21-11-2013

Annotated Agenda of the Sherpa meeting

Main features of Contractual Arrangements and Associated Solidarity Mechanisms

At their meeting on 26 November the Sherpas are invited to discuss:

- **General principles for contractual arrangements**
- **General principles for solidarity mechanisms to support contractual arrangements**

This paper sets out the background to these principles, explains how they can be developed within the existing process of the European Semester and should be used to guide discussion on a number of issues to be clarified in order to prepare draft conclusions for the December European Council.

1. Towards an integrated economic policy framework for growth and jobs

In a monetary union, an integrated economic policy framework is necessary to guide the policies of the Member States towards strong and sustainable economic growth and employment and to prevent excessive economic divergences among EMU members. The case for an integrated economic policy framework was set out in the December 2012 report "Towards a genuine economic and monetary union" and the Commission's communication "A Blueprint for a deep and genuine EMU - Launching a European Debate".

Over the past three years, the EU governance framework has been reinforced inter alia through improvements to the Stability and Growth Pact, the creation of a new Macroeconomic Imbalances Procedure (6-pack and 2-pack), and the Treaty on Stability, Coordination and Governance (TSCG). The European semester brings the different elements of economic governance together into a coherent process (see annex I).

The October European Council recognised the need to strengthen even further the coordination of economic policies, notably by increasing the level of commitment, ownership and implementation of economic policies and reforms in the euro area. The objective is to agree on the main features of contractual arrangements and of associated solidarity mechanisms at the December European Council.

The EU governance framework already includes a number of instruments that are comparable to contractual arrangements:

- Countries under financial assistance prepare a Macroeconomic Adjustment Programme[1].
- Countries for which an excessive imbalance procedure[2] is opened submit a Corrective Action Plan.
- While somewhat different in nature from those above, an Economic Partnership Programme has to be presented by Member States under an excessive deficit procedure[3].

But it is important **to reinforce economic policy coordination well before Member States face severe economic difficulties**. In this respect, contractual arrangements would represent an additional policy commitment in particular for the Member States not in the corrective arms of the Macroeconomic Imbalances Procedure, or under a macroeconomic adjustment programme. The consistency between the different instruments of policy coordination, including the Economic Partnership Programmes describing the policy measures and structural reforms of countries under an excessive deficit procedure, will need to be carefully analysed when designing the future contractual arrangements.

2. General principles for contractual arrangements

The objective of contractual arrangements is to enhance ownership and effectiveness of economic policy coordination. **Contractual arrangements would therefore build on, and be embedded in, the existing EU procedures for the surveillance of budgetary and economic policies in the context of the European Semester.** To meet the dual objective of ownership and effectiveness, mutually agreed contracts would need to rest on the following guiding principles:

Enhancing ownership and accountability

To ensure successful implementation of economic policies and reforms towards competitiveness, growth and jobs, mutually agreed contracts would require a high level of national ownership. This could be achieved in three ways:

(i) The economic policy measures included in the contracts should be "home grown". In practice, this means that the **Member States are those primarily responsible for designing and implementing their economic policy and reform measures within the policy coordination framework set out by the European Semester.** The European Commission would support this process through a continuous dialogue with Member States and through the negotiation of the contractual arrangements. Such dialogue should take place not only at technical level, but also

[1] Regulation (EU) 472/2013 of the European Parliament and the Council of 21 May 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).

[2] Regulation (EU) 1176/2011 of the European Parliament and the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances.

[3] Article 9 of the EU REGULATION (EU) No 473/2013 on "Common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

involve the political levels, both in the Member States and in the Commission. The contractual arrangements should be approved by the Council.

(ii) **The process of preparation of the contractual arrangements should respect the internal institutional and constitutional arrangements of Member States.** It should involve national parliaments, social partners and all other relevant stakeholders, as appropriate. The specific form of such involvement should be left to each Member State to decide according to their own laws and national traditions. Ideally, national parliaments should be consulted before the contractual arrangements are formalized with the Commission.

(iii) **National ownership in democracies presupposes that a renegotiation of the contractual arrangement in light of changing political circumstances would always be possible**. In addition, the Commission, as an institution accountable to the European Parliament, would report on its role in the preparation and monitoring of contractual arrangements to the European Parliament.

Binding nature of contractual arrangements

Such arrangements **could take the form of a politically binding commitment between the Member States, the Council and the Commission. If a contractual arrangement were to be accompanied with financial support, the associated financial support agreement would need to have a legal nature.**

Selectivity--focus on key obstacles to competitiveness, growth and jobs

While contractual arrangements could in principle cover a broad range of policies supporting competitiveness, growth and jobs (e.g. training, research, labour market, pension systems, business environment, public sector efficiency), **they should remain focused on a limited number of key microeconomic, sectoral or institutional weaknesses.** They would need to be tailor-made to the specific needs of each Member State, **and primarily concern areas where there are significant impediments to growth and jobs, and to the smooth functioning of EMU.**

Regular monitoring and conditional support

Strong national ownership and commitment are the central factors for the successful implementation of any economic policy measure. But regular monitoring helps ensure compliance. In practice, this means that contractual arrangements **should be specific enough and include mutually agreed benchmarks and milestones (e.g. submit a law to parliament; adopt a specific regulation, etc.). These milestones should be regularly monitored by the Commission.** In those cases where contractual arrangements are accompanied with financial support, **disbursements would be made conditional on performance.**

Applicable to all euro area Member States and fully compatible with the single market

Contractual arrangements should **involve all euro area Member States, but be voluntary for the others.** In addition, any measure undertaken in the context of a contractual arrangement should be fully compatible with the Single Market in all aspects.

Operational considerations and timeline

In concrete terms, contractual arrangements could be set up and included in the existing procedures as follows:

- **The National Reform Programme**, submitted in April by each Member State in the context of the European Semester, **could be the starting point** for the preparation of contractual arrangements. The countries under an excessive imbalances procedure or a macroeconomic adjustment programme would not prepare a separate contractual arrangement.
- On this basis, an intense dialogue would start with the Commission services, first at the expert level and then at the political level (commissioner(s) and minister(s) concerned). In the meantime, the Commission would have conducted in-depth reviews (published in March) for those Member States identified in the Alert Mechanism Report (published in November of the previous year alongside the Annual Growth Survey). In this dialogue, the Member State and the Commission would seek to agree on the key objectives which could be reflected in the country-specific recommendations.
- The preparation process of the contractual arrangements would intensify after the adoption of country-specific recommendations by the Council (in June/July), with the objective of concluding an agreement during the 'National Semester' and at the latest before the publication of the subsequent Annual Growth Survey in November.
- The contractual arrangement would be the outcome of a dialogue and fully reflect national priorities in the framework of the European semester. **It could cover one or several of the reforms proposed in the National Reform Programme and the country-specific recommendations. It would be specific and time bound. It could cover one year or several years.**
- In case of no agreement between the Member State and the Commission, there would be no contractual arrangement. In case of agreement, the contractual arrangement would be approved by the Council.
- **The contractual arrangements could involve financial support in full respect of Article 125 TFEU. This would depend on the specific situation of each Member State.** The nature (e.g., grants, loans and guarantees) and the size of the financial support would be decided on a case-by-case basis within the framework of an overall solidarity mechanism to be agreed.
- **Disbursements could take place in tranches conditional on performance.**

3. General principles for solidarity mechanisms

Economic policy reforms towards competitiveness, growth and jobs are in the interest of Member States, individually and collectively. They bring long-term gains, but often these gains are hard to measure and frequently only accrue in the medium term, most of the time beyond the usual electoral cycle. Moreover, they are typically resisted by vested interests who capture economic rents, rents they would lose after the reform. Reforms are thus associated with short-term economic and political costs and the provision of financial support may help overcome them.

The concept of providing financial support for the implementation of economic reforms is not new and should not be associated only with macroeconomic assistance programmes. The possibility of financial incentives within the Economic Partnership Programmes has been included in the Two-Pack[4]: "*Where appropriate, potential financial resources shall be identified, including credit lines of the European Investment Bank and other relevant financial instruments, as appropriate.*" (see Annex II).

European support through grants

In its March 2013 communication[5] the Commission suggested that the solidarity mechanism would be included in the EU budget as external assigned revenues, and be financed either by dedicated contributions (e.g., GNI key) or by new own financial resources dedicated to it.

European support through loans

The background of tight budgetary resources calls for further reflections on the financing and the nature of the solidarity instrument. This brings forth the question whether to apply the full range of possible forms of financial support (e.g., grants, loans and guarantees) from the outset, or instead to start with long-term loans. The forms of support and means available could grow over time and come to constitute a financing capacity for the euro area, as suggested in the report "Towards a Genuine Economic and Monetary Union" and the Commission's Blueprint[6]. While a combination of grants and loans is also a possibility, loans have three main characteristics:

- Loans are well suited to the fact that reforms tend to generate lasting benefits while implying transition costs.

[5] Communication from the Commission to the European Parliament and the Council 'Towards a Deep and Genuine Economic and Monetary Union - The Introduction of a Convergence and Competitiveness Instrument' COM(2013) 165 final

[6] COM (2012) 177

- In general, loans are incentives-compatible and would contribute to strengthening ownership of economic policy reforms. Adjustment efforts would be financed by the Member State itself, albeit with European incentives through access to financing at more favourable rates.
- Loans would imply only limited fiscal transfers across countries. Indeed, the transfer element would be limited to a lower interest rate than the market rate of most beneficiary Member States, capturing the positive externality of the reforms for the EU as a whole.

Compliance and financial incentives

Financial support often raises concerns about moral hazard. Reforms must not be delayed in expectation of financial support at a later stage. To allay such concerns, conditionality and monitoring based on observable milestones are essential. Financial support could be conditional on the implementation of a set of mutually agreed specific benchmarks. Financial assistance could be disbursed in tranches or, in the case of a loan, the interest rate subsidy could be paid out at the end of the implementation phase. While contractual arrangements would generally take the form of a political commitment between the Member States and the EU institutions, a financial support agreement would have a legally binding nature. Lack of implementation could therefore have various consequences, such as a suspension of financial support, or in the case of a loan even early repayment in cases of serious breaches of the loan agreement associated with the contractual arrangement.

The specific amount of financing would not be linked to the direct cost of reforms, which generally is difficult to measure. Financial support should be conceived as an incentive or as general support to the overall economy rather than as a compensation for the specific cost of reforms as such[7], as well as a broader signal of European support to the economic reform agenda of each Member State.

All participating Member States should in principle be able to access the financial incentives under the solidarity mechanism. Such symmetry would contribute to facilitating equal treatment and rigor in the elaboration and monitoring of the contracts.

[7] "Using financial support to encourage policy reforms: lessons from World Bank experience"; World Bank Oct. 2013

ANNEX I
The European Semester

The European Semester is the process within which the EU co-ordinates economic policy. This allows Member States time to plan economic policy measures and reforms towards growth and jobs and to interact with the Commission and each other before and after country specific recommendations are adopted. The annual cycle can be broadly described as follows:

- November (of year X -1) – Commission adopts the Annual Growth Survey (AGS) which launches the European Semester of the following year and the Alert Mechanism Report
- December – European Council establishes a shared analysis of the economic situation
- January – Commission bilaterals with Member States on implementation of country specific recommendations
- March – European Council fixes broad policy guidance based on the AGS
- March – Commission publishes In Depth reviews. Commission bilaterals with Member States.
- Mid April/end April – Member States submit National Reform Programmes and Stability or Convergence Programmes
- May – Commission publishes country specific recommendations
- June – European Council endorses country specific recommendations
- July – Council adopts country specific recommendations.
- October – Commission bilaterals with Member States on implementation of country specific recommendations
- 15 October – Euro area Member States submit their draft national budgets
- November – Commission issues opinions on the draft national budgets

The work of the Semester is built upon extensive analysis of a range of indicators[8]. The Commission uses a broad set of economic indicators for the purposes of strengthening surveillance of Member States' economies. It puts a particular emphasis on early warning indicators to detect macroeconomic imbalances in the real economy such as public and private debt, competitiveness (both price and external), unemployment, housing bubbles and the growth of financial sector liabilities. The Commission's analysis is constantly updated with information from Member States, international organisations such as the IMF, OECD as well as national and regional bodies.

[8] See Commission non paper on indicators of July 2013

ANNEX II

Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances

Corrective action plan

1. Any Member State for which an excessive imbalance procedure is opened shall submit a corrective action plan to the Council and the Commission based on, and within a deadline to be defined in, the Council's recommendation referred to in Article 7(2). The corrective action plan shall set out the specific policy actions the Member State concerned has implemented or intends to implement and shall include a timetable for those actions. The corrective action plan shall take into account the economic and social impact of the policy actions and shall be consistent with the broad economic policy guidelines and the employment guidelines.

2. The Council, on the basis of a Commission report, shall assess the corrective action plan within 2 months of submission of that plan. If, upon a Commission recommendation, the Council considers the corrective action plan sufficient, it shall endorse the plan by way of a recommendation listing the specific actions required and the deadlines for taking them, and shall establish a timetable for surveillance, paying due attention to the transmission channels and recognising that there may be long lags between the adoption of the corrective action and the actual resolution of imbalances.

3. If, upon a Commission recommendation, the Council considers the actions or the timetable envisaged in the corrective action plan insufficient, it shall adopt a recommendation addressed to the Member State to submit, within 2 months as a rule, a new corrective action plan. The Council shall examine the new corrective action plan in accordance with the procedure laid down in this Article.

4. The corrective action plan, the Commission report and the Council recommendation referred to in paragraphs 2 and 3 shall be made public.

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

Article 5

1. A Contracting Party that is subject to an excessive deficit procedure under the Treaties on which the European Union is founded shall put in place a budgetary and economic partnership programme including a detailed description of the structural reforms which must be put in place and implemented to ensure an effective and durable correction of its excessive deficit. The content and format of such programmes shall be defined in European Union law. Their submission to the Council of the European Union and to the European Commission for endorsement and their monitoring will take place within the context of the existing surveillance procedures under the Stability and Growth Pact.

2. The implementation of the budgetary and economic partnership programme, and the yearly budgetary plans consistent with it, will be monitored by the Council of the European Union and by the European Commission

Two Pack: Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area

Economic Partnership Programmes

1. If the Council, acting under Article 126(6) TFEU, decides that an excessive deficit exists in a Member State, the Member State concerned shall present to the Commission and to the Council an economic partnership programme describing the policy measures and structural reforms that are needed to ensure an effective and lasting correction of the excessive deficit, as a development of its national reform programme and its stability programme, and fully taking into account the Council recommendations on the implementation of the integrated guidelines for the economic and employment policies of the Member State concerned.

2. The economic partnership programme shall identify and select a number of specific priorities aiming to enhance competitiveness and long-term sustainable growth and addressing structural weaknesses in the Member State concerned. Those priorities shall be consistent with the Union's strategy for growth and jobs. Where appropriate, potential financial resources shall be identified, including credit lines of the European Investment Bank and other relevant financial instruments, as appropriate.

3. The economic partnership programme shall be presented at the same time as the report provided for in Article 3(4a) of Regulation (EC) No 1467/97.

4. A corrective action plan as referred to in Article 8(1) of Regulation (EU) No 1176/2011 may be amended in accordance with Article 9(4) of that Regulation to replace the economic partnership programme provided for in this Article. Where such a corrective action plan is submitted after the adoption of an economic partnership programme, the measures set out in the economic partnership programme may, as appropriate, be included in the corrective action plan.

5. The implementation of the programme, and the annual budgetary plans consistent with it, shall be monitored by the Council and by the Commission.