in operation.[72] First of all, with the SRM operating, when the local real estate boom turned into bust and several local banks became insolvent, the government would not have been involved in the rescue and the funding required to keep banks alive would have come from the Single Resolution Fund (SRF).[73] The ECB would have flagged the banks in difficulty to the SRM. The latter would then have decided whether to allow the concerned banks to fail, to put them into resolution or to save them.

Moreover, it is likely that the ECB would have recognised the existence of the housing price boom, and would have been more likely, than a local supervisor, to warn banks about excessive real-estate valuations, thus limiting the extent of the over-lending and construction.

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[70] The ECB will have to ensure the consistent application of the Single Rulebook and directly supervise banks either with assets worth more than €30 billion, or that constitute at least 20% of their home country's GDP, or that have requested or received direct public financial assistance from the ESM.

[71] The SRM will be fully operational in 2015 and provides a Single Resolution Fund (SRF), financed by the banks. The SRF will be created gradually over the course of eight years amounting in the end to €55 million. In the transitional phase, national resolution authorities will gradually transfer to the national compartments of the SRF the contributions raised at national level. Moreover, these national compartments will be gradually involved in the mutualisation in case of large banking resolutions (60% over the first two years and 6.7% in each of the remaining six years).

[72] The reason why Ireland is an interesting example is that in that case the nexus between banks and the sovereign became deadly tight. The Irish government reached the verge of default after offering blanket guarantees to banks liabilities.

[73] The Irish government would sustain costs only if domestic banks were allowed to go insolvent and the losses were to be so large that the national deposit insurance scheme had to intervene in order to ensure that no holder of an insured retail deposit made a loss.

In principle, the potential losses of the SRF should have been lower than those incurred by the Irish government. The bail-in rules under the Bank Recovery and Resolution Directive (BRRD) mandate that public funds can be provided only if shareholders as well as creditors have accepted a loss. This did not happen in the case of Ireland. At that time the entire euro-area banking system was in difficulty and it was thought that letting any banks fail would have sparked another panic, comparable to the one that followed the collapse of Lehman Brothers in the autumn of 2008.

In case a bank is resolved, who holds the debt instruments that are bailed in is relevant. If they are preponderantly residents, i.e. local households and other local financial intermediaries, potentially important channels of local contagion are likely to exist.

In addition to the role to be played in a crisis context, the creation of a banking union is key for restoring the market risk-sharing mechanisms and removing factors that contributed to or amplified financial markets fragmentation.

Many cross-border banks (i.e. operating in more than one Member State) had to deal with different approaches and preferences of the different national supervisory authorities. National supervisors have a natural tendency to protect national champions, limiting de facto many cases of optimal cross-border mergers and acquisitions between banks.

By transferring prudential bank supervision to the ECB through the SSM, this risk is greatly reduced. Cross-border equity investment in the banking sector should now become more frequent. This constitutes a further stabilising factor as the experience of the Baltic countries has shown (see Alcidi and Gros, 2014b).

As the SRM will gradually take up its bank resolutions tasks, government interventions to save banks are expected to gradually disappear and, therefore, investors will have a sound basis on which to assess the health of a bank rather than indirectly relying on the state of health of the sovereign issuer. This should further spur financial integration, greater diversification in the composition of cross-border financial flows and contribute to breaking the nexus between banks and their sovereign.

Overall, these three factors should improve the functioning of the monetary policy transmission mechanisms. Currently, the signal of historically low policy interest rates is poorly transmitted mainly to those Member States that need it most.

4.1.3 Banking Union: Is it sufficient?

A well-functioning banking union is crucial for the smooth functioning of EMU as it will overcome the difficulty banks encounter in obtaining cross-border information on borrowers or discounting the costs of different bankruptcy laws (Bignon at al., 2013). Also, it will promote better financial integration. However, the banking union project is far from being complete, as some relevant issues are still under discussion.

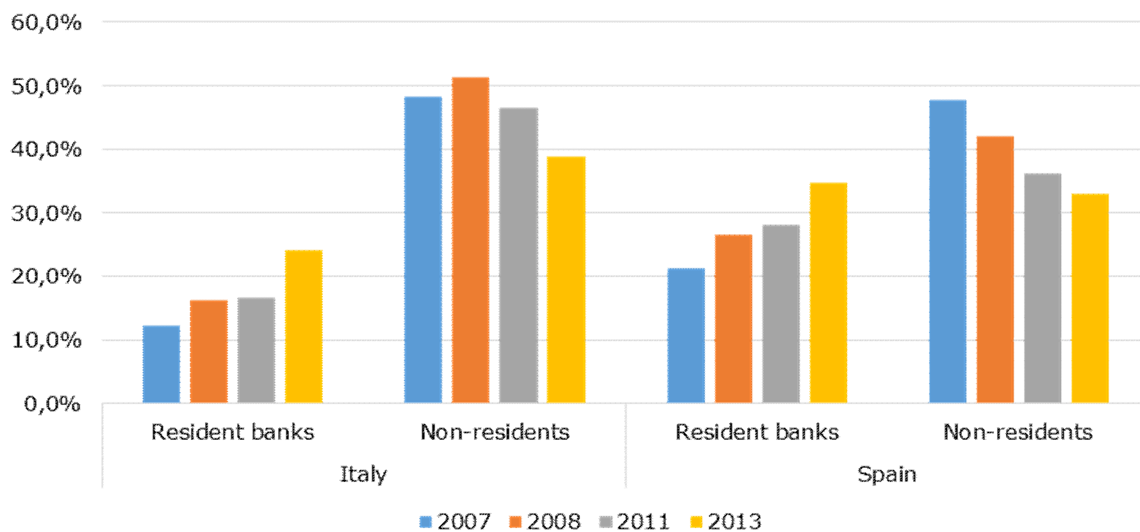
First, while progress has been made in recent years for a more efficient protection of bank deposits (raising levels of coverage up to €100,000) and the harmonisation of the rules as well as the financing requirements (the target level for ex-ante funds of the Deposit Guarantee Schemes (DGS) is 0.8% of covered deposits), further efforts are still to be carried out to ensure effectiveness of national DGSs and improvement of operating DGSs' rules in terms of speed of reimbursements, administrative simplification and funding. The drawback of this approach aiming at harmonising national DGSs rather than creating a Common European DGS is the risk that the banking union could be perceived by markets as a fragile creature, failing to eliminate the financial market fragmentation and falling short in the expectation of a return to a well-functioning monetary policy.

Secondly, it still lacks a solid central fund for the recapitalisation of banks. The current size of the SRF is relatively small compared to both the banks' assets supervised by the SSM (approximately worth of €25,000 billion) and the overall capital of the sector (about €1,000 billion). Moreover, how the SFR relates to the ESM is still unclear.

Thirdly, the potential for some local channels of contagion from banks to the sovereign remains if the SRF lets a bank fail. In this case the national DGS fund would have to bear at least part of the financial burden (provided the losses are larger than the 'bail-in-able' capital of 8% of assets). Moreover, when the losses are very large relative to the balance sheet of the bank, there might be a direct conflict of interest between the SRF and the national DGS. Indeed a high contribution by the SRF to keep the bank in question afloat would translate into a lower risk of losses for the DGS. Against this risk, the SRF might have an interest in pushing national DGSs to contribute to any rescue operation, although the latter would have no legal obligation to do so as long as the bank is not formally insolvent.

Fourthly, fragmentation along national borders is still high in the sovereign bond markets. The process of re-nationalisation of sovereign debt massively undertaken by domestic banks has even reinforced the perverse link between domestic banks and domestic sovereign debt. For example, in 2013, only 38% of Italian debt was held by foreign entities, a percentage considerably smaller than during the most acute period of the crisis. A similar consideration holds also for Spain (see Figure 18).

Figure 18. Share of government securities held by resident and non-resident banks (% of GDP)



Source: Authors' elaboration on Banco de España and Banca d'Italia data.

Finally, the availability of a solid central fund for the recapitalisation of banks in crisis is relevant also in consideration of the rising share of non-performing loans in Europe. PwC (2014) estimated that banks across Europe are still holding loan assets worth €2.4 trillion, which they regard as non-core or non-performing. Therefore, the pressure for further deleveraging in the EU banking system is unlikely to subside soon. In addition, the recent ECB stress test has shown that some large EU banks need to raise additional capital. A solid and well-functioning SRM is therefore a pre-requisite to avoid the risk of relapse and a resurgence of the financial crisis.

4.1.4 *The quality of financial integration: The importance of equity market integration*

The process of financial market integration since the creation of EMU has been strong and rapid, but also uneven across markets. While it went farther in wholesale funding markets and bond markets, it was more limited in retail deposit, loan markets and, above all, equity markets (IMF, 2012).[74]

The most prevalent form of cross-border financial market integration in EMU has been represented by government bonds, mainly intermediated by banks. This was indeed predicted by the economic theory, as the disappearance of the currency risk was expected to eliminate major discrepancies between bonds issued by EMU governments with similar credit ratings. Under the hypothesis of equal inflation rates resulting from a single monetary policy (a hypothesis that in reality did not materialise) and sound fiscal positions, guaranteed by the SGP, macroeconomic fundamentals across the economies were expected to converge as well as the risk associated with government bonds, hence creating a similar risk-free asset for all euro-area residents (Adjaouté and Danthine, 2002).

Theory also correctly predicted a limited impact on equity markets from the single currency. The first reason for this was the historically low currency component in euro-area equity returns. The second is more articulated and has to do with the impact of EMU on economic and financial convergence. On the one hand, EMU institutional architecture was expected to exert a common pressure towards convergence of key macroeconomic variables, with a consequent effect on the dispersion of firms' profits and wages. On the other hand, the higher specialisation resulting from lower barriers to trade in both goods and financial products was likely to affect the equity-risk premium and the cost of equity capital, possibly leading to more heterogeneity.

It is difficult to empirically assess the impact of the single currency on equity markets' returns, as equity returns are not directly comparable as bond yields. Cappiello et al. (2006) document an overall increase in co-movements in the EU equity markets. However, correlations for equity markets are much lower than for bond markets and the documented small increase in the co-movement in equity markets is limited to large euro-area economies only. This suggests weak integration. More recently, Bekaert et al. (2013), using a large panel data set of bilateral measures of equity market segmentation, document both a reduced equity market segmentation across member countries after joining the EU and a relatively small integration effect on equity markets resulting from the euro adoption.

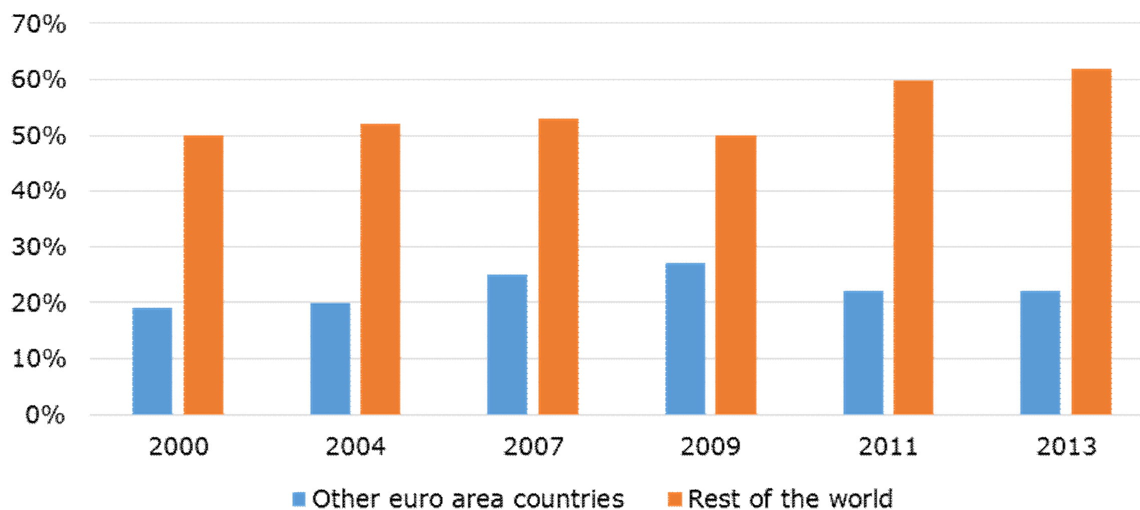
The extent to which the former influence dominates the latter largely depends on the extent to which the arbitrage opportunities of the financial integration would have been seized by market participants. The data on equity diversification in the first decade of EMU offer weak evidence of changes similar to those that occurred in the debt market since the inception of the euro.

Figure 19 shows that the percentage of euro-area investment funds' cross-border holdings of equity issued in other euro-area countries has not dramatically changed since 2000. It is also

[74] Before going further in the discussion, it is worth to remind that bonds and equities, are both financial assets, but their characteristics are very different. Bonds give the bond holder the right to be repaid and to receive interest until repayment, in exchange for providing funding to the issuer of the bond. Conversely, a shareholder owns a bundle of rights, some economic, e.g. dividends, others governance-related, i.e. voting rights.

worth noting that in this case a prominent role has been played by EMU banks: at end 2007, about 25% of equity holdings of euro-area banks were in other European countries.

Figure 19. Investment funds' holdings of equity issued in other euro-area countries and the rest of the world (% of the total)



Source: Authors' elaboration on ECB data, 2014.

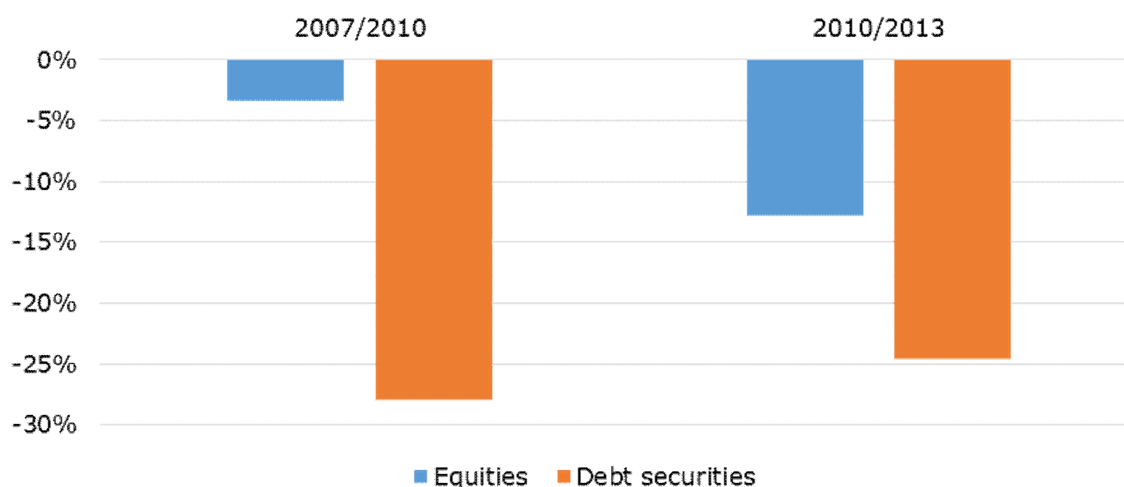
The degree of cross-border ownership of equities in the euro area is significantly lower than would be expected in a fully integrated market, in which investors spread their investments across the entire euro area to reap the benefits of diversification (ECB, 2014). This has reduced the ability of investors to achieve full diversification and hence negatively affected the capacity to smooth income and consumption.

Kose et al. (2007) find that an increase in foreign equity holdings equal to 100% of GDP with no accompanying change in debt openness would lead to a 12% decrease in the dependence of idiosyncratic (i.e. country-specific) shocks to consumption from idiosyncratic shocks to gross output. Corcoran (2008) suggests that the smoothing-out effect can be as high as 96%.

The differences between debt and equity instruments have been a specific feature of financial integration in the EU before the crisis. However, most recent data suggest that the situation is gradually changing. Since the onset of the crisis, equity-market performance has exhibited a lower degree of cross-country heterogeneity than that of bond markets. While the euro-area sovereign bond markets experienced severe tensions and a significant degree of segmentation, equity markets demonstrated a higher resilience.

Figure 20 provides evidence of the higher resilience of equity markets vis-à-vis debt markets by looking at changes in the exposure of EMU core-economies towards peripheral countries during the financial crisis. The exposure through debt securities (mainly intermediated by the banking sector) collapsed, recording a reduction of 28% during the period 2007-10 and a further retrenchment of 25% between 2010 and 2013. By contrast, the fall in the exposure through equities has been more limited, 3% between 2007 and 2010, and an additional 13% between 2010 and 2013.

Figure 20. Percentage changes in exposure of EMU core-economies towards peripheral countries



Note: Core economies: Austria, Finland, France, Germany and the Netherlands. Peripheral countries: Greece, Ireland, Italy, Portugal and Spain.
Source: Authors' elaboration on IMF data, 2014.

Therefore, as a complement to banking union, it is key to promote a more genuine and complete financial integration by increasing direct cross-border equity ownership. This would help remove the kind of integration, mostly through bank intermediation, that exacerbated the boom and bust cycles in peripheral economies.

This integration process is actually starting to take place: the observed fall in share prices and labour costs in peripheral economies are creating investment opportunities attractive for core country companies and investors. Core countries' equity exposure vis-à-vis peripheral countries increased by 5% over the period 2012-13 (i.e. after the peak of the sovereign debt crisis), whereas it fell by 3% vis-à-vis other core countries.

However, rebalancing portfolios towards equity investments requires public support and decisive legislative action. There are factors related to the specific economic and market situations in individual Member States which significantly hinder such developments.

Despite the difficulty in tackling country-specific differences, there is large room for manoeuvre in removing legal and regulatory obstacles that underpin the fragmentation of equity markets across EU jurisdictions. The ECB (2014) recognises that, in addition to the legal aspects related to the life cycle of securities, capital markets remain underdeveloped as a result of insufficiently harmonised corporate governance rules. Due to their governance features, equities are more closely linked to the legal system under which the issuer is regulated and this varies significantly across Member States due partly also to different national taxation regimes and other factors, such as different legal frameworks for crisis management and insolvency.

Important technical limitations, such as the lack of an integrated European market infrastructure, add to problems related to the legal frameworks. More than a decade ago, the Giovannini report (2001) identified 15 barriers to integration of cross-border clearing and settlement, but many of them are still there and it is still unclear when and how these issues will be addressed.

A systemic revolution, similar to that taking place in the banking sector through the banking union, would be needed in the field of capital markets. The establishment of a European Securities and Markets Authority (ESMA) has been an important step in the right direction of

a more harmonised framework in the supervisory field. But the national competent authorities still have large discretion in the enforcement in the application of supervisory standards.

By defining a more homogenous set of rules at EMU level and by establishing a central supervisor for capital markets, investors would have a better basis and rules to assess the risk of the issuer and firms would be able to more easily increase capital by issuing equity to investors across borders.

4.2 Internalising EMU externalities: Fiscal risk-sharing mechanisms

The crisis has revealed the inability, especially at EMU level, to efficiently deal with asymmetric shocks. These inefficiencies have contributed to reinvigorate, after long years of absence, the debate about the possibility of creating a common budget to deal with asymmetric shocks, similar to that adopted in the United States and in other federal states. The impact of adverse regional or state macroeconomic shocks can be absorbed or mitigated by resorting to a central fiscal mechanism. This represents a natural fiscal counterpart to monetary policy, with the latter being tasked for price stability at the aggregate level, but it does not necessarily imply fiscal union.

In the EU context, these considerations become particularly evident in an historical perspective. The first failed attempt to form a monetary union in 1970 (the Werner Plan and the European 'currency snake') was criticised retroactively on the grounds of its exclusive reliance on monetary mechanisms and the absence of an adequate common fiscal system. This is certainly not surprising if one compares the EU governance architecture with monetary unions of other developed economies. In the United States, Canada and Germany, monetary union is supported by a joint federal budget accounting for about 20-25% of GDP, with important functions of macroeconomic stabilisation and inter-regional redistribution. On average, between one-half and two-thirds of the initial macroeconomic shock is absorbed by the federal budget.

In the case of EMU, the view at the time of its creation was that a centralised fiscal institution to assure the smooth functioning of EMU would have emerged later, when the need would become evident. The current debate is therefore completely split between what would be desirable and what is in practice politically achievable in an endless discussion strongly influenced by internal tensions between debtor and creditor countries in the core and periphery.

However, some steps have been registered in this field and some changes in this direction can be partially discerned on the horizon. The lack of a common budget for the euro area became a major concern and the need for some elements of fiscal union started being recognised.

The Van Rompuy report (Van Rompuy, 2012) foresees in the third stage of reforms towards a Genuine Economic and Monetary Union (i.e. after 2014), the creation of a limited 'fiscal capacity' at the central level to strengthen the ability of EMU to withstand shocks. This 'capacity' should be used to facilitate adjustment by individual countries to asymmetric shocks and may take the form of a system of mutual insurance between Member States where the contributions and disbursements would vary according to the position of individual countries with respect to the business cycle. In the future, the resources required for the financing of this scheme may be supplemented by own resources from a common budget or by borrowing on the market.

The Communication of the European Commission for a deeper and genuine EMU (European Commission, 2012a) also considers the issue of the fiscal capacity and elaborates further on some of the elements contained in the Van Rompuy report. In the context of enhanced EMU fiscal capacity as a counter-cyclical tool, the document advocates the issuance of euro bills by a central authority and to progressively replace the bonds issued by individual countries. A European Treasury Department attached to the Commission would represent the central element of a future 'fiscal union' with the task of managing the fiscal capacity and common issues of debt securities. Most of these key elements are missing in the Van Rompuy report, which prefers a rather vague formulation, likely to avoid vetoes in the European Council. There is, however, need and urgency to clarify the content and scope of a fiscal union. The difference of stance described in the two documents and the lack of progress shows that political backing for an EMU (additional) fiscal capacity remains elusive.

The Van Rompuy Report was instrumental to spur the academic and policy debate on how to complement the monetary union with a fiscal union (see for instance Fuest and Peichl, 2012; Fuceri and Zdzienicka, 2013; Gros, 2013b; Pickford et al., 2014).

Admittedly, views on the contours of the fiscal union still differ across EMU members. There is a need to make progress on important specific elements of a fiscal union, in particular on the content and limits of debt mutualisation as well as forms of solidarity among countries.

The next section represents a first step along this path, by discussing why a common fiscal capacity would be beneficial for EMU and how it could be built in the medium run, by the creation of a supranational fiscal risk-sharing mechanism, like an unemployment insurance scheme.

4.2.1 Why does EMU need a fiscal capacity tool?

In a monetary union, the key task of monetary policy is to preserve price stability, while the main burden to stabilise the economy is left to fiscal policy. In principle, governments can achieve the goal of stabilisation using (exclusively or by mixing them properly) at least two types of fiscal policy instruments: either as inter-temporal transfers within a certain region or country or as inter-regional transfers. The choice between the two instruments, however, depends largely on the type of fiscal regime adopted at supranational level. Indeed while the first implies the adoption of national measures, the second requires the establishment of a centralised EMU budget.

So far, in the absence of a centralised fiscal policy, the Member States have responded to asymmetric shocks in an autonomous way through their fiscal balance, i.e. by increasing the deficit via the automatic stabilisers (revenues, social spending, etc.) according to the contingent needs. This solution, however, may generate (and has indeed generated, as the crisis has shown) problems related to the sustainability of the deficit, leading to a continuous increase in the debt-to-GDP ratio and, therefore, of the risk of insolvency.

In light of the above considerations (and of the experience of the crisis), the traditional theory of the optimum currency area (OCA) suggests centralising a portion of national budgets, in order to allow fiscal policies to redistribute aggregate demand through transfers between countries hit by different shocks. Temporary shocks can be stabilised through automatic transfers; conversely, permanent shocks require structural interventions that are able to affect the prices of the factors and hence their mobility.

The role of fiscal instruments was advocated already in the MacDougall report in the 1970s and Majocchi and Rey (1993) had proposed the creation of a "conjunctural convergence facility" to mitigate asymmetric shocks by a common fiscal instrument in the 1990s. Such a

system was not designed to operate automatically. It had to be triggered by a common evaluation of Member States about the effective idiosyncratic causes of the shocks.

More recently, Farhi and Werning (2013) show, using a theoretical framework, that under incomplete markets where macro-insurance markets are imperfect or non-existent (i.e. are not able to provide a full risk-sharing for certain states of the nature), a role emerges for government intervention. They prove that the establishment of contingent transfers within a fiscal union increases the overall welfare of its Member States. Indeed, an efficient insurance arrangement can be implemented through ex-post fiscal transfers or 'bailouts' that are contingent on the shocks experienced by a certain country. Moreover, the bigger (and more persistent) the asymmetric shock, the greater are the welfare gains. Interestingly, they demonstrate the beneficial role of fiscal transfers also under the hypothesis of complete financial markets, as private insurance is inefficiently low.

EMU currently lacks such an instrument of common fiscal policy. There have been some innovations in the financial rescue mechanisms devised to avoid contagion in case of sovereigns under emergency conditions, such as the EFSF and later the ESM. Nevertheless, these are instruments for crisis management which take the form of loans rather than transfers. In other words they do not work as tools for risk or burden-sharing in response to shocks. An absolute blockage over the creation of a fiscal union with a budget of a proper size for both expenditures and taxation remains.

Fuceri and Zdzienicka (2013) emphasise that the answers provided by ex-post stabilisation fiscal policies are more expensive and less efficient than ex-ante, preventive measures. The experience of the so-called bottom 'save states' is an example. To finance the EFSF first, and the ESM later, about €700 billion, equivalent to 7.5% of GDP of the euro area, had to be mobilised. To these, must be added the social and economic costs of unemployment, lack of growth and loss of human capital. Early intervention of anti-shock fiscal policies would have had a lower cost on all European economies. The IMF estimates that, had the euro-area countries pooled a share of their GDP on the order of 1.5%-2.5% to finance an insurance fund, the negative effects of the crisis could have been reduced by up to four-fifths.

Before going forward, it is important to clarify the type of fiscal capacity we are referring to. Fiscal policy is generally defined as the power to tax citizens and centralise government spending (welfare, pensions, infrastructure, education, etc.). Such a mechanism would not be applicable today in Europe. A full federal fiscal policy would require a permanent transfer of powers and resources from national governments to the European institutions. The budget constraints for national states would be even greater and spending decisions would be taken in Brussels. At the moment, there is neither consensus nor the political institutions that would be necessary for a transfer of power of this magnitude.

What EMU needs is an intermediate and realistic model. It needs fiscal capacity in the form of a shock-absorbing mechanism that reduces the economic and social costs of the convergence process. The tools that already exist, such as the European Structural Funds, cannot be considered as a true fiscal instrument for absorbing shock. Their target is territorial as they aim to help the poorer regions to adapt to the competition created by the single market. What EMU needs is a fiscal mechanism that may stabilise idiosyncratic shocks through simple transfers to those Member States most severely hit, that is, cash payments (generated by a federal tax system or by contribution of the Member States) intended to stabilise the current available income.

4.2.2 *A shock-absorbing mechanism: The case of the European unemployment insurance scheme*

Following the Van Rompuy report (2012), the debate around the concept of shock-absorbing mechanisms has significantly increased. One of the most concrete examples of such a mechanism currently under debate is the European Unemployment Insurance (EUI) scheme. The existence of a supranational unemployment scheme is indeed a common feature of many monetary unions (for the sake of comparison, Box 4 describes the current US system of unemployment insurance).

Box 4. The US system of unemployment insurance: The US federal unemployment compensation scheme

In the United States, unemployment insurance provides benefits to those workers who have lost their jobs not through their own fault. Each state has its own unemployment system, administrated under the supervision of the Federal government. To be eligible to receive benefits, workers must: i) have earned a certain minimum amount before the loss of their job; ii) must be prepared, available and able to work; and iii) must be looking to work and be able to prove their efforts to find a job.

Unemployment insurance in the US is fully financed by contributions paid by the employers, contrary to practice in most European countries. Employers pay the state two different types of contributions to the unemployment insurance scheme:

- The federal law on taxes for unemployment (Federal Unemployment Tax Act, FUTA), is responsible: i) for the administration of the programme at the federal and state level; ii) for the federal extensions related to unemployment benefits; and iii) for granting extra loans to states. The FUTA contribution rate is the same for all employers and the tax rate for employers amounts to around 6% of labour costs.
- The unemployment insurance scheme of the states (State Unemployment Tax Acts, SUTA)*, are responsible for administering the standard unemployment benefits at the state level. The contribution is mainly based on the number of employees that an employer has terminated (i.e. firms that fire more employees also pay more) and, secondly, the financial soundness of the Trust Fund unemployment insurance (Unemployment Insurance Trust Fund). The employers complying with the state contributions receive a FUTA credit, even if such credit may be reduced if the state has federal loans in arrears or if the state does not follow the rules set at federal level (see below).

Three main characteristics of the federal-state relationship in administering unemployment insurance schemes are worth noting:

- The system is administered at federal level by the US Department of Labour, which sets broad rules that state programmes must follow (categories of workers to be covered, the functioning of the Extended Benefit programmes, the maximum state unemployment tax rate to be imposed on employers).
- States can get loans from the Federal Unemployment Account if they run low on funds, but the deficit needs to be cleared in the long run.
- The system centralises part of the organisation at the federal level but still allows each state the possibility to personalise certain features and requirements.

* The rate of contribution varies across states and according to the type of firm, years of activity and other parameters. Hence no single number would fully summarise the scheme.

This is not a novelty in the academic and political debate. Already during the initial phases of the establishment of EMU, the idea of creating of such a system was discussed. Table 5 summarises the main proposals that have been brought forward since the design of EMU.

Table 5. The different proposals for a European unemployment insurance scheme

AUTHORS	KEY PARAMETERS	FUNCTIONING
STRICTLY DEFINED UNEMPLOYMENT INSURANCE SCHEMES		
Majocchi and Rey (1993)	Dependent on the evaluation of Member States to rule out idiosyncratic causes unrelated to external shocks	- Provides loans and grants to the struggling state to pay benefits or invest, in employment schemes
Italianer and Vanheukelen (1993)	National deviations in the annual change of the unemployment rate from the EMU average	- System of direct payments to the Member States, which will have the freedom to decide how to spend those funds
Mélitz and Vori (1993)	Income per capita or unemployment rate deviations compared to average sum of the deviations in the EU	- By-product of an enlarged union budget and in the context of an extended "European solidarity"
Bajo-Rubio and Diaz-Roldan (2000)	Drop in the unemployment rate, compared to the preceding 12 months	- Each country pays around 1% of tax revenues into a common budget that then redistributes these funds to the beneficiary countries - Functions on a monthly basis - In action if at least one country is experiencing a drop in its unemployment
Jara H.X et al. (2013)		- Sets a minimum standard for the Member States, which could, in severe cases of crisis, be complemented with supplements and extension - National channels for raising contributions /distributing the benefits by / to employers or employees
Delpla (2012)		- Supplement to national schemes - Financed by an annual contribution equal to 1% of GDP by each Member States and only if the European Labour Contract were adhered to - Benefit would be conferred only if the sum of national and euro-area benefits did not exceed a maximum threshold
Dullien (2007, 2012, 2013		- All employees in EMU are insured; they contribute a share of their wages up to a certain threshold, linked to each country's average income - Average insured wage is 80% of the average wage in each country - Replacement payment is 50% of the insured wage - Over the cycle, contributions to the scheme cover all pay-outs - Unemployment benefits are paid for 12 months - Unemployment insurance can build up reserves and borrow in the capital market - Possibility for each Member State to continue to offer additional national services/benefits on top of the supranational coverage
Pisani-Ferry et al. (2013)	A set base value (1.5% of GDP) plus a factor of the deviation of the individual unemployment rate from the euro area average	- Financed by a corporate income tax applied to the whole euro area - Euro area-wide applied corporate tax rate of 12.6% - Unemployment insurance scheme of about 1.8% of euro-area GDP

de Crombrugghe (2014)	n-year moving average of the actual unemployment benefit expenditure	- Funds the current unemployment expenditure of the member countries - Charges them on the basis of a backward-moving average of their past expenditure - In case of correlated shocks, temporary imbalances would require a common borrowing and lending capacity
INSURANCE SCHEMES SIMILAR TO THE UNEMPLOYMENT INSURANCE SCHEME		
Hammond and von Hagen (1995)	GDP fluctuations from the economies long-term equilibrium path	- The whole amount collected should always be distributed; - It should compensate a great part of the relevant shocks; - It should guarantee Union budget neutrality.
Enderlein et al. (2013)	Output gap as a main trigger, which could be complemented with indicators such as inflation rates and short-term (cyclical) unemployment	- Cyclical adjustment insurance fund (CAIF); - Payments would need to be calculated as part of an early autumn forecast so that national budgetary processes would still be able to factor in CSI payments; - Definition of a common rulebook for domestic stabilization.

Source: Authors' elaboration.

Although there are differences with respect to how the mechanisms work, certain elements such as the key parameters used and ways of identifying the 'asymmetry' of the shock emerge as common to all proposals.

First, the EUI scheme should act as a shock absorber to cushion mainly asymmetric shocks to the economy, and thus overcome coordination failures and individual countries' budget constraints.

Secondly, most of these systems are conceived as an insurance system and not as an automatic direct transfer of resources from one country to another. Accordingly, the funds are designed in such a way that individual countries take turns acting both as taxpayers and beneficiaries, depending on their position over the economic cycle. Therefore, from the perspective of the individual country, the net cost would be zero in the medium term, while the benefits in terms of reduction of economic shocks would be positive for all states. Other systems, instead, foresee a single tax base for all the Member States: in this case, national boundaries are not significant, as the contributors are not the states, but directly the employers/employees on which direct taxes are levied.

Despite these similarities, differences exist among the proposals. Following the work of Gros et al. (2014), it is possible to provide a synthesis of the pros and cons of the different approaches.

The most important difference among the various proposals is the indicator that triggers the insurance scheme. The EUI could either be applied following a 'business as usual' approach (i.e. to be activated whenever a worker becomes unemployed for a given number of weeks) or be activated only in exceptional circumstances (i.e. when public finances are put under stress by a larger demand for unemployment benefits). In this second case, it would need the adoption of a reference set of indicators that could capture the exceptionality of the economic shock.

Table 6 summaries the trade-offs between the two main indicators, behind the two different approaches, discussed in the literature, namely the short-term unemployment rate and the unemployment gap.

It appears that the latter indicator, despite the difficulty of setting a discretionary benchmark of what constitutes an 'emergency level' of unemployment, is better able to capture the impact of the shock. It therefore provides a solid basis for a 'catastrophic insurance' EUI model; conversely, short-term unemployment appears to be more appropriate for a 'harmonised system', as it is directly linked to the number of unemployed workers entitled to receive an income-support benefit.

Table 6. Indicators to trigger EUI, pros and cons

Indicator to trigger EUI	Pros	Cons
Short-term unemployment rate	Clear and unambiguous, fast response to shock	Higher variability across European countries
Unemployment gap	Better captures longer-term impact of the shock	Ex-post revisions, difficulty in setting up benchmark

Note: See Gros et al. (2014) for an extensive discussion of the main characteristics of the two indicators.

Source: Gros et al. (2014).

A further characteristic along which some of the proposals differ is the way through which the Member States' contributions are regulated. Some of the proposals foresee the requirement that expenditures should be balanced on an annual basis, others require a substantial balance over the cycle or a system that is able to treat a country that is in persistent deficit vis-à-vis the system. Table 7 summarises the pros and cons for three options.

The first one is an unemployment benefit scheme that is balanced annually, that is whatever is collected during the year is redistributed across countries during the same year. From the one hand, it avoids the problems related to the capacity of the EUI to borrow in case of deficit. On the other hand, it would create relevant technical and practical complications, as it would require a permanent calibration of the system on an annual basis, leading to unpredictability and uncertainty at the national level.

The second possibility is the absence of any fiscal rule governing the disbursements/payments of the EUI. It would ensure the greatest flexibility to deal with a variety and different combinations of (symmetric and asymmetric) shocks, but at the same time, it would hardly be considered politically acceptable as it would establish an open-ended commitment.

The final possibility consists of establishing a system that would be balanced, but only over the economic cycle. In other words, the fund would be able to run surpluses annually, but would need a fiscal balance over the medium term. Rebalancing could occur via an automatic increase in each country's contribution after a certain number of years of deficit, or by automatically limiting EUI transfers after a certain period of time. This system would be similar to that currently operating in the US (previously explained in Box 4), where states can borrow from the federal account if needed, or the federal system is authorised to increase the employers' contribution for that state in order to accelerate the speed of the rebalancing path. This option, even though more complex, represents a good balance between the need for a system that is counter-cyclical and the risk of redistributing towards countries with structurally higher levels and rates of unemployment.

Table 7. A fiscal framework for the EUI, pros and cons

Fiscal framework	Pros	Cons
Annual balance	Simplicity, no need to deal with borrowing capacity	Unable to respond to the frequent combination of symmetric and asymmetric shocks, consequently likely to provide the least support when most needed
No fiscal rule	Simplicity and strongly anti-cyclical, especially in sustained downturns	Open-ended commitment for Member States – difficult both politically and technically
Balanced over the economic cycle	A combination of countercyclical policy with constraints on the overall cost and contribution	Technically more complex than the other two options

Note: See Gros et al. (2014) for an extensive discussion on the main characteristics of the three possible indicators.
Source: Gros et al. (2014).

The final difference among the different proposals is the definition of common EU standards for the unemployment benefits disbursed under the EUI. Although automatic stabilisers exist in all EU countries, large differences exist, for example, in terms of generosity and coverage ratios.

To overcome this situation and to let the EUI to operate in the same way in all the Member States, two (not necessarily perfect substitutes) instruments are possible: harmonisation through the definition of common European standards for the unemployment benefits, and imposing a conditionality in the use of funds under the EUI. Table 8 summarises the pros and cons of the two approaches.

Harmonisation would appear the most natural and simple way. It could be achieved de jure, by the definition of a regulation on minimum standards for unemployment benefits, or de facto by setting up a unified European benefit system partially or completely replacing national systems. Either way, common standards would need to be agreed upon for the key dimensions of unemployment insurance: coverage rates, replacement ratios, duration and eligibility. Nevertheless, this way would present significant challenges, as the current national systems heavily differ and it would not be easy to alter national equilibria reached in the past.

With respect to conditionality, the possibility for the supranational authority to have a say on how common funds are used is an open question. If on the one hand, it would help more reluctant countries to accept the creation of a common system; on the other hand, it is not easy to define the legitimacy of a supranational authority imposing the implementation of labour market and welfare reforms.

Table 8. Standards and conditionality applicable to the EUI

Procedures	Pros	Cons
Common European unemployment benefits standards	Clarity Strong signal of Social Europe for citizens	Requires politically challenging unification Provides less scope for incorporating national preferences

Conditionality	Strong anti-cyclical impact guaranteed Higher political/social support	Alternative uses by national government might be more efficient Can create imbalances in generosity/coverage between the European system and other national parts of a benefit system

Note: See Gros et al. (2014) for an extensive discussion on the main characteristics of the two elements.

Source: Gros et al. (2014).

Finally, it is also important to stress how, from a political and social point of view, the creation of a EUI scheme could also demonstrate European cohesion in a visible and tangible way to European citizens, by introducing a mechanism for permanent/long-term solidarity across EMU and by setting common standards for unemployment supports within the euro area.

Overall, while far from the idea of full fiscal union, a common fiscal capacity with a very specific use, such as the unemployment insurance scheme, could deliver important improvements in the function of EMU and hence increase its output legitimacy. While it will continue to fuel a large debate, it is politically possible and sensible. Unemployment represents one of the key policy areas where EU action, as opposed to country-level action, can be more effective in response to spillover effects, at least under certain circumstances.

Conclusions

The democratic legitimacy of a polity, institution or policy decision refers not only to its legality but also to its acceptance by citizens and its conformity with democratic principles and common values. Executive powers transferred to the EU level to solve the euro crisis and with the objective of improving the functioning of EMU have reduced Member States' discretion in key policy areas, but they have not been accompanied by corresponding mechanisms to ensure political accountability. As a result, the democratic credentials of the economic governance of EMU have been called into question and citizens' disaffection with the EU has increased.

Legitimacy can be assessed both in its output and input dimensions. In general, output legitimacy rests on the ability to deliver results and solve problems. In the context of EMU, it rests on its ability to deal effectively with functional externalities. Conversely, input legitimacy relates to the participation of citizens, mainly but not exclusively through the election of their representatives and the capacity to hold those elected officials accountable.

Shortcomings in the output legitimacy of EMU have been exposed by the crisis and its incapacity to mitigate the adverse effects. Shortcomings in the input legitimacy of EMU governance have their origin in the initial conception of the project itself, which gave priority to the delivery of results over democracy, but these have been exacerbated by the recent changes.

The institution of a fully-fledged political union with fiscal capacity would not only help to overcome these two shortcomings, it would also reduce the system's vulnerability to citizens' disapproval. As is the case at the national level, citizens' support would then revolve around specific policies and actions rather than questioning membership and the whole structure itself.

A federal approach, however, is nowhere close on the near horizon. Nor is it at all clear that EU citizens will ever accept such a solution.

With these caveats in mind, this study has examined feasible ways to balance the technocratic and executive character of EMU by increasing its accountability and creating conditions for EMU to be able to deal with its functional externalities so as to improve both its input and output legitimacy. With this purpose in mind, the study first assesses the degree of legitimacy, both input- and output-oriented, of the current system of governance of the EMU. The changes in recent years, which have tried to manage the effect of the crisis and to overcome the limits of the previous governance structure made evident by the crisis, led to the design of a governance system focused on fixing problems through ad-hoc solutions without attempting to make it either transparent, accountable or fully legitimate.

At a minimum, the EU can coordinate and supervise the Member States' fiscal and macroeconomic policies, but it can also enforce corrective actions and subject a country to enhanced surveillance and a macroeconomic adjustment programme. The role of the EU institutions is different in each particular situation, but broadly speaking, the European Commission has played a central role in the assessment of Member States' performance, the surveillance of national policies and the establishment of corrective actions, all of which usually require the intervention in varying degrees or the approval of the Council. The role of the ECB is relevant in the case of the adjustment programmes. These decisions have an impact on the tax and spending policies of Member States and on the living standards of EU citizens, but it is very difficult for citizens to hold those responsible for adopting the

decisions accountable, given the limited role of the EP and the national parliaments in the process and the relative and diffuse responsibility of their representatives in the Council.

In terms of output legitimacy, which is assessed on the basis of the ability to reduce the risk that idiosyncratic shocks will spill over into other countries in the form of negative externalities and to mitigate such negative effects, it is far from clear that this compensates for shortcomings in the input legitimacy. There is no clear-cut evidence of an improved ability of EMU to deal with spillovers under any of the specific circumstances that could arise within the new governance system. Admittedly, this may be influenced by the fact that the crisis is not yet over and the current low economic performance inevitably weighs on the judgement of whether EMU is able to deal with the problem. Moreover, the ability of the system to reduce the likelihood of future crises, which is the main rationale of the new governance system, cannot yet be tested (assuming that this can be done).

Overall the main finding of the assessment is that EU constraints on the exercise of national discretion tend to increase with the risk of (larger) spillovers. When such risk increases, the intrusiveness of the EU increases and input legitimacy tends to weaken.

While this reflects the approach often applied by nation states, and one that is usually accepted, it raises important legitimacy problems for the EU level where the executive is not fully accountable to the general electorate. This has resulted in tensions arising between the EU institutions and between the EU and the national levels.

The second finding is that a lower input legitimacy is not necessarily offset by higher output legitimacy. The expectation that stricter intrusion should lead to better capacity to deal with externalities is not yet supported by robust evidence.

The third finding is that a rule-based system and the attempt to de-politicise EU decisions suffer from serious limitations. When a country moves into conditions of stress and crisis, as the rule-based system is failing in achieving its objective to prevent externalities from happening, decisions of a political nature become inevitable. For those decisions, due accountability must be ensured.

The study then explored the possibility for improvements in economic governance of EMU, concluding that changes are required on two levels – institutional and economic. The input-oriented legitimacy of EMU can be improved by strengthening the involvement of the EP in the European Semester and in the scrutiny of the macroeconomic adjustment programmes, as well as by improving parliamentary oversight of the European Council and the Eurogroup and, where appropriate, the ECB. In order to do so, the EP needs to be endowed with the necessary resources and to undergo an upgrade in its organisational structures. The creation of a subcommittee of the Economic and Monetary Affairs Committee for the parliamentary oversight of EMU decisions would contribute to this purpose and allow for a more effective format of inter-parliamentary cooperation with (and among) the national parliaments of the euro-area countries.

The other kind of changes relate to economic mechanisms that could improve the functioning of EMU by increasing its ability to either reduce the emergence of negative externalities or mitigate their impact. For this purpose, financial integration matters as a tool of market risk-sharing and a fiscal capacity for EMU matters as a tool of fiscal risk-sharing.

Well-functioning market-sharing mechanisms (which do not require pooling public money) should be complemented by common fiscal instruments to absorb and mitigate the effects of negative externalities emerging from shocks. A common EMU insurance against idiosyncratic shocks can represent the starting point for more complex policy instruments, as found in other successful monetary unions.

Such mechanisms, both market-based and fiscal, can contribute to reduce the risk that negative externalities will trigger large crises that pose serious risk to the output-oriented legitimacy of EMU as a whole. This aspect is particularly relevant in the absence of a political (and fiscal) union, but not only in that context. All accomplished federations usually have both kinds of mechanisms in place.

Overall, the study suggests that, however unlikely it is that political union will emerge in the near future, specific aspects of EMU legitimacy can be improved. While this may not represent the optimal solution from a legitimacy point of view, it will help to make economic governance in EMU more democratic and effective, and thereby help to regain citizens' support, which remains the key pre-condition for a successful monetary union and for more dramatic changes envisaged at institutional level.

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